

Annuitants: Uses and Abuses

January 2005

Exploring the pro's and con's of Annuitants

Usually, our January edition of *Fiscal Fitness* is a financial checklist. We decided against writing that again this year for two reasons: 1) the proliferation of such financial articles and 2) we didn't really have much to add to last year's edition. For reference, visit the January 2004 Fiscal Fitness on our website: www.houlihan.biz.

Instead, for whatever reason, we have been inundated lately with questions regarding fixed and variable annuities. As loyal stewards of our clients'/friends' best financial interests, we will address this vexing product by defining the basic types of annuities and their characteristics. We will also share some potential uses and shameful abuses.

An annuity is an investment product sold (primarily) by insurance companies. It is a contractual relationship that has two basic properties: Immediate or deferred payout and whether the investment is fixed or variable. First, some definitions:

- 📖 **Immediate payout** occurs when the initial investment (or series of investments) is deposited and the insurance company commences payout for the "annuitant" (the recipient). This payment can be a certain period of years or for the rest of the annuitant's life (termed annuitization).
- 📖 **Deferred payouts** are more common. After the initial investment is deposited, the annuitant delays receipt of the funds until a future date – usually retirement. Payout options can be customized for the annuitant's needs.
- 📖 'Fixed' rate annuities describe the underlying investment of the funds. They are invested in safe, low interest bearing assets. Usually the yield is slightly more than CD's and money market rates.
- 📖 'Variable' rate annuities are similar to mutual funds. The annuity owner is given an investment menu of "sub accounts" to choose from. The investment options can range from money markets, bond funds to more aggressive stock funds. The risk of the investments is transferred from the insurance company to the annuity owner.

Next, let's examine the main characteristics of all annuities:

- 🔑 **Tax deferral** – Annuities are afforded special treatment under the tax code to allow deferral of federal/state income taxes on income and gains generated until the money is withdrawn. This is their main selling point.
- 🔑 **Death benefit** – If you die before the insurance company has started making payments to you, your beneficiary is guaranteed to receive a specified amount – typically at least the amount of your initial purchase. This can be comforting but is more likely irrelevant.
- 🔑 **Surrender charges** – If the annuity owner withdraws money from a variable or fixed annuity before a certain contractual time period (usually 5-8 years), the insurance company will assess a surrender charge. This surrender charge is a percentage of the withdrawn amount and declines gradually over the terms of the contract. This surrender charge is assessed to recover the front end selling costs. However, contracts will often allow the owner to withdraw 10-15% of the contract's value annually without charge.
- 🔑 **Expenses and charges** – Layered annual expenses that can add up to about 2%-4% annually. Expenses matter – a lot.
- 🔑 **IRS penalty**- This is the price for tax deferral – if monies are withdrawn before age 59 ½, a 10% penalty will be levied on the amount withdrawn, subject to limited exceptions.

Uses and Abuses

Annuities, unfortunately, are often an oversold product driven by high sales commissions. They are inappropriate for IRA's or 401k's – it's akin to putting tax-deferred products inside an already tax deferred account. Generally, annuities may be beneficial when all IRA and other retirement contributions have been maximized – and then only carefully and when high marginal tax rates are a concern. Vanguard and T Rowe Price have recently developed fixed and variable annuities that offer improved investment options with lower annual expenses than traditional insurance companies. And, they are no-load (no commission) products. Fixed annuities may make sense if you wish to generate steady monthly income and are concerned about preservation of principal. Variable annuities, on the other hand, rarely benefit the investor due to high expenses and mediocre fund performance.

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