Chapter 1

Making Sense of Annuities

In This Chapter

- Introducing annuities: The big picture
- Deciding whether an annuity is right for you
- Checking out the nitty-gritty of annuities

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Many people confidently walk the financial high wire of life without a safety net. Others, especially those who are approaching retirement, feel more secure when a net is there to catch them — just in case the tightrope snaps.

If you prefer a financial safety net and you're willing to pay for one, then consider an annuity. Put simply, annuities are investments with money-back guarantees. Imagine a typical investment in stocks or bonds; then imagine that same investment with a guarantee that you'll get your money back with interest after (or over) a certain time period. That's an annuity.

Of course, annuities aren't quite that simple. Most annuity brochures and prospectuses contain enough disclaimers, footnotes, and contingencies to keep a dozen lawyers busy. But it's useful, at least at first, to ignore the complexities of annuities and take a high-level snapshot of what they are and how they work.

To resume the circus metaphor, an annuity is both a tightrope and safety net; it's an investment and insurance against the loss of that investment. Annuities aren't always as exciting as the investment alone (like a tightrope walker without a net), but they're not as risky. If you're in or near retirement, you might find such a trade-off appealing.

In this chapter, I give you the basics by explaining what annuities are, what they do, how they work, who should buy them, and so on. In the interest of full disclosure, I also share my own opinions about annuities, because my opinions inevitably shape this book.

Annuities: Older Than You (Probably) Think They Are

Because people don't know how long they'll live, they don't know how much money they'll need to support themselves for the rest of their lives. The history of annuities is the search for a solution to that problem.

Annuities have existed for at least 1,800 years. In ancient Rome, contracts called *annua* promised a stream of payments for a fixed number of years or for life in return for an up-front payment. Speculators who sold insurance for Mediterranean shipping ventures sometimes offered these insurance contracts to the public.

Wealthy Romans often willed their heirs or friends an income for life. Because tax collectors needed to know how much that income would cost the benefactor's estate, they also needed to know how long those heirs or friends were likely to live. In AD 225, a Roman judge named Ulpanius produced the first known mortality tables. By his reckoning, a 30-year-old Roman man would live until age 60, on average. Any man over age 30, he concluded, had an average life expectancy of 60 years minus his current age.

William Shakespeare is said to have invested a large part of his wealth near the end of his career in an "annuity-like arrangement." In pre-Renaissance Europe, both the Church and assorted annuity dealers sold life annuities to raise funds. As early as 1540, the Dutch government sold annuities to finance wars and public works, just as modern governments sell bonds.

In the 1600s, special annuity pools called *tontines* operated in France. In return for an up-front payment, purchasers of tontines received a lifetime income. As purchasers died over time, their income was divided among the survivors. The last purchaser to die collected the remaining money. Tontines were eventually banned — partly because they gave the last two or three survivors a motive to kill each other!

Edmund Halley, the famous astronomer, used the birth and death records of an isolated German town to create the first modern set of mortality tables. He surmised that if the town had 600 30-year-olds but only 300 57-year-olds, a 30-year-old's average life expectancy must be 27 years. He published his tables in 1693, but they weren't widely used for another century.

The first record of annuities in the United States is from 1759, when the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers was chartered in Pennsylvania. In 1812, the Pennsylvania Company for Insurance on Lives and Granting Annuities was founded.

After the stock market crash of 1929, many people turned to guaranteed annuities as a safer place to put their retirement savings. The modern era of annuities began in 1952, when TIAA-CREF (the educators' retirement fund) offered the first group variable deferred annuity — a precursor of other employer-sponsored retirement savings plans.

Individual annuities (which are purchased by individuals from insurance companies) flourished after the tax reforms of 1986, when deferred annuities became the only remaining financial product that allowed people to save and invest unlimited amounts on a tax-deferred basis. As of 2007, Americans have saved more than $1 trillion in annuities, along with the trillions they hold in employer-sponsored retirement plans and other accounts.

Today, many economists and finance professors (not to mention life insurance companies) hope that the baby boomer generation, whose oldest members are just beginning to retire, will rediscover the original purpose of annuities and use them to turn their 401(k) accounts and IRAs into guaranteed lifetime income.

Should You Get an Annuity?

So, should you get an annuity? This is a not a simple question. The only sensible answer is that certain annuities are right for certain people. If you recognize yourself in any of the following categories, then you should definitely explore annuities further:

- **People in high tax brackets** often like deferred annuities because they can contribute virtually any amount of money to the plan and still defer taxes on the gains for as long as they like.
- **Middle-class couples in their 50s who are earning $100,000 or less and have a savings of $250,000 or more but no pension** should like income annuities. They have a 50-percent chance that one of them will live to age 90.
- **Financial advisers** sometimes put their wealthy clients' money in variable annuity subaccounts (mutual funds) instead of conventional (taxable) mutual fund accounts so that they can defer taxes on any gains they realize when buying and selling fund shares.
- **Pessimists** — otherwise known as *Cassandras, doomsayers,* and *bears* — who believe that the gigantic, highly leveraged house of cards (the United States' financial system) may collapse at any time, should like the guarantees that annuities provide.
- **Women** are much more likely to need annuities than men. It's true. Women live significantly longer and are therefore at greater risk of running out of savings.

> Single or widowed women are more likely to be poor in old age than single or widowed men. Many people expect that, in the future, as birth rates in developed countries (the United States, Japan, and much of Europe) fall, and the number of elderly citizens rises, a retirement financing crisis will occur. Women will probably bear the brunt of that crisis.

For more on this topic, see Chapter 5.

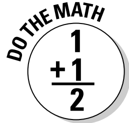
Raising Your Awareness

As I mention earlier in this chapter, I hope this book raises your awareness of annuities and makes you a reasonably savvy consumer of these complicated but useful financial tools. And although I try not to prejudice you for or against them, I do share my point of view, make judgments, and draw conclusions.

So, as you read, don't be surprised when you hear elements of my credo more than once:

- **Costs matter.** John C. Bogle, the founder of The Vanguard Group and the best friend an individual investor can have, has said it loudest, "Costs matter." Don't expect annuities to be cheap; guarantees are expensive. But be vigilant about the annual costs, fees, and expense ratios you'll pay, particularly if you buy a deferred variable annuity. See Chapter 8 for more information.
- **Don't invest in a contract you can't understand.** Many annuities are highly (and sometimes necessarily) complex. They may have moving parts that can change your costs from year to year, and they often function in counterintuitive ways. Many annuity prospectuses defy comprehension entirely. If one contract makes no sense to you, investigate another.
- **The survivorship credit is the core strength of annuities.** Income or immediate annuities distribute the assets of deceased contract owners to the remaining owners, thus enhancing the income of all surviving contract owners. This often-neglected feature makes an annuity an annuity, and some experts think it should get more attention.
- **Creative combinations of annuities should be explored.** The question is not, "Should I buy an annuity?" The question is, "Is there an annuity or a combination of two or three annuities that can give me the financial security I need in retirement?" A creative mixture of deferred and immediate annuities can often do the trick. For tips on how to work this magic, see Chapter 15.

- **The best annuities are yet to come.** Many of today's annuities are prototypes of better annuities to come. As more baby boomers retire and recognize that they need guaranteed lifetime income, they'll demand cheaper, more attractive annuities. For more information on new types of annuities that are just around the bend, see Chapter 15.



Mortality pooling (see the sidebar "Survivorship credits — the unique aspect of annuities" later in this chapter) allows all annuity owners not only to receive lifelong income but also to maximize the amount of income they receive from a fixed amount of money while living. For instance:

  - If a 65-year-old man retires with $300,000 and wants it to last at least as long as he lives, research shows that he can safely withdraw about 5 percent a year ($15,000) from age 65 until around age 90.
  - If the same man buys a single life annuity with $300,000 at age 65, he can receive more than $25,000 a year for life, no matter how long he lives. To protect his beneficiaries, he can buy an option that guarantees payments for a certain number of years or until he dies, whichever is longer.

Annuities guarantee a pension-like income for life better than any other financial product. There is no more efficient tool for converting a specific sum of money into a monthly income that lasts as long you live — even if you're still kicking at 105.

So why don't more people buy annuities when they retire? There are lots of reasons, which I describe at length in Chapter 4. But it's likely that more people will buy annuities in the future. People are living longer and saving less. Fewer employers provide pensions. Social Security benefits may be trimmed back. Millions of people will replace their lost pensions and benefits with annuities.

Seeing How Annuities Work

Annuities are intended to help you save for retirement and supplement your retirement income. To encourage this practice, Uncle Sam lets you defer taxes on the growth of your annuity. And to discourage you from spending your annuity assets before retirement, the IRS penalizes you for any withdrawals from annuities and other tax-deferred investments before you reach age 59½.

Various types of annuities can make your retirement more secure by helping you:

- **Save for retirement.** Before you retire, fixed deferred annuities (including CD-type annuities, market value-adjusted fixed annuities, and indexed annuities) allow you to earn a specific or adjustable rate of interest on your money for a specific number of years, tax-deferred. They're also a safe place to park money during retirement. See Chapter 6.
- **Invest for retirement.** Before you retire, variable deferred annuities (a basket of mutual funds, essentially) allow you to invest your savings in stocks or bonds and still defer taxes on all the capital gains, dividends, and interest that mutual funds usually throw off every year. See Chapter 7.
- **Distribute your savings.** Most baby boomers who retire with six-figure balances in their employer-sponsored retirement plans aren't sure how fast or slow to spend their savings. An immediate annuity or a variable deferred annuity with guaranteed lifetime benefits can provide structure to the process. See Chapter 8.
- **Insure against longevity risk.** Just as life insurance insures you and your family from the risk of dying early, an income annuity or an advanced life deferred annuity (ALDA) can insure you against the risk of living so long that you run out of money. See Chapter 10.
- **Manage your taxes.** Everybody with a big 401(k) or 403(b) plan will retire with a massive income-tax debt to the government. A life income annuity allows you to spread that tax liability evenly across your entire retirement. See Chapter 15.

The strength of an annuity's guarantee depends on the issuer's ability to pay you back. Every insurance company receives ratings for financial strength from the major rating agencies (A.M. Best, Fitch, Standard & Poor's, and Moody's Investors Services). ***Note:*** Do business only with carriers who have an all-A rating. (See Appendix A for more on these ratings.)

Note: To understand the functions of annuities better, you need to look at the types of annuities — and there are several. Please review the chapters in Part II to understand the types of annuities and what they can do for you.

The annuity purchase process

Like some other vital commodities (think air, gasoline, or even money itself), annuities are both ubiquitous and invisible. You don't smell, hear, or taste annuities, yet they're all around you. For example:

- Social Security benefits, pensions, and structured settlements of personal injury lawsuits are all annuities.
- Many state lottery jackpots are paid out as annuities.
- Thousands of university employees contribute part of their paychecks to group retirement annuities.

But the annuities in this list aren't the focus of this book. Instead, I focus on the individual annuities that people purchase from insurance companies or their designated representatives. Here's a rough description of the sales process:

You probably buy your annuity from a licensed insurance agent, broker, or financial adviser. Standing directly behind these intermediaries are brokerage firms (for brokers and financial advisers), marketing organizations (for independent insurance agents), or the insurance companies themselves (in the case of career insurance agents). ***Note:*** Insurance agents aren't licensed to sell variable annuities. (See Chapter 16 for more about this licensing.)

The transaction includes these steps:

1. You meet with the agent or broker to discuss your finances and choose a suitable product.
2. You complete an application and the agent or broker submits it to the contract issuer for approval.
3. After your application is approved, you send the contract issuer a check for the minimum amount (every carrier sets its own minimum initial premiums) or more.
4. The carrier sends you your contract.

   You have 10 to 30 days to reconsider your decision and send the contract back for a refund.
5. If you decide to keep the annuity, put the contract in a safe place. Shoeboxes, filing cabinets, desk drawers, and safe-deposit boxes are among the preferred destinations (but not necessarily in that order!).

Be sure to check out Chapter 16 for more on the sales process.

Important participants in the annuity food chain include:

- **Annuity issuers:** Only insurance companies issue annuities. Hundreds of issuers are out there, but the 25 largest firms — household names like The Hartford, MetLife, and Prudential — account for about 90 percent of all annuities sold each year.

Some insurers are publicly owned and some are mutually owned. The two types may have different cultures, attitudes, and slightly different products:

- Publicly owned firms are owned by their stockholders.
- Mutually owned firms are owned by their customers.

Look for a company whose view of risk and reward matches your own.

- **Annuity distributors:** Distributors serve as middlemen between the carriers and the producers (see the next bullet). In many cases, they employ or supervise the producer, making sure the producer complies with insurance and investment laws. Distributors include
  - *Wirehouses* (Large, established full-service brokerages like Merrill Lynch and Morgan Stanley; so called because their ancestors were among the first to use the telegraph or "wire")
  - Independent broker-dealers like Raymond James and LPL (Linsco/Private Ledger) Financial Services
  - Banks like Bank of America and Wachovia that sell annuities through their branches
- **Annuity producers:** Years ago, most insurance companies employed an army of career agents to represent their products. Although carriers like AXA Equitable, New York Life, and others still employ these "captive" agents, many insurers now rely entirely on independent agents, brokers, and bank officers to sell their annuities.

These independents can recommend any annuity they want. In practice, they may steer you toward their list of preferred products or carriers. Be aware that a producer may earn a higher commission or a free trip to Cancun for selling certain products. Feel free to ask the producers about their rewards. See Chapter 19 for more questions you should ask.

- **Direct marketers:** Some (but not all) insurance companies sell no-load (that is, no sales commission) contracts directly to the public. If you're the self-reliant type and don't need an agent or broker to explain annuities to you, you can buy your annuity direct and save that added commission cost.

No-load mutual fund companies like Vanguard, Fidelity, and T. Rowe Price also sell no-load annuity contracts over the phone or Internet or by mail. Their contracts are issued by third-party insurance companies.

Relatively few people buy annuities direct. Most people need intermediaries to explain annuities and help them choose the right one. There's nothing wrong with that. But you can save big by cutting out the salesman.

Chapter 16 contains even more information on how to acquire annuities, so please flip to that chapter when you're ready to know more.

Getting your money out of an annuity

Putting money into an annuity is relatively easy. Getting money out is "sticky" — that is, more complicated.

Annuities are "sticky" for a reason. The benefits of fixed deferred annuities, variable annuities with guaranteed living benefits, and income annuities all depend on your agreement not to touch your money for a while. To discourage you from taking out your money until the "cake is baked," in a sense, insurance carriers and the government both charge fees or levy penalties on early withdrawals.

But insurance companies and the IRS aren't totally inflexible about withdrawals. For instance, you can withdraw 10 percent of most fixed annuities every year without a penalty. The newer income annuities allow emergency lump-sum withdrawals and provide for almost unlimited withdrawals to pay for nursing home care. You can tailor an income annuity so that, if you die before receiving at least as much as you paid for your annuity, your beneficiaries will recover the difference. For more details, see Chapter 13.

Understanding the dual nature of annuities

Think of annuities as the financial world's version of the platypus, the egg-laying mammal that's part duck, part beaver. They're neither pure investments nor pure insurance; instead, they have one foot in the investment world and one foot in the insurance world. I've also heard them compared to the Osprey — an aircraft that can hover like a helicopter and fly like a plane.

Ospreys don't hover as well as helicopters and don't fly as well as planes, but no other vehicle in the world does both. Similarly, annuities aren't the most lucrative investments and they don't insure you against every financial disaster. But, for the right candidate, they can offer an attractive blend of earnings and safety that few other readily available financial products can match.

Part investment, part insurance

An annuity is an *investment* because you give a sum of money to a financial institution with the hope that you'll get back more than you put in. Your investment — in this case, a *premium* — can range in size from $2,000 to over $2 million. The financial institution, usually an insurance company, puts your money in its general account (if you buy a fixed annuity) or in a separate account (if you buy a variable annuity).

An annuity is also *insurance* because a small portion of your premium buys a guarantee (the exact nature of the guarantee varies with the type of annuity). For example:

- In fixed annuity contracts, your guarantee is the rate of return for a certain number of years.
- In the latest variable annuity contracts, your guarantee is the locked rate of return.
- With an immediate annuity, the guarantee is your income.

Risk reduction versus risk taking

Annuities are all about trade-offs between risk and return. The guarantees reduce your risk of losing money, but the fee for the guarantee generally reduces the potential growth of your investment. ***Note:*** That's not always the case, but the principle holds true — lower risk brings lower returns.

If anybody tries to convince you that an annuity lowers your risk without curtailing your potential return, put your hand on your wallet and slowly back away. There are no free lunches.

Survivorship credits — the unique aspect of annuities

When you buy an annuity for lifetime income, you throw your money into a pool with money from thousands of other annuity owners your age. This is *mortality pooling;* Social Security and corporate pensions are based on the same principle.

With annuities, an insurance company puts the money into its own interest-bearing account or into a separate account where your money goes into subaccounts (mutual funds) that a professional fund manager oversees. All owners then take an annual income from that pool.

Each month (or quarter, if you prefer) you receive a payment consisting of three elements:

- A little bit of your principal
- A bit of the pool's investment growth
- A bit of the money left behind by fellow annuity owners who have died

  This amount is your *survivorship credit* or *mortality credit.*

Of course, this income depends on (is "contingent upon," the lawyers might say) certain circumstances:

- If you die early, you may not receive as much as you put in.
- If you live exactly to your life expectancy, you get back exactly what you put in, with interest.
- If you live past your life expectancy, you get back much more than you put in.

True annuities serve two purposes: They guarantee you an income for life (or a specific number of years), and they maximize your income rate while you're alive.