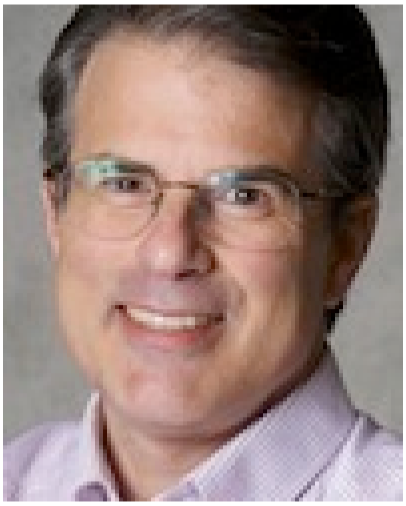
A Primer for Annuity Newbies

By Kerry Pechter *Thu, May 28, 2020*

Here, by popular demand, I offer a 10-minute tour of annuity products, using the same classification system that I used when writing Annuities for Dummies.



Many advisers have joined the *Retirement Income Journal* community recently, and many of them are new to the world of annuities. I've been asked to create a quick tutorial on this complex topic, if brevity with annuities is possible.

Annuities are special tools for investors who are willing to give up part of the upside potential of their investments in return for some protection against the downside risk. Unfortunately, to everyone's confusion, most journalists mash-up the characteristics of different types of annuities when describing them.

All annuities do share certain qualities: They offer tax benefits, only life insurers can issue them, and every contract allows the owner to convert the underlying assets into an annuity—an income stream that will last for a certain period or for the owner's entire life.

But the similarities end there. I first divide annuities into two categories: those used primarily for asset accumulation before retirement and those used primarily for generating income in retirement. Within each of those two major categories, I indicate the different ways they are invested: in mutual funds, bonds, or options.

Bear in mind that this article covers only the crests of the annuity mountain range; there are not only endless valleys but also countless cave systems waiting to be explored. Each of the product types described below exhibits almost infinite variation, and the variations themselves fluctuate over time.

Annuities for asset appreciation (before or during retirement)

Using bonds (with no risk of loss). Suppose you're looking at certificates of deposits as safe short-term investment but the yields don't interest you. You might look at ***fixed deferred annuities***. You hand your $100k over to a life insurance company. The insurer puts your money into its general fund, where it earns about 4% per year. It subtracts its expenses—say, 1.5%—and pays you 2.5% a year. You have no risk of loss. Advisers must have insurance licenses to sell these products.

Using mutual funds (with risk of loss). You may have a large sum—up to $1 million or so—that you'd like to see grow tax-deferred for several years. You've already contributed the maximum to tax-deferred accounts like IRAs or 401(k)s. You'd also like to trade funds without generating taxable gains. Consider a ***deferred variable annuity***. You invest in a mix of stock, bond or balanced mutual funds. The money resides in a "separate account" (outside the insurer's general account) with your name on it. The mutual funds can gain or lose value, so you have a risk of loss. Only advisers with security licenses can sell this product.

Using options (with zero risk of loss). What if you're unsatisfied with fixed annuity yields but don't want to take the risks associated with mutual funds. You might compromise by purchasing a ***fixed indexed annuity*** (FIA). You hand your $100k over to a life insurance company. The insurer puts your money into its general fund, where it will earn about 4% per year. Then, instead of paying you 2.5% per year, it spends that $2,500 on options on an equity index or exchange-traded fund.

If the index goes up and the options pay off, you participate in the gain. You can't lose money if you hold the contract until it expires at the end of a 1, 3, 5, 7 or 10-year term. You can—but aren't certain—to gain one or two percent more than if you had bought a fixed deferred annuity. Advisers with insurance licenses can sell these contracts.

Using options (with limited risk of loss). What if you like the idea of a fixed indexed annuity but you want a chance for higher gains and you're willing to accept a limited risk of loss? Then you'd be talking about products called ***structured variable annuities*** (aka ***registered index-linked annuities*** or RILAs). You'll be investing in options, but this time you have a wider range of possible outcomes. You might, for instance, lose up to 10%, or you might incur the net loss beyond the first 10%, but your potential gain is higher than any FIA can offer.

Annuities that produce retirement income

Using bonds, with mortality pooling, with limited liquidity, starting now. You're ready to retire and start living on savings. You don't have a pension. You have Social Security but it won't cover all your basic expenses. You've heard that you can't spend more than 3% of your savings each year without a risk of running out of money before you die.

You don't have a pension, but you're willing to buy one of your own, with part of your savings (tax-deferred or taxable). You can buy a ***single premium immediate annuity*** (SPIA). Your premium goes into the insurer's general fund, sequestered with the money from other people your age.

In return, you receive a fixed, guaranteed monthly or quarterly income for life or for a specific period of years (perhaps as part of a bucketing or income-laddering strategy). The safe annual payout will be about 5% of your initial premium. That's more than the safe withdrawal rate because you'll receive a bit of the original principal, a bit of the interest on the bonds in the general funds, and a bit of the assets of other annuity owners who die before you.

Using bonds (with mortality pooling, with limited liquidity, starting some years from now). Let's suppose that you like the product just describe, but you want to delay your first payment for several years. A ***deferred income annuity*** (DIA) will do the job. Everything works the same as the single premium immediate annuity, but your income starts years in the future.

Using mutual funds (without mortality pooling, with full liquidity). Remember the variable deferred annuity from above? Imagine that a special feature of this product allows you to switch income on, switch it off, or take as much of your money out whenever you like—but still promising you (as long as you restrain your spending) that if your own money runs out before you die, then the insurance company will continue making monthly payments to you until you die. This special feature is called a ***guaranteed lifetime withdrawal benefit*** (GLWB).

Using options, without mortality pooling, with full liquidity. Imagine the GLWB I just described, but attached to a fixed indexed annuity instead of a variable deferred annuity. Contract owners buy the contract, receive interest credits and bonuses for up to 10 years, and then start receiving a guaranteed minimum amount of monthly income for life. They never lose access to the account value as long as it's positive.

Using bonds, with mortality pooling, with limited liquidity, starting a few years from now, for distributions of qualified money after the Required Minimum Distribution start date. Invented by the U.S. Treasury in 2014, this product resolves a technical problem for people who couldn't buy deferred income annuities with tax-deferred money from a 401(k) or traditional IRA because it would have conflicted with their obligation to begin withdrawing money from those accounts at age 70½ (now 72). The IRS now allows taxpayers to apply 25% of their tax-deferred savings (up to $130,000) to the purchase of an income annuity whose payments begin between age 72 and age 85.

Less common annuities

Medically-underwritten or "***impaired annuities"***. It's a myth that people in poor health should not buy SPIAs because they're likely to die before they get all their money back through monthly payments. But at least one life insurer (Mutual of Omaha) will enlarge the monthly payouts from a SPIA for people in poor health. They simply revise the person's age upward. A 65-year-old man with a heart condition might be charged the same price for the annuity as a 72-year-old man in better health.

Charitable remainder annuity trusts. These contracts are useful for retirees who want guaranteed retirement income and a tax deduction for a future contribution to charity. The donor typically pays into a charitable trust, which pays the donor a fixed income stream until he or she dies. Any money that remains in the trust at the donor's death goes to the charity.

Secondary market annuities. When the victim of a serious accident wins a large settlement in a personal injury lawsuit, the settlement often includes an annuity that pays an income for a specific number of years. To convert the annuity to cash, the injured party might sell it, at a discount, to a settlement company. The settlement company will then sell the annuity through a broker to a member of the public who wants a specific payout at or over a specific time.

Such contracts have been controversial, because in some instances accident victims accepted less than fair compensation for their annuities. The industry has largely survived legal scrutiny, but the supply of secondary market annuities is small. What's the attraction? Their payouts are said to be about 15% higher than the payouts of retail period-certain single premium income annuities.

Conclusion

Annuities are also accused of complexity. When they are, it's partly because so many mathematical variables—interest rates, volatility levels, mortality rates, the number of people who keep their contracts or surrender them—enter the calculation of whatever financial outcome the life insurer has promised the purchaser.

Annuities are also accused of having high costs, and sometimes they do. That's partly because annuities are investments with warranties—you’re paying an insurer to absorb the cost of a market crash or the risk that you’ll outlive your savings. Traditional stocks and bonds make no promises, and the owner bears both the upside and the downside risk. Annuity fees can be high when the life insurer recoups the upfront fee that it pays a broker—unless the purchaser pays the broker himself—by charging the client annual fees.