

Annuities are Sorely Misunderstood

By Kerry Pechter Fri, Jun 3, 2022

About 97% of all annuities sold are deferred annuities. I think of them more as tax-deferred, principal-protected investments than as personal pensions in retirement. Most people don't know the difference.



Most people, and I mean the average person-on-the-street, most of Congress, as well as many investment advisers and most mass-media journalists, don't know much about today's annuities.

They may know the obsolete textbook definition of an annuity as an annual income. But they do not understand how annuities can be, should be, or are in reality, used.

There's a fundamental misconception in the public mind. It isn't just the normal discrepancy, true of any industry, between the tidy illusion that an audience sees and the messy reality backstage. It's not just a matter of annuities being hard to grasp.

My strong impression is that the most of the public believes that all annuities are used to generate lifetime income in retirement. And that's just not true. Most aren't.

One of the first things I learned after joining an annuity marketing department 25 years ago was that *almost no one ever annuitizes a deferred annuity* contract. Since about 97% of all annuities sold are deferred annuities, this means that only immediate annuities, whose sales are a tiny percentage of overall sales, are true annuities. (Sales volumes of deferred income annuities, which the owner commits to convert to guaranteed income at some future date, are even smaller.)

All deferred annuities have a clause somewhere in the contract that allows the owner to convert the value of the contract to a lifetime income stream. That clause, and the fact that annuities are issued by life insurance companies (many of whom sell far more deferred annuities than life insurance policies), is the only reason we call them annuities at all. (By *income* stream, I don't mean a source of interest yield such as a "fixed income" investment. I mean a guaranteed paycheck,)

At the risk of divulging common knowledge, it's equally true that neither the life insurance agents or advisers at broker-dealers and banks, nor the purchasers of the deferred annuities themselves, nor the life insurers that manufactured the deferred annuities, rarely if ever request or recommend that a deferred annuity be converted to income at some future date.

This has to be confusing for the public. They believe that the product is about longevity insurance—protection against underestimating the length of time you will need an income during retirement—when in fact the product is about investment protection.

The majority of deferred annuities are used as tax-favored *investments*, with some insurance features. The performance of almost all annuities that are sold—deferred variable annuities, fixed indexed annuities, and registered index-linked annuities—relies directly or indirectly on the growth of equity values.

If contract owners want some protection against outliving their savings—the purpose of a real annuity—they have to pay an extra fee for a complicated “living benefit” rider that offers a weak version of a true annuity. These riders can make it more, not less, confusing to spend down your savings in retirement. A true life annuity makes that process simpler.

The widespread misunderstanding of today's annuities has hurt progress toward resolving some important issues. Regarding annuities in 401(k)s: Congress gave a green light to *any* annuity in 401(k)s, apparently not understanding the differences between types of annuities. Plan sponsors aren't likely to accept annuities in 401(k)s when they realize that today's annuities are, mainly, a type of investment. Regarding Social Security reform: Will Americans vote to keep Social Security if they mis-believe that private deferred annuities with living benefits protect them just as well against outliving their money?

Mishandling these questions could be disastrous. And we can't wait much longer for answers. More than half of the Boomers are already retired. Social Security's fate could very well hang on the results of the 2024 election. What we don't know about annuities is going to hurt us.