

Caveat Emptor? Shifting Attitudes on Annuities

by Jim Grote, CFP

Historically, most financial planners have not been fans of annuities. Conventional wisdom has been *caveat emptor*—let the buyer beware. Planners didn't like the high annual fees, first-year bonuses that quickly vanished, the conversion of capital gains to ordinary taxable income upon withdrawal, commission-driven churning of accounts, and the fact they are tax time bombs for heirs because annuities lack a step-up in basis.

Conventional wisdom is beginning to change. As Harold Evensky, CFP, of Evensky, Brown & Katz in Coral Gables, Florida, told *Money* magazine in its November 2002 issue, "A year ago, I would have washed my mouth out if I said the word 'annuities.' Now I believe they can be an important part of retirement planning."

Financial planners interviewed by the *Journal of Financial Planning* generally concur with Evensky's change of heart. Their new conventional wisdom is *pareat emptor*—let the buyer prepare. Annuities are becoming increasingly attractive because of increased client longevity, anticipated single-digit equity returns in coming years, the risk of unsustainable levels of portfolio withdrawals, more product flexibility and a continued decline in defined benefit plans.

Nonetheless, many planners interviewed by the *Journal of Financial Planning* feel that the word "annuities" still has a scatological ring to it. While they are warming up to fixed annuities, especially for distribution purposes, many remain dubious about variable annuities during the accumulation phase, though they concede that there may be real value for some clients because of their improved insurance features like death benefits and guaranteed payouts. And the issue of annuitization remains a matter of lively debate.

Indicative of this conflicted relationship with annuities is Gary Barnes, LUTCF (Life Underwriter Training Council Fellow), of Barnes Consulting Group Inc. in Denver, Colorado. Cautions Barnes: "When somebody says the word 'annuity,' it's like using the word 'cancer.' What are you really saying? What type of annuity? What application? What company? What product? What internal costs? There are so many variables to the word, that unless you are more specific, you don't even know what other products you are comparing it with."

Variable Annuities: Bathed in Fees

What usually annoys planners is not annuities per se, but variable annuities. Recent sales trends appear to mirror this distaste. In 1998, according to Eric Sondergeld, corporate vice president of LIMRA International Inc., variable annuity sales outpaced fixed annuity sales three to one (\$99.5 billion to \$32 billion). Today, that ratio has changed dramatically. At the end of the third quarter of 2002, fixed annuity sales (\$82.5 billion year-to-date) had almost caught up with variable sales (\$88.3 billion year-to-date). (See Table 1 for more detailed analysis.)

TABLE 1

Annuity Sales Comparison

1998 Sales				
	Immediate	Deferred	Structured Settlement*	Total
Fixed Annuities	\$2.1 billion (1.6% of sales)	\$26.6 billion (2% of sales)	\$3.3 billion (2.4% of sales)	\$32 billion
Variable Annuities	\$0.3 billion	\$99.2 billion (75% of sales)	n/a	\$99.5 billion
Total				\$131.5 billion
2002 Third-Quarter Year-to-Date Sales				
	Immediate	Deferred	Structured Settlement*	Total
Fixed Annuities	\$3.4 billion (2% of sales)	\$75.6 billion (44% of sales)	\$3.5 billion (2% of sales)	\$82.5 billion
Variable Annuities	\$0.4 billion	\$87.9 billion (52% of sales)	n/a	\$88.3 billion
Total				\$170.8 billion

* Structured settlements refer to single premium contracts purchased by property-and-casualty companies to distribute damage awards to claimants of personal injury or wrongful death lawsuits over a period of time rather than as a lump sum.
Source: UMMA International Inc.

Craig Miller, CFP, started in the insurance industry in 1981, and has assisted companies in product development. Now a planner with Century Management in Austin, Texas, Miller made a tough transition to fee-only planning in the mid-'90s. He has not used variable annuities since 1998.

"This is the worst time to use variable annuities," he says. "In a bull market, variable annuities often outperform their illustrations, but in a bear market it's just the opposite. According to a consensus of the speakers at the Financial Planning Association's Retreat in April 2002, the market will average five to seven percent over the next six to eight years. If you subtract annuity fees from these returns, you're left with very little. Yet agents are still using illustrations showing 12 percent returns based on 10-year and 15-year averages."

Miller still sees a lot of investors younger than 59 1/2 making six-figure incomes and buying variable annuities that are sold strictly on tax deferral. Nine times out of ten, these investors have not taken advantage of more cost-effective options available to them. Miller also has seen many annuity investors who have taken a bath in the last couple of years and just want out. "I find more people trying to get out of annuities than trying to buy them. Agents are motivated to sell annuities based on the incentives offered by the insurance company without investigating the other options available to the client."

With experience in the insurance industry going back to 1968, Pat Rupp, CFP, heads Pat Rupp & Associates in Dayton, Ohio, a franchise of American Express Financial Advisors. For Rupp, the trend from variable to fixed annuities is counter-intuitive. "Insurance companies need to sell something. The stock market is down, so they switch from promoting variable annuities to promoting fixed annuities. Now, if you were a client, wouldn't you want to have it the other way around? Annuity salespeople should be selling variable annuities now, when the market is down." Not that Rupp's devil's advocate position makes him a fan of variable annuities. He only uses variable annuities when a 1035 tax-free exchange is the only avenue available for clients wishing to switch to American Express funds.

Joseph A. Tomlinson, FSA, CFP, can't work up much excitement about variable annuities, either. An actuary since 1977 and former head of annuity product development and marketing for a major financial services company, Tomlinson took early retirement to start Tomlinson Financial Planning LLC in Boston, Massachusetts, this year.

"More than 95 percent of the annuities on the market are too expensive," he says. "Within the tiny universe that's left, I

tend to look at fixed annuities and avoid variable annuities.” When Tomlinson does use annuities, he prefers low-fee annuities.

Like Tomlinson, Ron Beaton, CFP, only uses no-load, no-surrender-charge annuity products, and even then, only sparingly. He keeps a close eye on variable annuity expenses, especially for people whose accounts he says should not be in annuities at all.

“I had one client who’d been talked into moving his business’s retirement plan from Merrill Lynch into a large insurer’s variable annuities with the ensuing double tax deferral. Some of his sub-accounts were running annual expense ratios of better than three percent. When he found that out, he was extremely upset. He was willing to pay the high surrender charges to move his qualified plan (a money purchase pension plan) again, once I pointed out the amount he could save just by the lower expenses year after year. Even with my fee and Vanguard’s fees, I saved him a full two percent a year in fees right off the top.”

Variable annuities fit only three classic client situations, according to Beaton.

1. Someone who has maxed out all other retirement options, has excess income and could benefit from tax deferral.
2. Someone with an unnecessary or high-fee cash-value life insurance policy who would like to bail out but faces a tax hit because the cash value is higher than the premiums paid into the policy. In this case, the client can take advantage of the 1035 tax-free exchange to roll the insurance policy over into a variable annuity, carry over the cost basis and continue tax-deferred growth with the lower-fee investment options that the annuity provides.
3. Risk-averse clients who want to lock in a rate of return with the tax deferral or who can’t stomach stock investing without the guarantee that they will receive their principal back.

(For more information on this subject, read “Are Variable Annuities Right for Your Clients?” in the [January 2003 Journal of Financial Planning](#).)

Wagging the Tax Tail

According to Miller, the majority of sales pitches for variable annuities can be reduced to one pitch—tax-deferred build-up. But this tax advantage is offset by a myriad of tax disadvantages. “Alternatives to annuities are usually more cost effective. Most sales pitches involving annuities key in on the tax deferred build-up without properly addressing the negative aspects of annuities. Ninety percent of the time, taxes are not the primary concern of the client. Quite often, a higher return can be achieved outside the annuity wrapper; in many cases, it is simply better to make your returns and pay taxes on them. As the saying goes, don’t let the tax tail wag the dog.”

Tax disadvantage one. If you purchase equities inside an annuity, you end up paying ordinary income tax on the capital gains in those equities when you withdraw your money. But as Beaton notes, “Some people have such an aversion to taxes, they don’t care about paying taxes on ordinary income in the future. They just have an aversion to taxes now. It’s more a matter of personality than finance.”

Tax disadvantage two. While annuities may be great for money you plan to spend during your retirement years, they are the worst vehicles imaginable for money that will be passed on to your heirs, contend many planners. With no step-up in basis at the annuitant’s death, heirs pay ordinary income tax on the annuitant’s entire capital gain.

Tax disadvantage three. For people like Tomlinson, who believe in passive investing, variable annuities have little or no tax-deferral appeal because index funds are tax-efficient anyway. John McGeeney, president of Innovative Solutions Consulting in Louisville, Kentucky, and an attorney who specializes in annuity product development, goes one step further. “Capital gains tax deferral is far superior to annuity tax deferral because capital gains can be deferred permanently (given a step-up in basis at death), they carry no tax penalty for early withdrawal, and receive a much more attractive tax rate.” For McGeeney, the only investments worth wrapping an annuity around are investments generating lots of ordinary income (like junk bond funds or high turnover equity funds).

Tax disadvantage four. Some planners are particularly gripped by double tax deferral—annuities nestled uselessly

inside qualified retirement plans. Beaton admits to having a virtual crusade to get the word out about this abuse. He sees this pattern especially in nonprofit institutions with their tax-sheltered annuities or 403 (b) plans. But Beaton acknowledges that insurance companies tend to corner the TSA market because many brokerage houses or mutual funds won't take on institutions that have numerous small accounts that grow slowly, as is typically the case with nonprofits.

Bells, Whistles and Warnings

Do the newer extra features on annuity products attract the interest of planners? Yes and no. Rupp finds three features of interest: (1) the gradual lowering of M&E charges, (2) the automatic rebalancing of variable sub-accounts and (3) the death benefit step-up on more frequent anniversary dates. With the death benefit stepped up to the highest contract anniversary value instead of the original investment value, the insurance significance of annuities is much greater than in the past. McGeeney agrees but wonders if this benefit is too good to be true in the long run: "Insurance companies are having a tough time keeping adequate reserves for this liberal benefit in a bear market."

The possibility of principal withdrawal after annuitization receives general acclaim from planners. But they tend to emphasize the cost of all these added features. Deadpans Beaton, "The bells and whistles have not attracted me. As a general rule, annuities are an oversold product."

Having spent years in annuity product development, Tomlinson cannot work up any more enthusiasm. "I like keeping things cheap and simple. You're paying something for all the bells and whistles. They're just like the extras on a new car. The annuity features I see are mainly designed to help make a sales story. The customer has no way of evaluating guaranteed minimum income benefits and such, and knowing what he or she is really paying for them."

John Robbins, CFP, of J.F.R. Financial Services in Trenton, Michigan, could not agree more. "The various features being offered today do have their advantages, but the costs often outweigh the benefits." The most popular benefits today, according to Robbins, are the first-year bonus products and the living benefit riders. The downside to first-year bonus products? The high first-year interest rate is often followed by below average renewal rates and a lengthy surrender charge of 7–15 years, locking the client into a contract that over its lifetime may put much less money in the client's pocket than other guaranteed options. The downside to living benefit riders? GMIBs (guaranteed minimum income benefits) that offer clients the option to annuitize based upon a minimum return of four to five percent normally entail a life-only election with a payout of only four to five percent on the principal. The catches with guaranteed principal riders are that you usually must elect a packaged portfolio, pay 0.45 percent, and the guarantee does not kick in for 10–15 years.

However, Robbins believes some clients are more than willing to pay the added cost for the guaranteed death benefit. "The variable annuity within a retirement plan may not look good to the academics who are crunching the numbers, but it may look very good to the clients concerned about their beneficiaries." A guaranteed death benefit, even one decimated by ordinary income tax levels, is better than the possibility of no inheritance at all.

Barnes shares this concern. "I rarely annuitize annuities so that the client or beneficiaries get their principal back." While annuities are seen as a bad deal in bear markets, heirs are way ahead in bear markets. With death benefit features, heirs might be guaranteed 100 percent of a client's annuity, even though the sub-accounts in the annuity might be down 50 percent.

McGeeney warns about the potential legal liability attached to rolling clients from one annuity to another in a bear market. "In a bear market, many annuities now have much higher embedded death benefits than their current account values because the death benefit was tied to the highest anniversary value. If you roll to a new product and the client happens to die, their beneficiaries may receive substantially less. That's potentially a basis for getting sued." However, McGeeney says there can be a silver lining for some clients.

A close reading of the death benefit clause can make all the difference in the world. For example, take an older client who invested \$150,000 in a variable contract years ago (surrender charges no longer apply), saw their highest contract value reach \$200,000 at the height of the bull market, but now has a fair market value of only \$100,000 in their sub-accounts. Cause for despair? Not necessarily. If the contract's death benefit is reduced "dollar for dollar" for partial withdrawals, then a large withdrawal (\$99,000, for example) results in an account value of \$1,000, but a locked-

in death benefit of \$101,000. An older client who can't buy term insurance recoups two-thirds of his or her original investment and receives \$101,000 worth of insurance for \$20 a year (200 basis points on their \$1,000 account value). However, if the contract's death benefit is reduced on a "pro rata basis" for partial withdrawals, then the remaining death benefit is only \$2,000 rather than \$101,000. It's all in the details of the policy language.

Withdrawal Symptoms and the Annuity Fix

What does get planners excited about annuities? With their retired clients suffering severe withdrawal symptoms, fixed annuities might provide the right fix to this dilemma.

Doug English, CLU, CFP, of CUNA Mutual Insurance Company in Charleston, South Carolina, works solely with people retired or retiring. "The bear market has brought to life how scary it is for folks to withdraw funds from equity portfolios or even balanced portfolios. They are suffering the impact of reverse dollar-cost averaging, and the plain emotional factor is tremendous. They are mortified at the decrease in their portfolios and bristle at the thought of selling equities to make systematic withdrawals out of a decreasing pool of funds."

While English agrees with most of the criticism leveled against the accumulation side of annuity products, he is experiencing increased activity on the distribution side. "I use very few annuities on the accumulation side. But on the distribution side, you have enormous emotional value added." English recently had a 66-year-old woman contact him who held \$440,000 in equity mutual funds and had seen her portfolio sink 50 percent. As she had an energetic mother in her late eighties, she was very concerned about paying her monthly bills over an extended period of time. She needed a guaranteed \$800 a month to supplement her Social Security.

English shopped insurance companies until he found one with the lowest investment needed to guarantee \$800 a month. He put \$140,000 into a variable annuity and annuitized the income stream (75 percent fixed and 25 percent variable). With her income secure, she chose to take more risk with the rest of her portfolio. "She now has tremendous peace of mind that she has not had for the last three years. We planners get so caught up in the dollars and cents. But what our customers take home is the peace of mind we deliver to them. Annuities lessen clients' fear of the market because they don't have to live off what the market is doing."

Robbins feels the same. "Annuities have become very attractive the past three years. While investors were incurring significant surrender charges to get out of contracts before, they are now selling their mutual funds and stocks at a loss to invest in guaranteed products." Fear has replaced greed; concern over avoiding worst-case scenarios has replaced concern over finding the highest return possible. Barnes notes that clients are much more sensitive to risk after the September 11 terrorist attacks. Rupp concurs that "most clients are very aware they can lose it all in stocks. Enron, WorldCom and the like are examples of why some clients have large fears over losing all their retirement money. Annuities are very accommodating when clients hit bad financial times and become dependent on their investment income. Of course, when their financial situations improve, they are always mad that they were sold an annuity earlier in life and are even more upset they cannot easily get rid of it due to tax and surrender charge implications."

With fixed annuities offering 3 percent minimum guarantees (and some paying higher rates), fixed annuities provide a welcome alternative to certificates of deposit (below 2.5 percent for six-month certificates and up to 3.5 percent for five-year certificates) and to short-term bond funds (2–4 percent with substantial market risk). When Rupp illustrates these three alternatives to his clients, they select fixed annuities about 66 percent of the time. Barnes's older clients like fixed annuities as CD alternatives for several reasons. Fixed rates are higher. Unlike CDs, some insurance companies offer the option of a ten percent withdrawal with no surrender fees, penalties or administration charges. Furthermore, some fixed annuities offer no-cost riders that give clients access to the entire principal (without penalty) if they go into a nursing home or require in-home care. Although it cannot be advertised, a life insurance company's guarantee fund protection at the state level might be similar to FDIC-insured CD accounts (as is the case in Colorado, according to Barnes).

I'm Annuitizing My Children's Inheritance

To annuitize or not to annuitize is a controversial question for planners. While sales of immediate fixed annuities as a

percentage of overall annuity sales have inched forward in recent years, they still account for a small percentage of sales. Clients are clearly reluctant to turn their assets over to insurance companies. Bumper stickers that read, "I'm annuitizing my children's inheritance," have not appeared yet. But their time may be coming.

Given the glum outlook for stock market returns in the near future and the ever-increasing risk of longevity, fixed immediate annuities are becoming increasingly attractive. Tomlinson argues, "I think for some portion of your wealth, annuitization is a very good thing as a risk management tool. You create your own defined benefit pension plan and reduce your longevity risk. If your company gave you a defined benefit plan, your heirs wouldn't be getting the money anyway."

English believes clients are usually more concerned about stable retirement income than about their heirs' inheritance. "The most common response I get from clients when asked about their heirs is, 'The heirs will get what's left. Whatever I don't spend, they're welcome to.' Furthermore, clients never annuitize their total assets or even a majority of their total assets."

Rupp receives very different feedback from his clients. "We generally do not annuitize the fixed contracts, but pay the earnings out systematically. This protects the lump-sum value for the owner and the beneficiaries to enjoy." Of his firm's 630 clients, only 5 clients have annuitized their investments. Barnes doesn't like annuitization because he thinks the extra return doesn't warrant the risk of losing the entire principal to an insurance company.

According to English, annuitization makes sense for three reasons. First, the extra return is significant. The added benefit of mortality comes into play in annuitized products for people over the age of 65, with returns at 7.5 percent and north of that figure. "If we can give people a larger income to spend so they can have more fun in retirement, then how much value is that?" Second, annuitized products deflect the criticism that annuities transform capital gains into ordinary income. Annuitized products return a part of your income, free of tax. Granted, that tax-free portion is a return of principal. But for English, the point of annuitized products is not to receive the highest internal rate of return on your investment, but to buy the highest amount of insured income. The third argument for annuitization is the insurance aspect: the client is buying a retirement income insurance policy.

Beyond this incalculable emotional value of not outliving your assets, especially in a bear market, the mathematical value is gaining acknowledgement. Historical analyses and Monte Carlo simulations have shown the danger of projecting withdrawal rates as a simple percentage of assets. The question is, what are the odds of sustaining those simple withdrawal rates? In the [December 2001](#) issue of the *Journal of Financial Planning*, John Ameriks, Bob Veres and Mark Warshawsky explored how annuitizing a portion of investment assets affects the sustainability of portfolio withdrawals ("Making Retirement Income Last a Lifetime"). At a 4.5 percent withdrawal rate, nonannuitized portfolios had a much higher "failure rate" than partially annuitized portfolios. "The retirement portfolios that were 25 percent or 50 percent invested in annuities were still making income payments to the hypothetical retirees 40 years after they left work," the authors wrote.

In an era of increased longevity and decreased equity returns, these numbers provide food for thought. As a tax-deferred investment product, annuities are susceptible to an array of criticism. *Caveat emptor*. Even with the low-cost alternatives of some variable annuities, John McGeeney can ask, "Why pay 38 basis points to recharacterize capital gains as ordinary income for an index fund?" As an insurance product, annuities are much harder to argue with. *Pareat emptor*. Gary Barnes concludes, "Is an annuity good or bad? It just is. It's how we use it. What a person requires to sleep at night is different for everybody."

Jim Grote, CFP, is a financial writer whose articles have also appeared in Bloomberg Wealth Manager, MorningstarAdvisor.com and Planned Giving Today. He can be reached at jimgrote@hotmail.com