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The Truth about Annuities

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Traverse City, MI --- In the very recent past I have analyzed more annuity statements than ever in my career which means they are being sold like hotcakes at a fundraiser. It is not uncommon to see an uptick in the sales of these investment products during times of market instability. People become uneasy and lose confidence in the markets and they flee to safety. Annuities “seem” safe. What I generally find is the people who own them don’t truly understand what they own. Annuities have their place in the investment and insurance worlds but, they can be very confusing and expensive. Because of those two facts, they merit some thoughts...

There are three basic kinds of annuities; Fixed, Index and Variable. The annuities I referenced above were all Variable Annuity’s or VAs. Simply stated, a VA is a contract between a person and an insurance company that allows the owner to invest in the market through vehicles called subaccounts that basically mirror mutual funds. The original purpose of an annuity, when they came on the marketplace, was to allow the contract owner to receive a stream of income from the product at some point in the future. However, the majority of the annuities that I see are not purchased for the income benefits they offer. Many contract owners don’t even understand the income benefits at all or ever intend on utilizing them!

Case in point; the GMIB or Guaranteed Minimum Income Benefit. For the sake of illustration, let’s meet Arnie Annuity Owner. In 2003 Arnie Annuity Owner placed 100K of his retirement money into a Variable Annuity with a large, well respected insurance company at the advice of a local financial advisor. Since 2003 the account had been growing with the stock market and Arnie was happy, until a near 50% loss in 2008. Surprised by that Arnie wanted some advice. He thought he bought something that didn’t lose money.

When I met Arnie I asked him “What is your understanding of this contract.” The answer I got was on par with the answer I get most often when I ask this question, “I invest in the market and if my account loses value, the company will go back and credit me 5%.” Arnie purchased the 5% for life INCOME benefit believing

that benefit would pay him 5% annual compounding interest if his account ever lost money. Sure he signed something saying he completely understood that but, he didn’t understand it. I had to sadly explain to Arnie that his contract doesn’t have a guaranteed GROWTH benefit but, an income benefit which, in simple term means; if the value of your account goes down, due to poor market performance in the subaccounts, you can utilize the income benefit and receive annual payments of 5% of your original premium, or your account value, for a specified period of time.

Let me spell this out in a simplified illustration: You invest 100K like Arnie. If the 100K, at the end of the 10 year contract period has lost value you can “turn on” your income benefit (provided you meet all the criteria) and receive 5K a year for the rest of your life. Payments of 5K a year takes 20 years to return your original 100K. That is AFTER 10 years of holding the annuity. If you add that up, what you get is a 30 year investment that pays you back your original principle of 100K. 30 years to recoup your principle! AND, if you elect your benefit by annuitizing the contract (which you have to), you forfeit your original premium to the insurance company. That means you no longer have the 100K in an account somewhere generating interest.

Some VAs do offer enhanced features and lock-ins that make them seem glossy and sophisticated but, they are all basically the same carrot on a different stick.

If you invest in a 10 year contract with no intention of ever electing the income benefit, or without a clear of understanding of what you bought, then you are investing in expensive make shift mutual funds with an added insurance cost. Not to mention that, historically speaking, it would be highly uncommon for a diversified portfolio to be negative over a ten year period thereby negating the need for the income benefit in the first place!

The internal fees inside Arnie Annuity Owner’s contract were also outrageous. He paid 1.65% in Mortality & Expense, sub account expense ratios between .85 and 1.85%, a GMIB benefit charge of .35% and a \$35 annual contract charge. Arnie’s investments have to make between 3 and 4 percent a year just to break even.

Annuities, Variable or otherwise, have their place in the investment and insurance world. They are appropriate for a certain investor seeking an INCOME stream later in life. Some annuities can function as a safe or fixed instrument inside an investor’s total asset mix. But, it is my belief that because they offer attractive commissions and are “easy” to sell, these products are often sold inappropriately. If you own one of these vehicles, do some research. Read your prospectus or contract. Search information on the internet or seek a second opinion. Knowledge is power. Empower yourself.

About the author: *Kelly is an investment manager with fee-only Registered Investment Advisor, Legacy Financial Services Group, LLC. Alongside Legacy’s founder and CEO, Derek E. Weeks, Kelly specializes in bringing long term success and peace of mind to business owners and retirees. Kelly can be reached via email at kelly.kaz@charter.net or by phone at 231.933.0631.*