The Truth Behind Annuities

Simply put, an annuity is an insurance product that pays out an income. You give the insurance company a lump sum of money or periodic payments and the insurance company will make payments to you on a future date or series of dates.

While annuities are touted as useful retirement planning tools, annuities can be quite complex and require careful analysis by the investor. The terms and conditions of the insurance contract can vary widely between annuity products and insurance companies. In addition, changing regulatory requirements cause insurance companies to adjust these terms and conditions.

What is an Annuity?

Unlike stocks and bonds, annuities have unique features that require investors to accept more restrictions. Here are few of the characteristics an investor would see in an annuity:

Limited liquidity (if any at all)
After contributing to the annuity, it may allow for some withdrawals; however, the investor may be subject to steep penalties even if the withdrawal is required as part of a Required Minimum Distribution. Annuities were not developed with the RMD in mind that you are legally required to take each year.

Death Benefit feature (at a price)
Frequently, an annuity will include a death benefit guarantee similar to life insurance product. This is not free and comes with a built in cost that can slowly reduce the account's value over time.

Taxes
While the funds contributed to an annuity have the benefit of growing tax-deferred, if you need to money prior to turning 59 ½, you may have to pay a 10% penalty to the IRS. Similarly, any gains on the investment portion of the account are taxed at your ordinary income tax rate. Investors in higher tax brackets may pay much more in taxes when compared to paying 15-20% in capital gains. Lastly, potential gains on death benefit proceeds may be fully taxable unlike traditional life insurance proceeds.

Returns
While marketed as "guaranteed", the return provided by an annuity may be much less than traditional investing in a diversified portfolio of stocks and/or bonds. While fixed annuities provide guaranteed returns, insurance companies are able to reset the interest rate paid at the end of the annuity's term. An investor could find him/herself earning a lower return than they could have investing in government securities.

In variable and equity-indexed annuities, account values mirror the returns of the insurance companies' sub-account investments (typically stocks, bonds and mutual funds). These returns are further reduced by insurance company management fees, operating expenses, and other charges unique to the individual annuity.

Although annuities may guarantee the investor a minimum return, the maximum return can be less than the full performance of the underlying sub-account investments. While the benchmark may have seen substantial returns, annuity returns are typically reduced by a “maintenance charge”. If the S&P 500 increased by 8% and the “maintenance charge” is 3%, the investor would only see a 5% return. Extra charges, fees, and expenses can lead to much lower account values when compared to investing in stocks.

The benchmark followed by the annuity’s underlying sub-accounts often does not include dividend payments. As such, the annuity’s return will be lower than an index that did include dividends. From 1926 through 2012, the S&P 500 saw a 9.7% return with dividends reinvested versus a 5.6% return without reinvesting dividends. Not including dividends for reinvestment can greatly reduce an investor’s return in the long run.

Inflation

While guaranteed, fixed annuities may not return rates that are higher than the rate of inflation. This can cause a great deal of problems over the life of the annuity when your retirement savings is tied up.

Insurer’s Financial Strength

If the insurance company goes out of business, annuity owners may not receive the benefits for which they have been paying. While legislature have established some safeguards to protect investors, it’s important that the individual investor be fully aware of all the costs and risk associated to fully evaluate their annuity provider’s financial strength.

S&P 500 Investment versus Hypothetical Annuity

	Amount invested on 12/31/83	Time Horizon	Annualized Return	Account value on 12/31/11
S&P 500 Index	$100,000	30 years	10.95%	$2,258,495.33
Hypothetical Annuity	$100,000	30 years	7.4%	$851.389.80

Fees, Expenses & Charges

Annuities have many high, reoccurring fees that mutual funds do not charge:

Mortality: Compensation to the insurance company for assuming the risk over the period of the annuity contract as well as the broker’s commission

Operating & Administrative: Bookkeeping and administrative charges to maintain the annuity account

Sub-account Expense ratios: Expenses tied to maintaining underlying investments similar to a mutual fund company

Guaranteed Minimum Death Benefit: Additional charge to provide sum value of account to beneficiaries if the annuity owner passes away before the end of the annuity contract

Guaranteed Lifetime Withdrawal Benefit: Additional charge to deliver a guaranteed income for the remainder of the annuity holder's life.

Surrender Fees: Additional charge if you wish to withdraw your money before the surrender period has ended (frequently 7 years or longer). The surrender fee is typically a percentage of the withdrawal amount and declines as you approach the surrender period.

Typical Annual Fees for Variable Annuities

Variable Annuity Expenses	Annual Expense
Mortality & Expense Risk	1.25%*
Administrative Risk	0.15%*
Optional Guaranteed Minimum Death Benefit Rider	0.61%*
Optional Guaranteed Lifetime Withdrawal Benefit Rider	1.03%*
Fund Expense for Underlying Funds in Variable Annuity	0.94%*
Total Cost of Variable Annuity	3.98%

Average Fees as determined by the Securities & Exchange Commission

Even reducing the fees a few percentage points can greatly impact returns over the years invested.

Hypothetical Impact of Fees on Returns

Amount Invested	Time Horizon	Average Rate of Return	Annual Expenses	End Amount
$100,000	30 years	10%	3.98%	$577,609.06
$100,000	30 years	10%	1.60%*	$1,124,290.31

Includes average mutual fund expense ratio plus average advisory fee

What to Do

With the predatory nature of many insurance salespeople that sell an annuity's "guaranteed" return while generating a large commission, O'Connor Wealth Management believes that, for most people, it is in your financial plan's best interest to avoid them.

All annuities aren't bad, and many have great tax saving advantages, but the disadvantages greatly outweigh any tax savings you might see.

Advantages

- Guaranteed minimum return
- Tax-deferred growth
- Reducing your taxable income today

Disadvantages

- COMMISSIONS
- Paying large surrender fees if you need your money early plus a 10% penalty to the IRS
- Excessive & hidden charges
- Giving up control of your money
- Limited upside potential

For most investors, a diversified portfolio of stocks and/or mutual funds will provide a much better return at a much lower cost to you. You will be paying out less in expenses, fees, and hidden charges leaving more of your money to grow. The average stock mutual fund has returned 10.81% over the last 20 years. While the market may seem volatile during the short term, investing in profitable, growing companies across the world is a proven recipe for financial success. The greatest long term risk isn't losing your money. It's outliving it. We want to make sure you have enough to last you through your entire retirement.

For Investors Who Currently Own Annuities

Nothing happens without a plan. If you currently own an annuity, we are more than happy to evaluate it at **no cost to you**. Contact us for more information, and, depending on your age and circumstances, we may make one of several recommendations:

1. Wait under the surrender period is over to avoid surrender charges
2. Tax-free exchange to an alternative fee-only annuity that is much lower cost and has zero commissions
3. Cash out annuity and build a personalized stock/mutual fund portfolio

Ensuring you are on the right track for retirement is an important step in any financial plan. Through our investment experience, you can benefit from a simple analysis as to how you much are paying in fees and what alternatives are available to you.

Regards,

John V. O'Connor