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Annuities: guarantee not worth cost

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'Annuities are never bought—they are sold," according to an old adage in the financial planning industry. In other words, people tend to see annuities as attractive investment options only when they are being sold annuities.

Life insurance companies sell annuities as tax-deferred investment contracts. Annuities are designed to provide a guaranteed income benefit over a defined period or over the buyer's lifetime. Annuities are invested in mutual funds and earnings are tax-deferred. Unlike a 401(k) or IRA, there is no annual contribution limit or a required minimum distribution at age 70½.

Too good to be true?

The objective of annuities is to protect income during market downturns. While income may be guaranteed, it is paid out at a very low rate. Like any insurance product, payments depend on the issuer's ability to pay claims. Commissions, administrative fees, and surrender charges can be prohibitive.

Annuity management fees can run as high as 3% per year, on top of the commissions that can run as high as 10% of your investment. Furthermore, the mutual funds in which the annuity is invested charge an additional management fee.

Most annuities charge a surrender penalty if excess amounts are withdrawn within the first 7-10 years of purchase. If you withdraw additional funds in the first year, you could pay a penalty of up to 7% of the value. If you withdraw funds from the annuity before age 59½, you will pay an early withdrawal tax penalty of 10%, unless you meet one of the exceptions to the rule.

One of the selling points of an annuity is a death benefit guarantee. At a minimum, your beneficiary will receive the amount invested. However, this benefit comes at a cost; mortality and expense charges can amount to 0.5% to 1% annually.

Earnings are tax deferred

Agents selling annuities often suggest rolling over a 401(k) account or an IRA into a tax-deferred annuity—an unnecessary step since the earnings are already tax deferred by virtue of the products. Furthermore, when the holder of a non-IRA annuity dies, his or her beneficiaries will pay taxes on the gains. Compare that to a non-IRA mutual fund, in which the basis is "stepped up," meaning beneficiaries do not pay income taxes on the earnings.

Other ways to protect income

If your objective is to protect income during a downward market cycle, talk with your investment advisor about other alternatives. For example:

- Diversify your investments. Standard advice, but it bears repeating. Greater diversity leads to greater resiliency and lower risk.
- Reallocate your assets. As you get closer to retirement, you will want to be more conservative in your investment choices. You don't have as many years to recover from a downturn in the market cycle.
- Evaluate your retirement income needs. Examine all of your sources of retirement income, including pension plans, investments, proceeds from the sale of a practice or home, and Social Security. Weigh that against your retirement plans. You may discover that an annuity adds very little value to the mix.

Conclusion

Think through the pros and cons and consider the alternatives before you are sold an annuity.

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