

Annuities: the perfect investment if your goal is to die penniless

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A frequently aired commercial for a large insurance company presents an 800-pound gorilla, a common metaphor for a hugely important issue somehow often ignored. The gorilla in the ad is looming retirement. Annuities, championed as a source of “guaranteed income for life,” are touted as the means to address that gorilla.

As we have seen this past year, there are no sure things in the financial industry — at least in terms of returns to investors or even the existence of firms “guaranteeing” those returns.

Annuities, however, do entail a number of certainties: high fees, low returns and excellent commissions to those who sell them.

Annuity basics

An annuity is simply a stream of payments. When one buys an annuity from a financial institution, one pays money for a contract through which the selling firm promises the buyer a stream of payments at some point in the future. The streams can be steady or variable. They can start immediately after signing or well into the future. They can continue for a limited period or until death. The contract dictates the precise terms.

Firms add so many different features to goad people into buying an annuity it would take a book to explain. The contracts themselves are often book-length. But really, one only needs to know the fundamentals of a simple annuity. If the core product is deemed poor or otherwise, the add-ons are moot, especially since all add-ons come with fees exceeding the added benefit.

Fixed annuities

Decades ago, fixed annuities were the only type available. In fact, the main purpose one bought an annuity was to lock in a known, or fixed, amount of monthly income. In an environment in

which one might earn 5 percent on bonds, an insurer might offer a 7 percent “yield” on an immediate annuity.

However, there is a major difference between a bond and an annuity. Bonds mature; annuities do not. If you invest \$100,000 in a 5 percent bond, you earn \$5,000 each year and \$100,000 back on the maturity date. If you invest \$100,000 in a simple 7 percent annuity, you get \$7,000 per year until the annuity expires, and nothing else. If you bought this annuity and it promised payments for life, and you die two years later, you would receive \$14,000 total. The \$100,000 principal is gone.

There are “riders,” or additional contract terms, that can reduce the damage of adverse events like early death. One can lock in payments for a minimum number of periods, such as 10, 15 or 20 years. If one passes before the minimum period transpires, a designated beneficiary would receive the remaining payments. Other arrangements, such as having a joint and/or surviving annuitant, also can reduce the risk of early termination. However, each of these riders comes at a cost — usually payment reductions actuarially calculated to exceed the probable cost to the insurer.

Realize that when you buy an annuity, the insurance company takes your money and, after paying about 5 percent in commissions, invests the rest in the same securities you could have bought directly. Fixed annuities are typically backed by bonds. Year after year, the insurer strips more money out of the funds to cover administration, marketing and investment-management expenses. There is also profit. Nothing wrong with the latter; but know that fixed annuities in aggregate provide rates of return far lower than those you can get from fairly safe and simple bond portfolios.

Variable annuities

When sold, variable annuities are presented as a way that a buyer can lock in a payment stream and still keep the potential for growth in your portfolio. In truth, variable annuities provide a means for insurers to pass the investment risk they accept with fixed annuities back to you. Leaving aside costly riders that can guarantee certain easily achieved minimums, variable annuities are like mini-pension plans in which the buyer can choose a portfolio into which cash is invested. During the accumulation period, the balance of one's account will rise and fall with the market. When one enters the annuity period and decides to start receiving payments, the balance of the account will determine the size of the stream of payments.

Importantly, the fees — and thereby the reductions in invested assets — of variable annuities are huge. A typical contract will have non-investment expenses in excess of two percent annually, much of this used to compensate the sales force. There also will be investment management fees for the mutual funds selected. Given the captive nature of the funds offered through annuities, these fees often will be at the high end of the spectrum.

The bottom line: As opposed to investing directly in mutual funds, with a variable annuity one contracts to invest in a limited group of mutual funds, keeps all of the risk of those funds, and agrees to pay about two to three times the expenses rate normally faced with that kind of investment exposure.

For a moment, assume one desires to keep the growth potential of the market yet also wants payments in the form of an annuity later on. One could simply invest in the market directly, choose any combination of securities whatsoever, and then at a future date spend the accumulated assets on an immediate fixed annuity. Given the aforementioned concerns, there probably are better alternatives than the fixed annuity, but this scenario is clearly superior

to buying a variable annuity. In fact, almost any investment option is superior to buying a variable annuity.

A case in favor of a simple annuity

There actually is a situation in which an annuity could make sense. Alas, it is a sad one. But if you have no heirs, no needy friends, no interest in any cause or charity that might benefit from an inheritance — basically no desire or reason to have any wealth whatsoever upon death and wish to maximize your cash flow until your demise — an immediate fixed annuity that terminates when you do, might be the answer.

I would hope (suspect!) readers have more to live for and, as such, have reason to invest wisely. Despite the tag lines of commercials and clever ruses of salespeople, the only real guarantees annuities bring are lower returns on your money.



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