THE TRUTH ABOUT

BUYING ANNUITIES

"Annuities can make or break your retirement..."

Steve Weisman

Attorney and Senior Lecturer, Bentley College, Department of Law, Tax, and Financial Planning

Publishing as FT Press
Upper Saddle River, New Jersey 07458

This book is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional services or advice by publishing this book. Each individual situation is unique. Thus, if legal or financial advice or other expert assistance is required in a specific situation, the services of a competent professional should be sought to ensure that the situation has been evaluated carefully and appropriately. The author and the publisher disclaim any liability, loss, or risk resulting, directly or indirectly, from the use or application of any of the contents of this book.

FT Press offers excellent discounts on this book when ordered in quantity for bulk purchases or special sales. For more information, please contact U.S. Corporate and Government Sales, 1-800-382-3419, corpsales@pearsontechgroup.com. For sales outside the U.S., please contact International Sales at international@pearsoned.com.

Company and product names mentioned herein are the trademarks or registered trademarks of their respective owners.

Printed in the United States of America

First Printing August 2008

ISBN-10: 0-13-235308-3
ISBN-13: 978-0-13-235308-3

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education North Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educatión de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

Library of Congress Cataloging-in-Publication Data

Weisman, Steve.
The truth about buying annuities / Steve Weisman.
p. cm.
ISBN 0-13-235308-3 (pbk. : alk. paper) 1. Annuities. I. Title.
HG8790.W44 2009
368.3'7--dc22
2008005622

Vice President, Publisher
Tim Moore

Associate Publisher and Director of Marketing
Amy Neidlinger

Executive Editor
Jim Boyd

Operations Manager
Gina Kanouse

Development Editor
Russ Hall

Digital Marketing Manager
Julie Phifer

Publicity Manager
Laura Czaja

Assistant Marketing Manager
Megan Colvin

Marketing Assistant
Brandon Smith

Cover and Interior Designs
Stuart Jackman,
Dorling Kindersley

Managing Editor
Kristy Hart

Senior Project Editor
Lori Lyons

Copy Editor
Water Crest Publishing, Inc.

Design Manager
Sandra Schroeder

Senior Compositor
Gloria Schurick

Manufacturing Buyer
Dan Uhrig

To Carole, who makes all my ordinary days extraordinary. The dividends on our investment in a marriage license continue to outperform any annuity.

Saving for retirement used to be so easy. Companies provided pensions that would pay their retired workers for the rest of their lives, not to mention the fact that companies would also pay for health insurance for retirees. On top of that, there was workers' own savings. And don't forget the Social Security check that came in the mail every month. Retirees were set for the rest of their lives.

But times have changed. People are living longer. Baby Boomers facing retirement can expect to live considerably longer, but not necessarily healthier, lives than their parents. They will spend much more time in retirement. But few companies offer the kind of guaranteed, defined-benefit pension plan that formerly was so common. The 401(k) is king, and although it provides the potential for considerable retirement savings, it takes some effort and commitment by workers today to provide for tomorrow. As for health insurance, all too often companies are telling retirees that they are on their own. In addition, people are not saving as much as they did in the past. And even that Social Security check doesn't seem quite as secure as it once did.

Things look rough for retirees.

But to the rescue have come insurance companies and others with a product that guarantees it will provide retirement income for the rest of your life. The product is the annuity. It is not a new idea, but it may be an idea whose time has come, with close to 2 trillion dollars now invested in all kinds of annuities.

But is this the answer to our problems?

According to H.L. Mencken, "For every problem, there is a solution that is simple, neat, and wrong." Well, annuities are far from simple. And although they may appear neat, they are quite complicated. They also are dead wrong for many people who own them, particularly elderly purchasers of deferred variable annuities, who were sold inappropriate annuities by salespeople more interested in the high commissions that annuities bring to salespeople than in helping their clients.

But are annuities always wrong?

The answer is no. Annuities have much not to like about them, including high fees along with misleading and sometimes illusory benefits. However, this investment, which has been around since early Roman times, has evolved and continues to evolve in an effort by insurance companies and other legitimate issuers of annuities to provide secure retirement income for people. If you look hard enough, you can find lower fee annuities that provide benefits which may be tailored to your particular retirement needs.

But you need to know the truth.

Perhaps nowhere in the investment world is there more misleading and downright wrong information about an investment product than with annuities. But this book will tell you the truth. It explains, in clear and understandable language, basic information you need to know about the many different types of annuities. It tells you what the pitfalls of annuities are. It tells you about the lies and misrepresentations to avoid. It also tells you about where annuities might play a useful part in your own retirement planning, when to use them, and how to use them.

It gives you the rules in simple and concise language so that armed with this information, you can make an intelligent and confident decision as to whether annuities should be a part of your retirement planning. Oscar Wilde said, “A man who does not think for himself, does not think at all.” This book will give you the knowledge you need to make an informed decision for yourself about one of the most important issues you will face for the rest of your life—how to make your money last a lifetime.

TRUTH 1

The history of annuities

“I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left.”

—Voltaire

Annuities have had a rich and colorful history. The early Romans, inventors of such innovations as the public bath, the iron padlock, and the calendar, also developed the first annuities. In fact, the term "annuities" may have come from the Latin term "annua," which means "annual stipend." In ancient Rome, people would make a single payment in return for annual lifetime payments. Even then, retirement planning was a concern. Roman jurist Domitius Ulpianus developed the first known mortality table used for annuity purposes. Although he had little in the way of data, his actuary tables were found to be effective and were used for more than a thousand years.

Early annuities also were used by governments to raise money to fight the many wars deemed necessary by the rulers of seventeenth century Europe. Even in the middle ages, increased taxes were not a particularly popular activity for the populace. Into this environment, a particularly intriguing form of annuity came into being, known as the "tontine." Under the direction of French King Louis XIV, to find a non-taxing way to fund ongoing wars, Minister of Finance Cardinal Mazarin hired Lorenzo Tonti, an Italian banker. Tonti developed the tontine in 1652. In 1693, the government of the United Kingdom established a state-sponsored tontine. Under the terms of a tontine, participants would purchase shares in the tontine. In return, they received income for life. The most interesting aspect of the tontine was that as more and more participants died, the annuity payments to surviving participants increased substantially until the final surviving tontine participant received a huge lottery-like payment. This one financial product combined, in effect, a war tax, a lifetime payment plan, and a lottery. Life in the middle ages did not get much better than that. The popularity of the tontine even extended to early America, where in 1790, Alexander Hamilton developed a form of tontine to reduce national debt. Unfortunately, the greatest lure to investors of the tontine—the possibility of a lottery-like windfall to the final participant—also was its downfall, as the inducement to hasten the death of other participants was deemed too much of an encouragement to murder. By the 1900s, tontines were gone from the annuity world.

Annuities were often used during the 1700s by European countries to raise money instead of either taxing or offering bonds, such as is done today. Initially these annuities were sold to everyone at the same price without any consideration of the age or sex of the annuity purchaser. Over time, as actuarial patterns were observed, the cost of annuities became more refined.

> The greatest lure to investors of the tontine—the possibility of a lottery-like windfall to the final participant—also was its downfall, as the inducement to hasten the death of the other participants was deemed too much of an encouragement to murder.

Annuities first appeared in America in 1759 when Pennsylvanian Presbyterian ministers were able to purchase lifetime annuity contracts from the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers, a company whose existence lasted almost as long as its name. However, the general public was not particularly attracted to annuities as a vehicle for retirement planning because, at that time, the best retirement planning was to have a large family that would take care of you in what passed for old age during America's early years. The first annuities available to the general public were not sold in America until 1912; however, the popularity of annuities did not take off until the Great Depression. Concerns as to the risks inherent in investing in the stock market motivated more and more people to buy annuities from large, stable insurance companies to pay for their retirement. These publicly available annuities were pretty basic in format. Unlike the stock market, the annuities guaranteed the return of your principal, as well as income at a fixed rate. Payments from the annuities could either be taken over a specific period of years or a fixed income for life. Legislation enabling the general availability of annuities was enacted in the 1930s shortly after the enactment of Social Security. At the time, Social Security was not intended to provide the primary funds for the retirement needs of aging Americans. Rather, it was intended to merely supplement retirement planning that would be done by individuals themselves through such investment vehicles as annuities. The tax deferral aspect of annuities was made a part of the early annuity laws to further encourage people to provide for their own retirement.

Variable annuities made their appearance on the annuity landscape in 1952, when some creative actuaries came up with the first annuities that would base their payout upon the performance of separate investment accounts held within the annuity. The Teachers Insurance and Annuities Association–College Retirement Equity Fund, commonly referred to as TIAA-CREF, sold the first variable annuities. Early variable annuity purchasers were able to choose from a limited number of investment accounts to have as the basis for their annuities. However, due to regulatory complexities, the major insurance companies did not generally sell variable annuities until 1960; it was not until the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 that the modern variable annuity was born. Over the years, legislation has continued to appear from time to time to curb practices considered abusive—as in 1988, when the Tax and Miscellaneous Revenue Act (TAMRA) was enacted to tighten loopholes created by the earlier Tax Reform Act of 1986.

Today's annuities… offer many more choices to investors to tailor their annuities to their own specific needs and desires.

Today's annuities may not be as much fun as the tontine of the 1700s, but they offer many more choices to investors to tailor their annuities to their own specific needs and desires. Greater expansion of investment choices to individuals within their variable annuities, death benefits (an oxymoron, if ever there was one), and reduced surrender charges are all developments that are a part of the evolution of the annuity.

TRUTH 2

Immediate annuities

"The question isn't at what age I want to retire, it's at what income."

—George Foreman

Immediate annuities are a financial product designed to provide you with an income stream for life. They are bought with a single lump-sum payment and begin to make payments to you right away. Instant gratification. What could be more American than that? For example, you give the insurance company, say, $100,000, and it pays you $600 per month for the rest of your life. Immediate annuities can either be fixed rate or variable rate.

Fixed rate annuities

The fixed immediate annuity pays regular payments at a specific locked-in interest rate on either a monthly, quarterly, semi-annual, or annual basis. Each payment consists of a partial return of your initial investment along with earnings. The amount of the monthly payment depends on your age and the options that you chose within the annuity contract. An immediate annuity can provide you with income for life or even for the lifetime of you and your spouse. Alternatively, it can be structured to provide income for periods of up to 20 years. The amount of your monthly payment that relates to the money you initially put into the annuity is tax-free. However, the earnings portion of your monthly payment is subject to income tax. Fixed immediate annuities are a good investment for older people who are afraid of outliving their savings. They also are attractive to people who either don't understand the stock market or believe they do understand it and find it too unpredictable a place to invest for their retirement.

Fixed immediate annuities are a good investment for older people who are afraid of outliving their savings.

A fixed immediate annuity works best for you if you think that you will live longer than the insurance company actuaries think you will. With life insurance, you win if you die early because you get (or more accurately, your beneficiaries get) a large sum of money after paying a small amount of premium. With lifetime fixed immediate annuities, you win by living longer than the company actuaries predict because you are paid by the company for as long as you live, regardless of how much money you put into the annuity.

The older you are when you purchase a fixed immediate annuity, the more the company issuing the annuity is willing to pay you. This has nothing to do with the company being favorably inclined toward the elderly, but everything to do with their belief that the older you are, the more likely you are to die sooner. And just as people like to hedge their bets at the horse races by betting on more than one horse to win, you can also hedge your bet on your fixed immediate annuity by choosing an option that will require the company to continue to pay your beneficiaries if you die earlier than might be expected. This option to have payments continue even after your death is available for specific periods of time, ranging from five to twenty years. Obviously, however, if you purchase such an option, your cost will be greater and your payout less than if you just rolled the dice and bought a fixed immediate annuity that provided for payments only during your lifetime, because the company is bound to pay for a longer period of time. A similar, but less costly, alternative is to buy an annuity that will pay to your beneficiary the balance of whatever you initially paid for the annuity if you die before having at least received back what you initially paid the company.

Variable immediate annuities

Unlike the fixed immediate annuity, the amount you receive through a variable immediate annuity changes depending upon the return on the portfolio of investments that form the basis of your annuity. Unlike the fixed immediate annuity, the amount that you receive monthly is never guaranteed at any set amount. For many people who choose annuities in order to avoid the confusing array of investment choices available to them outside of annuities, having to choose the underlying investments in their annuities tends to compound the confusion of an investment that is confusing enough on its own.

The amount you receive through a variable immediate annuity changes depending upon the return on the portfolio of investments that form the basis of your annuity.

The choices within a variable annuity are usually limited to an array of investments similar to mutual funds, called *sub-accounts*. The sub-accounts, in turn, may be composed exclusively of stocks, bonds, money market instruments, or a mixture of these investments. These sub-accounts may appear to be the same as mutual funds offered by the same investment managers to the general public as stand-alone mutual funds, but they are prohibited by law from being the exact same mutual funds. The return of investment on these sub-accounts can differ significantly from a mutual fund offered to the public by the same mutual fund manager.

TRUTH 3

Fixed rates

“An investment in knowledge always pays the best interest.”

—Benjamin Franklin

If your dog or cat could talk, they probably would tell you that they are not too thrilled about being "fixed." But when it comes to a guaranteed fixed rate on their annuities, owners are pretty happy with the security of knowing that the rate of return they will be receiving from their annuity is fixed. People equate a fixed rate with a safe and secure investment. But fixed has a different meaning to the insurance companies issuing the fixed rate annuity than it may to you.

Insurance companies go by their version of the Golden Rule, which is that since they have the gold, they get to make the rules. And, according to their rules, the fixed interest rate that they promise to pay you on your annuity is not necessarily fixed for the full term of your annuity, but rather only for whatever period they decide they will guarantee a specific fixed rate.

Buried within the fine print of your fixed rate annuity may be a provision stating that the guaranteed fixed rate you are credited with in your annuity is guaranteed only for as little as a year; if you shop around, however, you can find companies that will guarantee their interest rate for as long as ten years. The actual interest rate you receive after the guarantee period is determined by the insurance company. Although there is indeed a minimum guaranteed rate, that rate is low—generally around 3%. For example, although the rate that attracted you to the particular annuity is guaranteed for only one year, you are left with a surrender period that will penalize you if you decide to leave the annuity for a better-paying investment at the end of that first year.

Buried within the fine print of your fixed rate annuity may be a provision that states that the guaranteed fixed rate that you are credited with in your annuity is only guaranteed for as little as a year.

Generally, as with Certificates of Deposit, the longer the length of the duration of the annuity, the higher the interest rate that the insurance company will commit to. In fact, you may find a close correlation between the guaranteed rates in a fixed rate annuity and the rates for a bank-issued Certificate of Deposit for a similar period.

I don't know the investment track record of Nostradamus, but when you are trying to determine whether you are better served by a long- or short-term annuity, a key factor is whether you think interest rates will rise or fall in the upcoming years. If you think interest rates will be rising, you will want to commit to the shortest period possible so that at the end of your annuity, you can get a new annuity with a new, higher interest rate. On the other hand, if you think that interest rates are likely to go down, you will want to get an annuity with the longest period of a guaranteed interest rate.

Look for annuities that guarantee your rate for the longest period possible.

TIP Look for annuities that guarantee your rate for the longest period possible. Some companies will guarantee your rate for as long as ten years. Also look for an annuity that does not have a surrender period that lasts longer than the guaranteed interest period, so if it makes sense for you to get out of the annuity, you can do so without having to pay a surrender fee. This is particularly important because once your initial guarantee period has run out, you are like Blanche DuBois in *A Streetcar Named Desire*, depending on the kindness of strangers—in this case, the strangers at the insurance company to determine the return on your investment. You also should ask your annuity salesperson for documentation of the renewal rate history of the company offering an annuity you are considering buying. If the company you are considering has a history of paying competitive rates even after the guarantee periods have lapsed, you can certainly feel more comfortable dealing with them.

TIP If you presently have an annuity that is beyond the initial guaranteed interest period, yet still within the surrender period, you are not entirely without options. You can make a tax-free 1035 exchange and purchase a more appropriate annuity that will pay you a higher interest rate for a longer period. (You can learn more about 1035 exchanges in Truth 19, "Tax-Free 1035 Exchanges.") Of course, if you are still within the surrender period of your original annuity, you will have to do a bit of math to calculate how much more you will earn with the new annuity and how long it will take you to recoup the cost of the surrender fees incurred when you exchange your original annuity for the new annuity. As a matter of investment strategy, also consider the length of the new surrender period, which comes with the new annuity.

Time to bail

An important provision in a fixed rate annuity is the Bail Out provision. This term, which is found within the fine print of your annuity contract, permits you to get out of your annuity without any penalty if, after the initial guaranteed interest rate period, the insurance company renews your annuity at an interest rate that is lower than the original rate by at least an amount designated within your annuity contract, which may be 1%. For example, if you had an initial guaranteed interest rate of 5% and, at the end of your guarantee period, the insurance company offered a new guaranteed rate of 4%, you would have a specific period of time after receiving notice of the proposed renewal rate to decide whether to either accept the new guaranteed rate or take your money out of the annuity without having to pay any surrender fees. It is important to remember, however, that if you do withdraw your money from an annuity to invest in something other than an annuity, you will be subject to a substantial federal income tax penalty if you are under the age of 59½. On the other hand, it should be noted that if you decide not to bail out and instead accept the new guaranteed interest rate, a new surrender charge period also begins.