CAMARDA INVESTOR EDUCATION SERIES

The Plain Truth About Annuities

Camarda Wealth
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The Plain Truth about Annuities: When to Use Them, When Not To, & What to Watch Out For

THE "ANNUITY WARS"

Welcome to one of the most confusing and hotly debated topics in the financial world. Our objective is to help clear the smoke and give you simple guidelines to help make smarter decisions about one of the most promising – but also potentially one of the most dangerous, expensive, and hard to get out of – financial choices out there.

Annuities are probably one of the most poorly understood – and most polarizing – "investment" types around. It seems like most financial professionals either love them or hate them. Certainly, financial salespeople can love them for the high, hard-to-spot commissions many of them pay. Some media pundits, "consumer advocates" and other advisors can hate them because of the very high internal costs, access fees, and high potential taxes. But everyone has an agenda.

> KEN FISHER – WHO RUNS ONE OF THE LARGEST INVESTMENT ADVISORIES IN THE COUNTRY – "HATES" ANNUITIES, SAYS ANNUITY SALESPEOPLE "LIE," COMPARES THEM TO PONZI SCHEMES, AND EVEN SAYS SOME SHOULD BE ILLEGAL.

Others, like "father of financial planning" Harold Evensky, also an advisor and Professor of Financial Planning at Texas Tech, were past opponents, but have come to embrace the "right" annuities as products have evolved and consumers' needs have changed. In 2015 he even said, "the immediate annuity will be the single most important investment vehicle of the next 10 years."

Other academics strongly disagree with Fisher's position. York University professor Moshe Milevsky says, "there is a magical, secret ingredient, a secret sauce, inside an annuity that can't be replicated' by other retirement products," and said some of Fisher's comments were "blatantly wrong." Dr. Michael Finke said that the annuities Fisher most hates "… could serve as an ideal default for most Americans rolling their defined contribution assets into an IRA. A competitively priced variable annuity product is hard to beat compared to an unprotected investment portfolio." Dr. Wade Pfau – a Princeton Economics PhD and a professor in the American College's PhD program in Financial and Retirement Planning – said "this is a very important retirement tool. It's very straightforward: a simple lump-sum payment, and you get income for life. It pools longevity risk across a large [group] of individuals; and because of its mortality credits, those who don't live long subsidize those who live longer. The mortality credits are part of a [retiree's] spending power. An income annuity can help preserve the remaining portfolio when someone lives a long time in retirement." Phau also said Fisher "is trying to act like he's doing his clients a service by paying their annuity surrender fees when he's really just taking it out of the investment management fees, he collects," implying Fisher's position may be as much about marketing as what's best for consumers. Milevsky added, "there is almost a consensus in the 'ivory tower' that annuities make sense for the consumer…there have been 2,000 articles about annuities written by card-carrying professors since the 1960s, and 99.9% of them are pro-annuities."

But popular commentator Suze Orman doesn't like them, and Forbes even ran an article called "The Great Annuity Rip-Off."

So, who's right? Like Evensky – whom I know and have worked with on some research ideas– I've had a change of heart about annuities over the years. I once ran ads headlined "Got Annuities?

The Dirty Secrets Your Agent Never Told You…" but with my continuing studies over the past decade, I come to have a more balanced perspective. The confusing truth is that both points of view are "right."

There are many horrible things about some annuities, and there are wonderful things about others. The right annuities – ***and getting it right is of huge importance*** – can do great thinks for you that nothing else in with world will – ***if*** you need these things done!

As with most things, the truth is somewhere in between various positions, and very much depends on your personal needs. Unfortunately, since annuities are so varied and complex, the “in between” part covers a lot of ground, and it’s easy to get lost. We’ll try to narrow it down for you, and help you understand the good, know how to spot the bad, and, most importantly, learn what is best for you.

Why You Need to Get Educated about Annuities

If you or someone you care about owns annuities, this special report could prove to be invaluable to you. And if you are considering the purchase of an annuity product – which probably means an insurance agent working for a bank, brokerage house, or “financial planning” company is trying hard to sell you one – reading this report first could save you anywhere from hundreds to hundreds of thousands of dollars, and help you make a much more balanced decision.

In clear, simple language that will sometimes incite you and occasionally amuse you, we will demystify these extremely confusing, complicated life insurance products, show you how they work, why they are often pushed so hard, and when you should probably avoid them, and when you should probably use them.

We’ll talk about the life insurance feature that is present in all annuities and show you how much this often-unneeded feature can cost in real dollars and cents. This information will probably amaze you.

Some of what you read here you may find disturbing, as we unravel the ways insurance companies and agents profit on the sale and continuation of annuities contracts. This work is not intended to be an attack on the ethics of the practices of insurance companies and their sales agents – as in most things, there are good and bad companies, and good and bad sales reps. For the most part, annuity sales practices are conducted within applicable law, although there are not infrequent challenges which occasionally result in substantial settlements. The important point is that much of what we will describe here is currently legal. Just because it is legal, however, does not mean it is good for you or in your best interests. Like for most purchases, you must ultimately determine what is in your best interest.

You’ll learn how annuities are priced, how the insurance companies make sometimes amazing profits from them, and why they are sometimes willing to pay commissions so high as to appear unconscionable to some. The sheer magnitude of some of these commissions in the most abusive cases may inflame you. Since these commissions are almost never disclosed, even if you ask, we will give you some very useful methods to estimate them for any given annuity, so you can see just how much a salesperson would be paid to motivate them to sell it to you. This is a very important point. If an agent says, “you will pay no fee or commission to buy this annuity,” this can be technically true but most misleading. The insurance company pays the commission, not you. But it clearly comes out of your money and can come from nowhere else. It also means that you have less money after the commission is paid, than before you buy the annuity – it cannot be otherwise.

We will show you where to look and how to figure out just how much the many types of hidden fees and charges add up to for a given annuity product, and you will begin to see just why the insurance companies are willing to pay sometimes huge commissions to agents to birddog this business for them. The hidden fees and charges we will show you how to estimate are usually never clearly accounted for on any statements you receive on your annuity. You need to dig deep in a prospectus, sample contract and sometimes supplemental materials to have any hope of seeing them for what they are and what they cost you before you buy. Often you will have to look in two or more places to gather all the information you’ll need to figure total costs.

While this has gotten easier in recent years with online tools, it can still be very difficult for a consumer to get all the facts on costs and product shortcomings.

But make no mistake, you can’t rely on the slick sales talk, brochures and DVD’s to tell you all you need to know – you need to research the fine print, or find someone you trust who knows how to do it for you.

To be clear, as in most markets, products pricing ranges from really good deals to outrageous

overpricing. Outstanding no load product has emerged in recent years, and quality companies offer solid contracts distributed by competent agents compensated by fair commissions for the guidance they provide.

Some annuity products have emerged which offer outstanding guarantees and other features that justify the costs and commissions earned by the companies and agents. But sadly, there is still too much abusively priced, shoddy product from companies with questionable ratings and perhaps dubious sales practices. The problem with annuities is the sheer complexity and murky "disclosure" in this marketplace which makes it very difficult for consumers to tell the difference between good and bad products, needed and useless features, and other key points to make sound decisions. To be fair, there is much solid, fairly priced, absolutely appropriate annuity product that satisfies needs as nothing, but the right annuity can. But there is also so much abuse – particularly seniors' abuse – in this area that consumers are warned to be especially diligent, and demand clear information and answers in writing.

We'll talk about insurance company ratings, since the guarantees come from the companies' promises – and abilities – to pay, and not from some rock-solid government program like FDIC.

We'll get into the rather complicated tax treatment that annuities "enjoy," and see why what is often touted as the big advantage of annuities can sometimes be a disadvantage, since these products can wind up being some of the most highly taxed vehicles in the "investment" world. If you already have annuities, this will help you understand your tax position, and help you consider strategies to control and minimize the tax hit, so that you can better plan to create the maximum wealth for you and the ones you love.

If you own annuities in otherwise tax-deferred programs like IRA's, 401(k)'s, TSA's, 403(b)'s, profit sharing plans, pension plans, and so on, you may be steamin' mad when you realize that annuities confer absolutely zero tax advantage, and actually increase your costs – and so shave your returns – for no good reason but that using an annuity was more profitable for the salesperson and the insurance company than the many other more reasonably-priced investment vehicles that could have been used instead. The number of times we encounter annuities in these plans in our professional practice, where the plan owner or trustee was not even aware that the product was an annuity – continues to shock even us, and we've seen it for years. Annuities offer no tax advantage in retirement plans, and the additional costs and expenses they can impose can really hold back the growth of retirement nest eggs.

On balance, we will also explain the benefits that annuities – and nothing else – can offer, such as guaranteed lifetime income and a way to manage "longevity risk" – the risk of outliving your assets – which can be a key feature in retirement planning.

We will clearly explain the different sorts of annuities, the kind that grow like investments, and the types where you forever exchange your money for a stream of payments, usually over your life span. You'll understand the difference between variable annuities – those insurance products which are also *securities* products, and so also regulated by the Federal government – and the fixed annuities which are only regulated by the various states. And we will explain the newer equity-index annuities, those state-regulated fixed annuities whose return is linked to the securities markets but always less than it, sometimes tragically less.

As we get into the various types, you'll understand where the underlying returns come from, so that you can see just what the companies can afford to really pay you after their commissions, expenses, and profits, and just what you could expect to make yourself if you invested directly in the vehicles on which the annuities are based.

Annuities are universally touted as offering guarantees, and we will show you exactly what kind of guarantees actually exist, and how strong – and how sometimes truly weak – they are in many cases, so that you can judge if they are worth their sometimes-high price in your situation.

You will find that the word guarantee is stretched to new levels of ambiguity for many of these products and is often shamefully misused in actual sales practice.

We will talk about why the apparent "free lunch" of "bonus" annuities can be the too-good-to-be-true promise that you may have suspected, give you some guidelines to calculate what is really going on, how you must ultimately pay for any offered front end bonus, why you'll never really get it, and how the insurance

company amazingly still makes tons of money even after their generous “gift.”

By the time you’re finished reading, you’ll be armed with a whole checklist of red flags to beware of in annuity sales pitches and taught how to detect when the proffered advice may be intended to fuel commissions and profits at the expense of your own financial goals and security.

We’ll show you what your best options are if you are already “stuck” in annuities due to adverse tax consequences, how to perform tax-deferred exchanges, where to find reasonably priced no-load annuities, and why this just postpones huge and inevitable tax hits. We’ll also lay out clear strategies to convert annuity investments into less expensive and lower-taxed vehicles if you finally decide to get out of them.

You’ll learn the basics of appropriate sales disclosure and be able to determine if all required elements were present when the annuity products which you own were presented to you. Then we’ll show you what you can do to make yourself whole if a sale was improper, and whom specifically to make complaints to in order to restore your financial position.

Finally, we will end with a bunch of “true stories” case studies about annuities taken from my professional practice. These will amaze and amuse you, show you just how pervasive overzealous annuity salespeople seem to be, and how overwhelmingly un-alone you really are. But mostly these stories will anger and inspire you, and help motivate you to be careful, use trusted, competent advisors, and make your own situation right.

By the time you read these stories, you should already have all the knowledge and tools that you’ll need to make it right, for you and those you love.

And you will discover if that if you have expensive and unsuitable annuities, that the fault for this is probably not yours for not doing your homework, but rather that of a commission-driven salesperson whose responsibility it was to fully explain the product and all the costs and limitations, and who was either ignorant of his or her craft, or chose to overlook the knowledge in hopes of bagging higher compensation.

Incentives to Sell Annuities – Agents and Companies

Why all the annuities sale pressure? Why are annuities seemingly being pushed by nearly every bank teller, broker, agent and financial planner, sometimes with all the enthusiasm and sweaty persistence of a carnival huckster? In too many cases, it is more about commissions than client needs.

Commissions that can start at what some would consider reasonable – like 4-7% – on the “fair compensation” annuities, and reach a wallet-busting 25% or more on the most client-pounding products than we’ve seen over the years

As an outlier example to make the point, let’s do the math on a 25% commission product: That’s a *quarter-million-dollar payday* for a few hours work in convincing someone to “deposit” a million dollars in a “high interest” annuity. Such abusive products are unusual, but I have seen them out there – and the smoke-and-mirrors accounting that many hide behind can make true costs very difficult to spot besides being very hazardous to your wealth health.

Of course, the money to pay those commissions does not magically appear, but rather can only come from the pocket of the purchaser in a manner so oblique and undisclosed than he probably will not even feel his pants move, unless the agent tells him, which can be far too rare. Let’s put this in “true story” terms.

In the early 2000’s, I met a nice couple in their late 60’s who had been approached to buy an annuity from a nice man who gave seminars in the local library.

The product seemed to offer the chance to make money in the stock market, while at the same time giving strong guarantees of principal and interest. So far, so good. They were tempted, but wanted a second opinion, and asked me to look at the brochure.

The first disturbing item was the surrender charge schedule: it would be *fifteen years* – to age 83, or so – before these folks could get their money back with no penalty. The penalty was a whopping *twenty five percent*

– $75,000 on the proposed “investment” of $300,000 – for the first *five years* of the contract.

As I dug deeper, I learned that the interest guarantee was so low as to seem like 0%, and that the principal guaranteed – *before* surrender charges! – was only 70% of what they invested, or $210,000 of the $300,000 proposed! In other words, a guaranteed loss of 30% right off the top.

Then they would have to pay the 25% surrender charges on what was left if they wanted their money back! If they wanted to cash out quickly – like for a life-prolonging operation or because they found a better investment option like a high-interest bank CD – here’s what they could count on:

Initial annuity premium	$300,000	
Guaranteed 30% loss	($90,000)	
Pre-surrender charge value	$210,000	
Surrender charge 25%	($52,500)	
Guaranteed principal value	$157,500	
Total charges/Net loss:	**$142,500**	**47.5%**

On *three hundred thousand!* Almost half their money! This is the “guarantee” that this retired couple really would have had when asked to “invest” every nickel in the world that they had! Of course, it was not explained that way by the nice man from the library. This amounts to an effective surrender charge of nearly 48%. *Forty-eight percent!*

Furious, I tracked down the insurance company which manufactured the annuity the next morning in the Midwest, truthfully told them I was a licensed agent interested in this product and asked for the commission schedule. Seventeen percent. They paid 17% – $51,000 of this couple’s $300,000 – to agents willing to sell their annuity. Enough for the agent to buy a boat – cash. Why?

Forget for a moment the questionable motives of the nice man from the library selling this fine product. Why in the world would an otherwise reputable insurance company – and this one’s been around for over a hundred years – be willing to compensate a sales force so handsomely to distribute its product? How could it afford to pay what most would view as obscene and abusive commissions? Why would it? Because of profits.

Some would say unreasonable profits, and some would use stronger language. Profits that may boggle your mind when we rip them, still wriggling, out of the Byzantine contracts that produce them, and lay them bare in the sunlight for you to see.

To some, it may seem that cases like this suggest some insurance companies, hungry for profit, have made monsters out of their salespeople, and reduced the investing public to no more than faceless cattle, obliviously awaiting the sharp edge of the commission knife.

Is this an isolated, one-in-a-million situation that has somehow slipped by the regulators? Sadly, I don’t think so. While at the more extreme end of the spectrum of annuity sales abuse, cases like this can seem all too common, and have been happening for years. Though one would expect that competition and disclosure should drive costs down to the benefit of the consumer, alarmingly, things seem to be going the other way: buried insurance and other costs have appeared to be rising.

While there *are* reasonably priced “good deal” annuities to be found – we’ll show you where, later, if you want or need them – they can very sadly be the exception to the rule of the blizzard of high-pressure, high-commission annuities littering the modern financial landscape.

What makes annuities so easy to push so hard? From the salesperson’s –the agent’s/financial planner’s/banker’s/stockbroker’s – perspective, those big commissions make these products easy to love. The percentage paid out in commissions seem unrivaled in the legitimate investment products world, with some so high as to approach the stratospheric levels paid out to push some life insurance. As we’ve already seen, in my experience annuities’ commissions have been as high as 25% of the investment in the worst cases.

These big commissions are almost always of the "back-end-load" variety, which makes them less than obvious to the prospective customer, even when the surrender charges are properly explained by the salesperson, which isn't as often as one might like. And even when they are mentioned, it is usually done in such a way as to make them seem far less expensive than they really are.

Back-end-loads – called surrender charges in the insurance industry – work like this. We'll use an example from the real world I researched a few years ago. A product called "P-10" has a surrender charges schedule described as 12/12/11/10/9/8/7/6/5/3/0, in the standard format for such things. What this means is that if you "surrender" – ask for your money back – in the first year after they cash your check, they'll keep 12% of your initial investment as a surrender charge. If you cash out in the second year, the cost is also 12% of your initial deposit, 11 % the third year, and so on, until the surrender charges are gone in the eleventh year. This product, by the way, paid a 9% commission. These charges are at best "semi-hidden" from a sales perspective, making them much less obvious during the sales process. Normally, you see what they are in print in only a few obscure places: in the prospectus, if it is a variable annuity (if it is not a variable annuity it is not regulated by the SEC and you get no prospectus); *sometimes* in small print on the application (an annuity is an insurance product, after all, for which you have to "apply") or on a separate grayscale disclosure form; and somewhere in the annuity contract, which you don't get until after they've cashed your check, and likely paid the commission. Much more prominent, on the statements, in the contract, on the salesperson's lips, and on your mind, is the "accumulation value," the amount we'll *pretend* you have if you do not want all of your money back. Eventually, after the surrender period has passed, the accumulation value is the same as the surrender value. But try to get out sooner, and you may be shocked to find that the surrender value is a whole lot less than you thought you after surrender charges, forsaken "bonus" interest, and other costs. Talk about "substantial penalties for early withdrawals!"

The best agents will go through the surrender charges with you as part of the process, but don't expect them to not downplay it – their income depends on your purchase. Some agents may not mention it, knowing that you will probably not even know they exist, or where to look. The worst will mislead you about them, even when confronted with a printed surrender charge schedule, telling the customer that they misunderstand. If you hear "don't worry about fees or commissions – I'm paid directly by the company!" – your guard should go way up. Ditto if they look you in the eyes and tell you that you pay no commission: while at best this may be half true (since the company technically pays the commission after they take your money) it can be extremely misleading since the commission comes directly out of your pocket. Ask instead if the sale rep is making a commission – and get the answer in writing.

The vast majority of contract owners never discover these charges – or the high annual fees, either – unless they try to cash out, or someone like me reads the material and points them out.

So, the back end loaded nature of annuities makes it a lot harder from an investor's perspective to see what's really going on, at least initially. This makes them easier to sell. For instance, if you had a 10% front-end (off the top) commission on a $500,000 investment, it would soon be obvious to you – as soon as you got a statement or the annuity contract – that you only have $450,000 left and that you paid what you might consider a huge commission. If you were told this up front, you might not buy, and you will raise bloody hell pretty quickly if you were not.

If, instead, everything you get says $500,000 except the fine print you never look at, you are much likelier to buy and keep, even if you know about it up front, because you can pretend it does not exist. Even when it's not that bad, it is usually easy to be confused and not catch the surrender charges.

Take note: whether it reads like "we take $10K and leave you $90K" or "we've made believe you have $ 100K" the $10K still comes out of your pocket. It can come from nowhere else.

Oh, and don't expect the agent to rave about his or her commission. Most won't mention it, and most will leave you with the impression that they work for free. Again, when pressed, too many will smile and say something like "don't worry, I'd paid directly by the insurance company." Which, of course, is *literally* true.

But make no mistake, the money comes directly out of your pocket – it can come from no place else if the insurance company is to turn a profit. Sadly, most agents never know – or care to know – just how much *you*

pay to them and the insurance company, however indirect and obscure the math is, though they tend to be very knowledgeable about their own compensation, and many can even be caught secretly calculating their commission while they chat with you, if you watch carefully – some may even text their significant other about their pending windfall!

GOOD SALES, BAD SALES: DUTIES AND DISCLOSURE

This leads nicely into the next reason why annuities can be easy to sell for those more interested in high commissions than in providing high value to investors: threadbare disclosure of material facts, like commission levels, surrender charges, costs and fees, risk levels, taxation, and the other factors which bear on a prudent, well-reasoned decision. Not that annuities are unique in this. Variable annuities share with most investments which are *securities* (and so regulated by the Securities Exchange Commission, or SEC) minimum required disclosure which is so obtuse and scattered as to be invisible in plain sight to most people. The tale is the same for mutual funds, "managed money," wrap accounts, and other "packaged" investments as well, and are only some of the many, many ways the financial industry dips its collective beak deeply into the pocket of the investing public with nary a trace or a thank you.

But the required disclosure for fixed annuities – those regulated only by the individual states' insurance commissions, since the life insurance industry lacks any Federal oversight – has been virtually non-existent, and still has a long way to go to be obvious to most consumers. Matters in this regard have been so bad that the companies themselves, in order to gird themselves against future litigation for misleading product sales, often impose more in the way of disclosure than the states require! Of course, it still has a marketing spin, and is usually in no way adequate to communicate the material facts to the person of average financial knowledge. Please note that equity index annuities – those that offer stock market-based returns, but guarantee return of principal – are fixed products beyond the reach of SEC disclosure.

This has been a major product growth area, and chances are strong you've been pitched one of these, especially after the market meltdown of 2008, and with the 2015/16 corrections. These are the kind that say something like "if the market goes up you make money, but if it goes down, your principle is guaranteed!" In reality, index annuities are complicated derivatives products, but they are not invested in stocks or other securities, and hence beyond the reach of the SEC – they are regulated by the States as the life insurance policies they really are.

The fact that annuities' commissions lack mutual fund-style breakpoints – where the percentage commission goes down as the dollar amount goes up, giving a volume discount, as it were – make very large dollar commissions possible. Fifteen percent on a million-dollar sale – and sales of this magnitude occur every day – means a $150,000 payday for one sale. Eight percent – a more typical payout, perhaps, still nets the salesperson $80,000. Fast. Breakpoints have been a staple of the mutual funds industry for decades. Even a "fair" commission of 7% nets $70K – not bad for a few hours' work!

Two more points, and I'm sure we will have convinced you to go out and sell annuities yourself, for profit and profit. Commissions are typically paid quickly, in many cases weekly, as soon as the investor's check is cashed, and any state-required rescission period – the ten to thirty day "free look" has passed. So the money is quick, as well as big.

And, finally, insurance agents, planners, and other salespeople who know the ropes can make tons more selling annuities than other investment products like mutual funds, since they generally get to keep the entire commission, instead of being forced to split it with their "broker/dealer" or sponsoring securities sales company. And many even seem to make a habit of finding "better" annuities every few years, and recycling investors' money in what can look like a perpetual commission machine.

BASIC ANNUITY ANATOMY

Let's begin with a basic premise: Annuities are life insurance contracts. Annuities are *life insurance*

contracts.

Those are just words, even with the repetition and the emphasis. So what does it mean? It means that instead of a direct investment in an investment vehicle, annuity owners exchange their dollars for promises – with lots of stipulations – made by life insurance companies. These promises may be straightforward or convoluted, indeed. But instead of having direct claim over specific assets – like shares of stock, or dollars in a bank – you have accepted a promise, which means that you are at least one more step removed from what you had thought you were buying.

These promises can often appear to be thin shadows of the property you thought you were purchasing, for a variety of reasons, which we will explore.

It is very important to realize that while all annuities have certain aspects in common, each one is a unique contract written by the insurance company's legal staff, and can vary tremendously from other annuities contracts, even those issued by the same company! It is important to read and understand to see just what you may have.

As "permanent" life insurance contracts, all annuities have two basic elements: a cash feature, and an insurance feature.

The cash feature is ultimately an income one, designed to pay income to the owner for some specified period, usually life. The insurance feature is some permutation of a death benefit, usually very watered-down, and usually very overpriced. We'll look at some hard examples in just a bit.

Since we are talking about a life insurance contract, these are things that you have to apply for, though in reality not too many applicants are turned down, since state of health really plays no role in issuing the veneer of life insurance. In fact, in the annuity world, poor health should equal better rates, but hardly ever does.

On the application, besides the insurance company, there are three parties who apply, though they can all be the same person, and often are.

The first party is the ***owner.*** This is the person who has the right to all the benefits of the property, which is the annuity contract, can access the cash value within the constraints of the contract, and can change those things the contract will permit, such as the *beneficiary.*

The ***beneficiary*** is the person or entity who gets the value of the annuity contract – if any remains – at the death of – you'll never guess – the *annuitant.* More on the annuitant in the next paragraph. In this, an annuity is like a life insurance contract, except that the beneficiary gets the bundle on the death of the annuitant, instead of on the death of the insured.

So what is an ***annuitant?*** As we will see in a bit, annuities are really designed to payout an income for a term which is usually based on someone's lifetime – even the word annuity is heavy on the "annual." If you think of a pension, where the pensioner gets so much for life, or a little bit less for their and their spouse's combined life – you will have a good idea of the basic premise of an annuity.

I know, I know, most of us think of annuities as *accumulation* products, and maybe the agent never told you about the automatic conversion to lifetime income provisions on page 46b of the contract. But trust me, they're in there.

Now, since the whole basic premise of an annuity is to generate lifetime income for someone, it matters who that person is that the contract's payout features are to revolve about.

How old they are – and how long they might live and collect – is a big one, for instance. The person whose life determines the annuity's payout behavior is called the *annuitant.* Insurance companies often describe the annuitant as the "measuring life," but that doesn't really tell us much by itself. So now you know: the annuitant is the one whose life determines the payout of the annuity – for instance if a "pure life," or payout only for the annuitant's lifetime, option is selected, then income stops at the death of the annuitant – and whose also is the life which acts as the insured so long as there is some life insurance benefit to the annuity.

The annuitant has no rights by virtue of being the annuitant; the life of the annuitant is simply a yardstick. Permanent conversion of an annuity's accumulation value into regular income – a process that cannot be undone

– is called ***annuitization.*** Annuity contracts specify some future age at which this will happen automatically, but most folks die or clean the contracts out long before automatic annuitization.

The owner controls the contract and gets to pick the parties at inception (usually once the contract is issued, the annuitant can never be changed). The beneficiary gets whatever life insurance value may be left at the death of the annuitant. The same individual can – and often does – play all three roles. Groups of people can also play any or all roles: Jim and Jack can own a contract measured by the joint lives of Jane and Jill, with John and Joan to split the proceeds if the annuitants die. And we are not even into contingent beneficiaries yet. But there still are only three basic parties, even if each party really looks like a party!

It is interesting to note that many insurance companies specify a maximum age allowed for annuitants, and actually cut the commission rates that they will pay salespeople for older annuitants. It is for this reason that unscrupulous agents may sometimes suggest that a younger spouse or child be specified as the annuitant, but this can be a very poor move for the annuity owner, for both tax and liquidity reasons. The reason that life companies prefer younger annuitant ages is twofold: most contracts will waive the surrender charges (fees to access principal in early years) at the death of the annuitant, and the older the annuitant, the sooner that will be, statistically speaking, and the shorter the insurance company will have the money available to recover sales commissions and profit on; the other reason is that the older the annuitant, the sooner the contract will automatically annuitize, and the sooner the company will have start paying out an income, which can also cut into profitability.

Types of Annuities

And so, we begin our tour of the mystifying world of annuities. **Welcome to the jungle.**

Immediate vs. Deferred Annuities

The first basic distinction among annuities contracts is between immediate vs. deferred. As we have seen in the preceding paragraphs, all annuities are designed to be *irrevocably* converted into income at some point, by definition. We might even say that deferred annuities – those that appear designed to grow like bank or investment accounts and offer some access to our principal – are simply waiting to grow up into immediate annuities, at which point our claim on principal goes poof, and we have only a stream of periodic checks where once was a mighty pool of liquidity. Once again, by contract and by design, a deferred annuity is an immediate annuity waiting to happen.

In a moment, we are going to make believe that there really *is* a distinction, but you MUST forever bear in mind that annuities are designed to ultimately convert liquid principal into income according to some contractual scheme. This is a fundamental characteristic of what annuities *are.*

We'll get into a bit more detail later, and for now will focus on the very basics. OK, here we go.

Immediate Annuities

Immediate annuities are annuities in their purest form. With them, the buyer irrevocably – which means you can never change your mind and undo the contract – converts principal into income, paid monthly, quarterly, or annually – which are the most common intervals – or every blue moon, for a specified term. The term can be for a period of years, and a good way to think of these annuities is like mortgages in reverse: instead of borrowing a sum and paying it back, with interest, over so much time, you give – actually lend – a sum of money in exchange for payments, with interest, until the contract has been repaid. The payback term can be very straightforward, like for twenty years, and at the end the entire sum has been returned at the contracted rate of interest. This simple type of annuity is called for a *period certain,* and the insurance company makes money by paying you a rate of interest lower than it expects to be able to earn on the money it invests.

This is very similar to how a bank makes its money, on the *spread* between what it earns, and the lower amount it pays depositors.

Buyers take note: in the ultra-low interest rate environment of the post Great Recession world, in many cases annuity payments may be calculated such that you barely get principal back with little or no interest, and it is possible that you get back less than you put in. There are many, many moving parts, and this is an oversimplification, but it is entirely possible to contract to receive lifetime payments that add up to less than you put in, sort of a negative interest effect.

But annuities, being life insurance contracts, are subject to the dark art of actuarial science, the cold equations of money and death, and most annuities are based on payouts figured on the life expectancy of the annuitant.

With enough lives in the pot, an actuary can pretty precisely calculate the average payout period – based on the average life expectancy of annuitants – and price annuity interest payout rates such that the insurance company is very likely to make money.

A *pure life* annuity pays for only so long as the annuitant shall life. Annuity payments continue only so long as the annuitant is alive. If we assume an average life expectantly of twenty years for a given age class, the insurance company really makes out on those that die sooner and gets hurt on those that outlive the life expectancy. This latter point – the ability to contract for income lasting longer than life expectancy if you live a long time – is a key benefit of annuities that nothing else (except a pension which is really an annuity) will do. More on these so-called longevity credits later.

Of course, as in Vegas, the insurance companies don't ever expect to actually get hurt. So long as they have enough players, the laws of averages come into play, and the house will always win, since it is the one who gets to set the odds, provided it is smart enough to set them right.

Let's look at an example from the good old days when the word "interest" actually meant something. Say we assume an average life expectancy of 20 years, and a $100,000 annuity premium to be annuitized into income. Also say that prevailing investable interest rates – like on high-grade corporate bonds, mortgages, and long-term government bonds – average 8%, and the insurance company can invest annuity premiums at that rate. Investing $100K at 8% for twenty years will pay $836/month for twenty years, after which – just like a mortgage in reverse – the principal will have been repaid with interest, and the payments will cease. If the insurance company sets its annuity payout rate at 5%, the annuity will actually pay $660 a month, leaving a spread profit for the insurance company of something like $176/mo. This will translate into a profit of $104,000 for the insurance company at the end of the twenty years, before expenses. This is the same thing as saying that $176 invested each month – the "extra" earnings on the annuity premium that the insurance company keeps – will grow to be about $104K after 20 years at 8%.

The blissfully ignorant annuity payout recipient will get $660 a month. If he (men have shorter life expectancies) dies sooner than twenty years, the insurance company pockets the unpaid balance. If she outlives the twenty years, the company will have to keep paying out of its profits until she dies. To put things in modern context, the payment would be $417 a month over 20 years with a zero-interest rate.

But those that say "the annuity owner bets they will outlive their life expectancy, and the insurance company bets they will die sooner" really miss the point. Insurance companies endeavor to predict with cold accuracy how long the average annuitant will live and build in a healthy margin to make sure they make money. And the trick is really in the interest rate used to figure the annuity payments: the lower it is, the lower the payment, and the more profitable the product for the company. Back in the 1990's as a life agent selling these kinds of products, I was constantly amazed at the difference in offered payouts for the same person for the same premium. Given (we presume) the same assumed life expectancy, and the same premium dollars offered, the monthly payout quotes varied widely. The only difference was in the interest rate used to figure the payout…and the profit for the insurance company.

Once you get a feel for this sort of black art, all kinds of payout periods come to mind. *Joint and survivor* means we will pay until the last of two people die, and, of course, given their sexes and ages, we can figure a joint life expectancy on which to base the payout period. *Joint and one-half survivor?* No problem! We'll figure full payout for his life expectancy, then mix in a payment cut in half for the balance of her life expectancy after he dies. *Refund* annuity – where they'll pay out the "unpaid" balance of the unpaid initial premium in case he dies before getting all of his initial outlay back at his death? Piece of cake. Since the insurance company can easily compute the average payout term in any such scenario, making money is easy, since it can always figure a payout level less than what it will make on the money paid in via immediate annuity premium, provided it gets average life expectancy right.

Of course, it goes without saying that the layperson is helpless at trying to duplicate the math and evaluating just what a "fair" payout level might be. Too many folks think that "getting the money back" – breaking even – after so many years is a fair proposition. Remember that getting $5K a year for twenty years is breaking even, but that at even 6% the really fair annual payment is over $8,700, a 74% difference. And that most of us can – and should – shoot for far more than 6% over a twenty-year income
Period – even with the low interest rates of the early 21st century. 8% bumps the annual payment to $10,200, more than twice break even. 10% brings it to almost $12K annually.

But for those with the right training and the right computers, making money by pricing annuities for insurance companies is as easy as setting up the slot machines in a casino.

This payment amount, by the way, can be based on the interest rate prevailing at the time of annuitization (best to shop, these rates vary from company to company even on the same day), in which case we have a *fixed immediate annuity* whose regular payment amount does not change from the initial schedule. While the schedule can incorporate future changes triggered by events like inflation or the death of an annuitant, the payment itself is determined by the interest rate at annuitization. *Variable immediate annuities,* on the other hand, have payments whose amounts vary based on the performance of securities markets, like stock indices. These can be complicated beyond the belief of the layperson and turn out to be real shockers for those on fixed incomes when the markets drop.

Deferred Annuities

Deferred annuities – and remember, they are by contract only immediate annuities in waiting, designed ultimately to annuitize the accumulated value into a payout stream on which the insurance company still plans to make money – are packaged to really look like investment products.

It is therefore the payout – not taxes, as so many improperly infer – that is deferred in deferred annuities.

It is this payout function, latent and lurking in deferred annuities, which is what makes an annuity an annuity. Never forget this.

With deferred annuities you put in so much – up front, on a regular monthly or other basis, or both – and hope to watch your money grow. With all of these, you need to beware of *surrender charges,* which are fees that you will pay if you decide to get out of your contract, and move the money, even into another annuity contract. Some contracts will assess a flat percentage, which will usually decline a bit each year – or after each of several years – by a percentage point or two, until the surrender period had passed. These surrender charge percentages have ranged from the merely expensive – like 3 or 4 or 8 percent – to the truly outrageous, like 30% of your invested principal, or more. It doesn't look like much, but 6% of $200,000 is $12,000 if you decide you want your money, and 15% of the same sum is $30,000. Surrender periods can range from a few years to over a decade, or more.

It can be easy to rationalize away surrender charges because you plan to keep the annuity for a long enough term to get past them but remember how tightly they can limit your options.

If interest rates go up again, but your contract does not keep up (because the insurance company is stuck with the low-yielding investments they put your money in, or knows you are unlikely to leave and pay a big surrender charge), you may find the liquid restrictions really cut into your returns.

Deferred annuities – and the remember deferred really means that the annuitization component, gateway into the land of lost liquidity, is by contract deferred to some future date – come in two basic flavors.

FIXED ANNUITIES

The first flavor is commonly referred to as *fixed* annuities. These are the simplest to understand, and analogous to CD's and other deposit accounts at banks. It is important to remember that the guarantees on these insurance products are far weaker than FDIC-type guarantees on bank accounts. They pay specific annual interest, usually set in advance each year, with guaranteed minimum interest levels. They can get wickedly complicated, what with bonus interest and other smoke-and-mirrors inducements, but at their core are very simple, at least for the insurance company issuing the contract.

The *surrender value* is the cash-out amount that you'd receive if you surrendered the contract and asked to move your money. The *accumulation value* is an amount that appears on your statements, as is what the contract is worth so long as you don't ask for all your money. It some ways, it is a make-believe number, since the surrender value is all, you have access to if you need more than just the interest and/or a small annual percentage of principal (usually 10%) of your money, which you can usually – but not always, check your contract – access free of surrender charges. So, surrender value is equal to accumulation value minus applicable surrender charges and other fees and "haircuts." A haircut, by the way, is an old securities term for taking a chunk out of value for some reason. They should have used "shave" instead.

Interest rates are usually a bit higher than banks, since they do not offer FDIC insurance, which means that the guarantee of principal and interest is basically an insurance company guarantee, and dependent on the financial strength and goodwill of the insurance company. Access to principal is often restricted, through surrender charges, for two primary reasons. First, in order to get a decent return (with a *portion* going to you), the insurance company will need to tie up the money for a longer period, and if they have to cash out of an investment in order to give you your money at an inopportune time, they will make you feel some of their pain. The second reason is because of the commissions they had to pay in order for a salesperson to bring them the business: if they haven't had enough time to make a profit on your money on top of the commission they had to pay to get it, well, again, that pain is for you.

This annual interest rate will usually be somewhere between mid-term (2-5 year) CD rates, and the rates actually paid on good-quality corporate bonds, mortgages, and the other things that insurance companies will invest in with the money collected in annuity premiums.

Market Value Adjustments (MVA's) are a kind of additional surrender charge that has nothing to do with commissions and are a way that the insurance company sometimes uses to pass risk on to the purchasers of annuities. They're kind of sneaky and make fixed annuities with them act more like the SEC-regulated variable annuities that we'll get into later – without the greater disclosure required of SEC-regulated products. They work like this: when interest rates go up, bond prices go down, which means if you cash in during a period of rising rates, the insurance company will get less for the bonds they put your money in. With MVA annuities, you will then get less, on top of any commission-derived surrender charges.

Let's talk about *bonus interest* for a moment. Bonus interest is an extra percentage that an annuity may credit to your premium when you buy and can look awfully good at first blush. For a "5% bonus" annuity on $100K, your initial "deposit" is considered to be $105K ... and then you'll "get" whatever annual interest the product pays credited to your accumulation value as the months roll on.

It is important to remember that we get little in life for free, especially from big financial institutions; when you get down to the nuts and bolts, the bonus is kind of nebulous.

It has to be; if the insurance company could conjure money out of the air, it surely would keep it for itself. Believe me, any bonus is reclaimed by the insurance company in higher charges and fees over the years that you keep it, or in stiffer surrender charges if you try to pull your cash before they have time to nibble it all back. If you think carefully on this, you will realize that it cannot be otherwise. Remember the "too good to be true" axiom. Particularly troublesome is where these smoky bonuses are pitched to make up the surrender charges on products the salesperson wants you to replace with his annuity; since the bonus is a chimera, the hapless investor can be subjected to two surrender charges, when before the new commission – I mean the new annuity – there was only one. Bonus interest in general, and on replacements in particular, has attracted a lot of unwanted attention to the insurance industry from the insurance and securities regulators.

The last wicked twist on fixed annuity contracts are the increasingly-popular *equity index* annuities (EIA's). These are important and have become quite pervasive. These are enormously complicated contracts that pay interest, which is based on the performance of securities indices, like the S&P500. Because they are fixed contracts, they can offer principal guarantees and guaranteed minimum interest, but often is so low as to

appear negative even before the sometimes-massive surrender charges that they carry. Remember the example of the elderly couple and the "nice man from the library" early in the book? Surrender charges on that product – after receiving the guaranteed interest on only 70% of their principal – amounted to a whopping 48% of their money. The pitch with these is that you can have the security of a guaranteed product with the upside of the stock market – which is a very compelling notion. Of course, this kind of security comes with a cost. Besides surrender charges, EIA's often typically apply cap rates – your return is limited to some cap, like maybe 10%, even if the marketing goes up 100%. They also often impose participation restrictions, whereby you only get a portion of the return, with the rest going to the insurance company. For instance, if your participation rate is 80%, and the underlying index does 5%, you get .8 x 5% or 4%. The basic EIA structure is something like this: the insurance company bundles your money with that of other annuity buyers to buy a bond portfolio that pays interest. You get a portion of that interest, as does the insurance company, and some of it goes to buy options on the stock market; if the options hit, you get some of the gains, and the company gets some too. The principal guarantees are based on the bonds but ultimately guaranteed by the insurance company, not the bonds. This is really just the tip of the iceberg on these complicated derivatives products, and you should read very carefully to make sure you understand before buying one. It gets much more convoluted, and can involve MVA risk, specific participation periods and methods, ongoing investor management requirements, and more. One last thing EIA's often share with other annuities' types, multiple and misleading "accounts".

Besides tracking accumulation and surrender values, EIA's often have income accounts, a number that only has meaning if you decide to convert to income payments but is not a cash value you can redeem. EIA's provide a bundle of features - convertible guaranteed lifetime income that can't be outlived, principle and sometimes minimum return guarantees, and access to participation in securities markets' returns without actually being securities – that are important and generally impossible for consumers to build on their own without an insurance company component. Products are attractive but very complicated and are often expensive and come with potentially disturbing liquidity restrictions. In my view, EIA's offer some of the greatest benefits – and most dangerous pitfalls – in the investments landscape today.

VARIABLE ANNUITIES

The second flavor of deferred annuity (though remember that those immediate annuities can also be "variable" because the payment is based on securities) is called variable, from the fact that your ***value*** *(payment* in the case of an immediate annuity) can ***vary*** based on the performance of securities markets. In other words, your account will be worth more or less depending on the stock and bond markets.

These products are often called "mutual funds in an insurance wrapper," and I think that description is a good one. Unfortunately, in many products the funds tend to be overpriced, and insurance and other costs can get layered on, sending total fees to untenable levels.

Often these fees are for unneeded – and sometimes grossly overpriced – features.

On the other hand, extremely low-cost no-load variable annuity product is available, often favored by those who prefer fee-only advisors.

Variable contracts are usually so convoluted and complex that many owners never really understand precisely what they have. Here are the salient points: unlike for EIA's the risks of gain or loss are as great as when dealing with most any mutual fund family and will be influenced by *your* ability – make no mistake, this is your responsibility, not the salesperson's – to select and maintain funds and investment asset classes which minimize risk and maximize gains. As many investors sadly learned during the Great Crash of 2008, this is no small feat. But proper investment management is another subject entirely.

As with fixed annuities, the insurance company is looking to make money on your money. With fixed annuities, they earn a banker's spread – invest your money at *x%* and pay you *x% -y%,* with y being their profit. With variable annuities, there are two distinct profit mechanisms: the mutual fund fee markup, and the life insurance cost, which they call the mortality cost. All mutual funds charge a percentage of investors' account value, to pay bills and make money for the fund. These percentages tend to be much higher in variable annuities (where the mutual funds are called "sub-accounts") than in fairly priced mutual funds. Insurance companies often profit by either putting their own expensive funds in their annuities, or by offering funds from other (usually big-name) mutual fund companies, then jacking up the mutual fund fees. Charging 1-2% *annually* for the mutual fund fee is by no means unusual, and this is *before* the insurance cost.

These fees – both for mutual funds and variable annuity sub accounts – are never accounted for on any statement. You have to dig in the prospectus – and sometimes in a prospectus supplement too – to find out what they are. But trust me, they're in there.

The mortality – read life insurance – cost is included because annuities, being dim life insurance contracts, guarantee that at least the value of your initial investment will be paid to your named beneficiaries at your death. So you have insurance, equal to your premium payments minus current annuity value, if you happen to die at a time when your annuity is worth less than you paid for it. Lately the insurance companies have gotten very creative at offering additional insurance features via riders, at substantial, additional cost. But this is the basic premise. Like the mutual fund fees, these insurance charges are never accounted for, so most people don't realize they exist.

A mortality charge of 1.25% is very typical and would equate to $6,250 per year in insurance charges on a $500,000 annuity. Remember that the amount of insurance is only the difference between the total investment and the value on the date of death; much of the time, there may be no real insurance at all.

For instance, if we invest $500K and the annuity suffers a huge drop to $400K AND WE DIE, there is $100K of insurance. Whenever the value is equal to or greater than $500K – and the longer we own it before dying, the greater the odds that the value will be greater than what we put in – there is no insurance.
Of course, those mortality charges keep coming out. In this example, $6,250 a year.

Contrast that with the going rate for term insurance: a healthy person of age 66 could buy $100K of insurance for something like $400 a year, with no rate increase for 10 years. He or she could die at leisure – market up, market down, no matter – and still receive a death benefit. In fact, they could buy over $1.5 million of such insurance, and still not pay as much as the hidden mortality charges in the annuity example above.

So, on variable annuities, the insurance company makes money – without any investment risk, I might add – in two principal ways: mutual fund fees, and insurance charges. Two percent a year is probably a fair average estimate, and not too far off the estimated "banker's spread" they make on fixed annuities.

And lest you think 2% is trivial, know that on a $500K investment, 2% more is 100K more in 10 years, and $250K more in 20 years. And 2% less via extra fees means so much less, as well. Bad as this is, many "full-feature" variable annuities cost upwards of 5% a year with all the bells and whistles. Even for those who need the features, that can be prohibitively expensive. And for those who don't, it can be tragic.

How Annuities are Priced: Costs, Fees, Charges and Commissions

Once upon a time, annuities were fairly simple products, on which the insurance company sought to make money on the interest rate spread between what it earned on bond-like investments, and the interest it paid out on life insurance contracts like annuity policies. In this way business was a very bank-like proposition – and at least one author referred to insurance companies as the "the invisible bankers" – with the twist of having to manages life expectancy risk along with interest rates.

These days, contracts, and opportunities for insurance company profits, have gotten lots more complicated. Besides the spread, contracts can be loaded with lots of other expensive features and riders, from guaranteed income, refund, death benefit, market high water mark, to investment reallocation and timing change privilege features. These can be on top of the administrative, mortality, sub account ("mutual fund"), premium tax, and other charges found in popular variable annuity products.

In many cases, total costs are astonishingly high, "hidden" in many different documents, and hard for consumers to figure out and put together. It can often be best to ask a knowledgeable advisor to examine a policy and report on total costs, to save you effort or to make sure you catch everything.

One rule of thumb, however, seems pretty accurate and is quite simple: you can usually infer the commission of the sales team pitching the annuity, and it is often close to the same percentage as the first-year surrender charge. If the first-year cost to get your money back is 8% - and it gets way worse than this – odds are good the agent team made the same. That's some $80,000 per million in annuity premium, folks, pretty much as a transaction fee with no real promise of ongoing service or investment management.

Types of Guarantees

At the end of the day, annuity guarantees are pretty much only as good as the insurance company's ability and willingness to pay your money back. While there are state guarantee funds to backstop failing insurance companies, these are nowhere near as robust as FDIC, and should not be considered absolute guarantees – if the insurer goes belly up, it may be years before you get your money, you may not get all of it, and if the fund goes dry, there is no telling what might happen.

So be warned. For this reason, insurance company ratings – similar to the bond ratings that help you gauge how likely you are to get your money back – are critical. Unlike junk bonds – junk because the promise of bond repayment is questionable – annuities don't trade on a marketplace and can be very illiquid considering surrender charges and redemption issues if a company gets into trouble. My suggestion is to stick with top-rated companies, and also those you expect to remain top rated over the period before which they will hold your money, perhaps as long as you live, or longer. Remember things can change, and a company sporting top ratings now may be a completely different animal later in your life.

The lure of lower rated companies can be high, since they will often offer consumers tempting features like above-market bonuses and more lucrative return formulas.

Remember that they will offer better terms because they may have to get investors to overlook the higher risk of defaults and will usually spin their ratings story as positively as they can. Don't forget that old "let's put some lipstick on this pig" commercial. Remember also that lower rated companies will often offer higher commissions, trips, and production bonuses to agents to get them to overcome their aversion, and that big payouts can make for a powerful sales pitch. If you choose to use a lower rated company, be smart, and only invest on the same limited basis you would consider for any other higher risk investment.

Tax Treatment

Annuities are taxed kind of as a hybrid between "qualified" retirement plans and IRAs, and regular taxable investments. For annuities inside such plans like IRA's,401k's, TSA/403b's, etc, the IRA tax treatment controls, and the entire value of the annuity – initial investment and all the growth – will be taxed as ordinary income in the year you take it out, which means you will pay your highest tax bracket on the distributions.

In other words, they are treated just like any other investment in such an IRA for tax purposes. The same is generally true for ROTH's – tax free treatment once the ROTH criteria have been satisfied – but check with your tax advisor to be sure.

Annuities outside of retirement plans – so-called "non-qualified" annuities, those you buy with after tax money – "enjoy" their own rather quirky tax treatment, which can prove rather oppressive. For one thing, the tax treatment is ordinary income (again, read your highest marginal tax rate), which can be double the rate on capital gains, generally applied to stocks and much mutual funds growth. This is worth underscoring – annuities' growth is generally taxed at up to double the rates on other types of investments. This can be a real damper on the wealth value for consumers, who can only consume what's left after taxes. And while the gains on non-qualified annuities are deferred – which means you don't pay tax until you actually pull money out of the contract – the same sort of 10% penalty as for IRA's applies to pre-59 ½ distributions. In that case, you pay your highest marginal tax rate (and the distribution can easily put you into a higher bracket), *plus* 10% of the taxable distribution. This is quite different from capital gains treatment on things like stocks, which are also deferred until you choose to recognize the gain and come with no pre 59 ½ 10% additional excise penalty, besides having a top tax rate about half of the top ordinary income tax rate. Finally, annuities are subject to last-in-last-out ("LIFO") rules, which means you have to pay the tax on all of the gain before getting your initial investment back tax free. This treatment can bunch taxable events, accelerate taxation, and drive higher rates, all of which can reduce the amount left for you and your family. This is also quite different than the rules for capital gains, which can be much more flexible in letting you and your tax advisor pick your tax shots, reducing tax recognition and better controlling rates to yield more for you.

In many ways, non-qualified annuities are saddled with some of the worst tax rules for investors, and this should give many investors pause.

On the other hand, losses on annuities are "ordinary losses" and can be deducted against other sources of income, like wages, without limit – a big advantage over capital losses. Those who are down should consider the wisdom of this exit ramp, especially during down market cycles where this applies. This can be a big value tax strategy for those "stuck" in annuities. Finally, those with gains should consider "1035" (the number refers to an Internal Revenue Code section permitting this technique) exchanges, which allow tax-deferred "rollovers" between annuities. This can be a big help in getting out of expensive, poorly managed annuities and into low-cost no-load products while avoiding current taxation.

PENSIONIZING ASSETS

Annuities, like pensions and Social Security, offer the promise of lifetime income, something no other investment class can do. With stock, bonds, real estate, and other alternatives, income that one cannot outlive is a risk-based probability (and a hard one to figure accurately), not a certainty. With annuities, so long as the insurance company stays in business and honors its promises, lifetime income is guaranteed. This is why lotteries and pensions often turn to annuities for funding, and it is an extremely powerful proposition. We explored earlier in this paper the various ways that annuity payouts can be figured based on single and multiple life expectancies, and contractual provisions like variable, equity index, and guaranteed withdrawal benefit rider accounts can complicate the income math and opportunity/risk permutations quite a bit.

This lifetime income feature is so important that in many cases it counterbalances and even overcomes the many shortcomings that particular annuities may be saddled with, including high costs, high taxation, illiquidity, and others.

For those whose asset levels are such that the ability to ensure lifetime income is uncertain – true for many but not all consumers – annuities should be seriously considered to fill the income gap, especially for those whose only true pension is Social Security, or for whom pension income is comfortable only so long as both spouses are living. For many, converting some assets to lifetime income – which I call pensionizing – is an important strategy which should merit serious consideration and analysis.

Unfortunately, this analysis – how much asset value to convert, what income deficit must be funded for, and when, and which annuity products offer the lowest costs, best value and most applicable features for a given consumer's needs – can be extremely complicated and is probably best not left to a given commission salesperson's advice.

Longevity Risks – Income and Inflation

The preceding section addresses one of the most profound risks facing today's retirees, that of longevity risk – the risk of outliving your money. For most people facing retirement today, traditional pensions, with the exception of Social Security, are very much a thing of the past. For most folks, Social Security provides a very baseline sustenance income, but is not nearly sufficient to fund a comfortable retirement. The balance must come from personal savings, but if we do not invest well, live too long, or both, odds are good that the well will run dry, even without the added risk of higher heath or long-term care costs. Annuities are really the only practical way to control this, offering lifetime, guaranteed payments. Like most things, such guarantees come at a price. We may not live as long as we hope, and risk getting less back from the insurance company than we pay for the guarantee. This, of course, is the only way the insurance companies can afford to pay for those that live much longer than expected. The other risk, though, is less obvious. Inflation – the high risk of rising prices, especially for things retirees really need, like health care, medication, and other lifestyle assistance – is not well addressed by most available annuity products. Unlike Social Security or traditional pensions, cost of living increases are not typically found in available guaranteed annuity products, or extremely expensive (read even lower payouts) when found. For most folks, a retirement income strategy combining Social Security, a limited amount of pensionized assets in quality annuities, and a pool of well-managed risk capital is probably the best compromise and best shot at achieving retirement goals

"Red" Money and "Green" Money

As should be obvious by now, annuities should really only be considered as part of a retirement income plan. And considered only – those with sufficient assets or income from pensions, businesses, rental properties, or other sources likely do not need them at all.

As pure investments apart from the income feature for which annuities were designed, annuities are generally a poor choice, given high typical costs, commissions, and rather oppressive tax treatment both at the income and estate tax levels. This is even true after considering the guarantees of equity index annuities, with principal protection and stock market participation. Unless you really need income, you will almost certainly make more money over the long haul by just leaving money invested in a stocks or mutual funds program – riding the ups and downs – than in a guaranteed annuity. In fact, the insurance company is counting on that, which is one of the reasons they can offer guarantees and still make a profit – by buying a guaranteed annuity, you transfer some or most of the long-term profit potential of the stock market to them.

That said, for those who have a retirement income gap – guaranteed income sources like pensions and Social Security do not add up to enough to fund a floor or minimum acceptable lifestyle – the Money Color concept can be a useful rule of thumb to help think about the issue and guide decisions. In this concept, "green money" represents guaranteed income sources like pensions, "yellow money" represents cash and cash equivalents like bank accounts and safe, short-term bonds, and "red money" represents risk capital, like stocks, subject to market fluctuations and changes in value. Here's the premise – put enough into green money to fund for a minimum acceptable lifestyle, deploying capital income annuities if needed to bring the level of guaranteed payments up to match floor expenses.

Keep enough in yellow money for emergencies and lifestyle splurges – within affordable reason. Put the rest into a sound red money investment program – which is the engine that offers the greatest potential for wealth growth – knowing you can comfortably ride out the inevitable swings since your needs are covered by green money.

Of course, this is a very gross simplification of an extremely complex problem, but it is very useful in offering a mental map to crystallize the problem and guide sound decisions. This can really help people avoid bad knee jerk decisions, or deer-in-headlights inaction.

ANNUITY INTERVENTIONS – REASONS AND STRATEGIES

As mentioned, sometimes annuities are perfectly appropriate, fairly priced, and important components of sound retirement strategies.

All too often – and most of the time in my professional experience – annuities are improperly sold and poor choices for many investors. They can increase taxes over comparable non-annuity investments, reducing net wealth. Costs often run much higher than other portfolio options, also reducing wealth. Both tax and internal costs are typically hard to spot, and investors may not know what is happening to them. Frequently expensive riders are layered onto policies, greatly increasing costs (and agent commissions in many cases!) to sometimes unbelievable levels. While riders can provide valuable income features, in many cases they are not great matches for client needs or goals, cutting growth for no good reason. For instance, I recently met a doctor who had sufficient pension income and did not need income from annuities – but had most of his money in them with expensive income riders. Since his main wealth goal was to pass money on to his son, the riders worked at cross purposes for him. Worse, income and estate tax treatment differences over alternate investment like stocks or mutual funds will result in a big chunk of potential inheritance needlessly going to taxes instead.

There are lots of good reasons to own annuities, but at least just as many to not own them, or to own more appropriate or less expensive ones.

Assuming it makes sense to get out, qualified annuities (those in things like IRA's or 401k's) can be surrendered (the term for cashing in a life insurance product) without fear of tax impact. Provided the product was a poor choice and the surrender charges are not onerous, you may wish to consider other products like mutual funds or individual stocks or bonds.

Even when surrender charges are high, it pays to get a detailed examination of total product costs – with some products costing in the 5% range each year just for the privilege of owning them, it may not take long to recover even a 10%-range surrender charge, and your ultimate wealth may be much higher taking the hit to reap lower ongoing costs and perhaps better investment management and performance. As mentioned above, actually discovering all the "hidden" costs in multiple documents is sometimes a challenge, and the skeptical may wonder if this is a coincidence. It may be helpful to have a professional review by someone who deeply understands these matters, to help ferret out the many potential costs and put them in context for you.

For non-qualified annuities – those not in IRA's and qualified plans – tax treatment is a little trickier. For those who actually have losses – far too many in my experience – you have the opportunity to write off an ordinary loss, which is much more valuable in most cases than the more common capital loss. In some cases, nearly twice as valuable, even before you consider the time value of money (capital losses by themselves are not meaningfully deductible unless you have offsetting capital gains, but ordinary losses come off your other income, right now, at your highest marginal bracket).

If you have us do the Portfolio Stress Test, we can help you determine your tax opportunities, or exposure. For those with significant gains in annuities, there are two basic strategies, 1035 exchanges, and what I call tax bracket arbitrage. 1035's let you "rollover" an annuity like an IRA, deferring any tax until you actually take money out. As mentioned about, lots of low-cost high-quality no-commission product has emerged that make destinations for money from expensive annuities. 1035's are painless but one must remember that annuities carry perhaps the highest potential tax rate of all investments, so deferring more gains to ultimately just pay more tax may not be the best plan. Tax arbitrage – which is not unique to annuities – just means pulling as much money out in low brackets as you can.

Take a look at the tax table below, courtesy of the IRS for the 2016 tax year.

Married Filing Jointly or Qualifying Widow(er)

Taxable Income	Tax Rate
$0—$18,550	10%
$18,551—$75,300	$1,855 plus 15% of the amount over $
$75,301—$151,900	$10,367.50 plus 25% of the amount ov
$151,901—$231,450	$29,517.50 plus 28% of the amount ov
[illegible]	[illegible]

Beyond mentioning that this is taxable, not gross, income, we won't get into the quagmire of tax math here but note that the complexity of the tax code offers much opportunity for tax savings and wealth building to those with advisors who actually understand it well, which unfortunately can often be a minority! It does not take a rocket scientist, however, to note that it is better to pay a 10% rate than a 40% (39.6%, actually). The first nets $9000 on $10000, the second only $6000, a lot less. So the essence of this "arbitrage" is simply not taking taxable distributions from annuities (or IRA's, or other similar discretionary vehicles) during high bracket years. Admittedly, this takes a bit of sharp, proactive planning – not so easy if you have a typical tax advisor/preparer who does works hard to save you tax and does not practice active strategy on the fly – but it not really complicated to do. Believe it or not, your bracket changes more than you may believe year to year, and your decisions can have more power and impact than you may imagine.

One final word on surrender charges. While many annuity sales are proper and well-disclosed, far too many are not. If you believe the sale agent did not fully disclose risks, charges, surrender charges or other material items, you should probably consider a complaint to the insurance carrier who issues the annuity and to your state insurance commission if you need to. There has been enough abuse – particularly in the senior market – that the companies and regulators are very sensitive to this. There is a good chance that you may get surrender charges back, and other concessions, if the sale was not pure, but only if you squawk enough.

RED FLAGS CHECKLIST

If any of the following apply, you may want to deeply consider if an annuity was properly sold to you, and if you should get an outside second opinion (like by requesting our free Portfolio Stress Test) or consider adjustments or alternatives to your annuity product(s).

- ☐ You don't have a need for income from your annuity products
- ☐ You don't clearly understand the connection between your annuities and income feature you need.
- ☐ Commissions, costs, and surrender charges were not clearly explained to you.
- ☐ You were sold annuities in an IRA or other retirement plan and conversion to a pension-like income stream was not the primary reason for buying the annuity.
- ☐ You don't understand how and how much your annuity sales agent was compensated, and how you pay for this.

- ☐ The ongoing costs for investments, riders, guarantees, life insurance, policy fees, market value adjustments, and other potential charges are not clear to you.
- ☐ You believe an advisor or insurance company is regularly overseeing and managing your annuity investment options.
- ☐ The annuity was positioned as almost too good to be true, and you have a sneaking suspicion that something is not quite right but can't put your finger on it.

ANNUITY WARS STORIES

The following stories are based on actual situations and shared by people we have met in our professional practice. Their names, and non-material details, have been changed, so as to protect their identity. In short, the stories have been fictionalized to save those affected farther embarrassment. The essential facts dealing with product representations and sales practices have been faithfully recorded.

These tales will amaze, amuse, and incite you. They may also inspire you to take

Most importantly, they will help you to realize that you are not alone, if you feel that you may have been subject to less-than-forthcoming annuities sales tactics. From the incredibly high frequency with which we encounter stories like these, we can only infer that this kind of monkey business is nearly epidemic where these products are concerned.

Some are truly beyond belief. And we see things like this *every day.* **The Politician's Wife** Judy came to one of our "Got Annuities?" workshops in Jacksonville, driving over two hours to get to the first scheduled session, even though one much closer would be held a day later. But she was nearly frantic and could hardly wait. She was also simmering mad.

Judy came up to me after the workshop, wanting to learn if she could do anything about the annuity she never wanted, but had unwittingly purchased for something like a half-million dollars.

It seems that she had agreed to invest with a representative of the stock-brokerage arm of a major life insurance company and had only learned that a variable annuity was the vehicle when the contract arrived in the mail some weeks after she agreed to the transaction. She claimed that the broker had referred to the investment merely as "the product," and had never told her that it was an annuity.

Later on, she came in with her husband, a prominent political figure in a small Florida city, who is also a practicing attorney. They are both intelligent people, with substantial net worth. He reiterated her contention that they were never told that their investment would be in an annuity during the sales process, which spanned many months. They also said that they had never received a prospectus, and one was not to be found in their file on the product, even though Judy's husband claimed she was a meticulous record-keeper.

Apparently, they had received a large lump sum from the sale of real estate and put the cash in a money market account with the broker, who was referred by a family member. They did not invest it right away, they said, because the "product was not ready," according to the broker. This is difficult to fathom, since hundreds of investment vehicles – myriad variable annuity products among them – were certainly available at the time they wrote their check. We can only surmise that this new annuity product had some special commission, contest value, or other allure for the broker, which is why he waited, and kept them out of the intended securities exposure for an inexcusable time.

In answer to specific questions by the lawyer and his wife, the broker said that he would make "next to nothing," when in reality the commission was something on the order of $40,000.

Moreover, the couple was concerned about fees and charges should they choose to access their money, and specifically asked about them. They were told that there would be no charges or penalties if they chose to withdraw the entire amount at a specified date that was important to them. In actuality, the surrender charge on their target date was about $50,000, according to the contract.

Before coming in, Judy had read this in the policy she got in the mail and called the broker about it. He told her that she had misunderstood the document, and that there would, in fact, be no charges, so she should not worry, and send in the policy delivery receipt.

As it turned out, the broker's answer was entirely factual, but completely unrelated to the question they had asked! Unfortunately, the answer – dealing with excise taxes – had nothing to do with the question the couple had asked, and amounted to unconscionable omission, if not outright misrepresentation. Whether this was due to ignorance or deceit, of course, does not matter.

They had also asked, they said, about other fees and charges for the investment, and were told that they were so nominal as to be insignificant. Of course, the insurance and mutual funds charges were on the order of several percent per year, or over $15,000 annually for these folks.

Both the politician and his wife were quite angry when they learned of the magnitude of the "miscommunication" to which they had been subjected and asked me to help them to file a formal complaint, requesting the return of their money.

The Widow and the Credit Union

Martha's husband died unexpectedly in his forties, and had left her a couple of hundred thousand, mostly by way of a life insurance policy. She was rather unsophisticated in money matters but knew she would have to watch her pennies in order to make in through retirement, since the modest pension she could expect at the end of her working days delivering packages for an overnight service would barely keep her above the poverty line. Martha had been referred to us by a friend, who was concerned that something was dismally amiss in her investment planning.

Like many in her situation, Martha turned to the good people in her credit union for help when her husband died, the place where she had banked for years, and the only place she thought to go when it came to financial matters. The registered rep (translation: securities salesperson) with whom she dealt was kindly, and she believed that his advice was simply part of the credit union's overall service to its members. She was shocked when she learned that he was a product salesperson earning commissions.

Soon after she deposited the proceeds from her husband's insurance policy, he began to approach her, telling her that she "had to do something" with "all that money." Although initially advised – by him – to "wait at least six months" for her grief to clear, he would prospect her on nearly every visit, and in short order convinced her to buy a bunch of products. They turned out to be back-end-loaded mutual funds, and a variable annuity. The new account application contained misinformation, painting her as having more liquid funds than she did, and so giving her a higher apparent risk tolerance than she had.

Martha became concerned when her account values began to plunge in a market correction, exacerbated by fund recommendations that tended to not control risk as well as might otherwise have been the case. When she called the credit union's branch manager, she was directed to the registered rep himself, who told her, essentially, to ignore fluctuations in value, that investing was "like baking a cake," and admonishing her for peeking into the oven too often. This bit about baking a cake really galled her.

Finally, Martha could take no more, and demanded, on several occasions, that her investments be liquidated, and the funds sent to her. Such an order requires oral instruction only. Yet the rep delayed, and finally sent her a letter for her to sign, in which she would admit to all responsibility for investment losses and surrender charges, as a condition for liquidating her account. She says this is the first time she was aware of any surrender charges. She balked and came to me.

When I first took data on Martha, it was clear that she really had no idea that she had purchased commissionable products, and truly believed that this "financial planning" was a free service of the credit union. But what really struck me was her "guaranteed" product: she had put $30,000 in a vehicle which she swore was invested in the stock market but could never go below her initial investment.

Of course, it smelled like a variable annuity, and of course, she would have to die to collect on the guarantee. When I suggested this might be the case, she said "Oh, no, it *is* guaranteed. My kids are OK. That money's for me." Even when the statements showed a drop in value, and she got doubletalk when calling the rep on it, she believed in the "guarantee."

Like so many others, she was amazed and angry to learn that she owned an annuity contract with a life insurance – only! – guarantee.

Although the account was small and she could never afford to pay me for my time, I was so incensed at the abuse of this unsuspecting widow and agreed to some pro bono work.

Calls to the branch met with a very friendly stone wall. I was referred to the rep's supervisor – legally charged with overseeing sales activity to make sure it was legal and proper – who worked out of another city and did not return any of my calls. Several hours and many threats later, I reached a compliance staff person at the insurance company's home office, who tried to refer me back to the rep's elusive supervisor, but finally agreed to contact Martha.

She eventually did, and basically told Martha that all of this was her fault, that she signed all the paperwork, and should have known better if this was not what she wanted to do. She was even kind enough to put all of this in writing, and mail it to Martha.

Martha has also filed a formal complaint but will probably have to go to arbitration to have any hope of being made whole.

THE ROUGE BROKER AND THE WRITTEN GUARANTEE

This is one of the most incredible stories I've ever come across since entering the financial world as a young stockbroker in the early 1980's. I'd thought I'd heard everything, but this one just blew me away.

Don had inherited several hundred thousand dollars from his father's estate and sought the advice of a local broker from a major firm, who convinced him to buy a variable annuity, describing the product in glowing terms, and promising both the chance for stock-market gains, as well as a rock-solid guarantee of minimum interest every year. A trusting but meticulous man, Don faithfully took notes on the glory of this product and returned a day or so later with a very specific document which recorded his understanding of the investment's characteristics and guarantees. The letter included the ways he was told he could profit, along with a schedule of the minimum guaranteed values for each year in the future that he could expect, if the markets did not cooperate and all he got was the guaranteed interest.

I even have a copy of the letter, and it says, in part, "that annually the account is guaranteed to increase by either 5% or, if the net increase of the portfolio (high water mark) is higher, than that amount will be the new guaranteed increase." Later in the letter, Don says, "if this is not correct, please correct any misunderstanding."

Of course, if true, such a guarantee would be a wonder of the financial world and a great thing to have. Unfortunately, such a thing is not possible, and is, in fact, a contradiction in terms.

But this is how the broker sold it, and this is the understanding that induced Don to buy. Moreover, Don wrote all this stuff down to make sure he got it right and brought it to the broker. The broker agreed that the information in the letter was right. Don asked him to sign off on the letter. The broker said he would have to show it to his branch manager first before he could sign it and went away. On returning, he said the manager agreed that it was correct, and the broker signed the letter of guarantee. Such a guarantee is of course illegal as all get out. As unbelievable as the foregoing has been, what comes next will truly chill you. The broker was terminated shortly thereafter, for unknown reasons.

Naturally, instead of the guaranteed increases, the value of the account plunged soon after purchase, on the order of 40%! Don, of course, seeing values plummet on his statements, inquired as to the guarantee.

The *new* branch manager said that the broker "should not have done that" and passed the case on to headquarters. Remember that we are talking about a huge, very major brokerage firm here.

Don got no response. He complained to the SEC. Nothing.

He had a lawyer buddy write a letter to the firm. It went unanswered. Don wrote a letter himself to the firm. This was finally answered by a lady in New York who referenced the guaranteed letter and said that clearly the broker's "intention" could not have been to guarantee anything, since such a thing was impossible. She went on to wish Don a nice day and the best with his investment.

Remember that Don was in procession of a signed, written guarantee, with very specific English! "Intention" played no part! The broker was the agent of the firm and had the apparent authority – bolstered by the manager "check" – to issue such a guarantee, to which the firm as the agent's principal would be bound.

Despite all this, the brokerage firm behaved as if all of this never occurred, and clearly was hoping to stonewall Don until he just gave up and went away.

In desperation, Don saw our ad for a "Got Annuities?' workshop, and came in. I called the lady in New York repeatedly with Don, and she constantly refused to take the calls. We have helped him draft a more effective letter of complaint, and we are confident that he will get all his money back, with specified interest.

His case is still pending.

THE PVC TYCOON

Harry's in his early 70's and still runs several companies, the most profitable of which cranks out plastic in Georgia like you would not believe. Phyllis is his wife. They're worth millions – mostly due to Harry's grit and sweat – most of it tied up in real estate and businesses. Since only a small portion of their substantial wealth was liquid, Harry and Phyllis were quite concerned about Harry's ability to finally retire and enjoy the time they had left.

This couple came to a workshop after watching the value of their products at a major brokerage house nosedive nearly 35% in less than a year. As it turned out, they had been with the same outfit for something like twenty years, and were barely break-even after all that time, when they should have doubled their money many, many times in that period, given what the markets had done in the 80's and 90's.

Of course, when they came in after the seminar and laid their portfolio on our conference table, we found it full of those high-commission annuities, even though it had been built at a stockbrokerage firm. The largest part of the portfolio was in a very expensive variable annuity, which had dropped something like $100K to $150K in the short time that they owned it. Once again, they did not know that they owned an annuity, or just precisely *what* they owned, only that whatever it was had a guaranteed return of principal in I'll say eight years.

As is often the case, losses were exacerbated by very poor choices of fund accounts, resulting in a concentrated portfolio exposing the owner to far more risk than anyone involved – salesperson or buyer – ever realizes until it's too late.

The hidden fees (which Harry and Phyllis said they knew nothing about) in this jewel went something like this: 1.25% mortality charge (fortunately, they wound up with the cheapest life insurance option), up to 1.3% for the most expensive available "sub account," and a whopping 1.5% for the 8 year "guarantee." Total charges ran to something like 4%, and, had the broker checked the box for the most expensive life option, could have approached 5% per *year!* The surrender charge was $40,000. This annuity was issued by a huge name insurance company.

The rest of their portfolio was comprised of other very expensive product, but none so breathtaking as the crown jewel described above.

The broker who sold Harry and Phyllis this load of stuff was described by them as a "very nice man."

Stunned after the results of this analysis, Harry and Phyllis went into denial, hoping, I suppose that things would magically recover and they would be able to retire into the sunset. Less painful to put the papers back into the box under the bed, than to confront the carnage of their financial life.

THE NICE MAN FROM THE LIBRARY

This is a story we drew from for one of the very first chapters.

Fred and Ethyl – both in their late 60's – went to a seminar at the local library and would up getting hard-pitched on a super-high commission annuity from a young fellow they described as a "very nice man," whom we'll call Ralph.

Ralph had some letters after his name (though when I investigated one of these "designations" I found the coursework to consist mostly of life insurance and annuities
sales and marketing techniques) and advertised his seminars in the local paper. After 9- 11, his ads took on a distinctly patriotic flair, swathed in flags, and touting annuities as being "patriotic" for patriotic seniors, and stating that they were somehow backed by the U. S. government (this is *specifically* prohibited by Florida statute).

But the ad looked good to Fred and Ethyl, and they went to the seminar, where they completed the coloring-book-level workbook to help them focus on their goals.

One of the pages showed a couple and their goals surrounded by cartoon alligators, and Ralph referred to the" mutual fund alligators," among others.

Ralph also claimed to have written a book and gave a copy to Fred and Ethyl. The book turned out to be mostly ghostwritten and published by a company that was paid by life insurance agents to customize such books for them. The agent would get his or her name and picture on the book and got to write or be interviewed for some custom material which made up a very small part of the book.

Fred and Ethyl were pretty impressed by the book. It seems that Fred had inherited a pretty good chunk from his Aunt and was wondering what to do with it. This was the first real money that the couple had seen; before the inheritance, they had a small bank balance and got by on Social Security.

Ralph, true to form, suggested that they take the entire inheritance and invest it in his "conservative" equity index annuity.

This is the one, you'll remember, with the 15-year surrender charge schedule – 25% for the first five years – and the only 70%-of-principal guarantee. The effective surrender charge was damned-near 50% the first year. The surrender charges – still over 12% in the *tenth* year – would not be completely gone until the couple were in their early

80's. And while the product was touted as offering a opportunity to participate in the performance of the stock market, the actual contract could allow the insurance company to pay as little as 6% per year, *no matter how high the market went.*

After these folks called me to their house, I sat at their table and read the fine print to them. As usual, they had heard only the syrup from Ralph's tongue, and saw only the big pictures of the happy elderly couples on the brochure.

Ralph called them, yet again, while I was there. Fred wondered why he was so anxious, and I jested that he had probably already bought the car.

I did not know until the next morning just how high the commission would be: 17%, or $51,000 on this sale. Fortunately, Fred and Ethyl got lucky and narrowly eluded the shiny, powerful trap. They wound up keeping their money where it was. Sadly, too, too many do not. This is the story that really inspired our series of "Got Annuities?" workshops, and, ultimately, this report.

THE PLUMBER'S HELPER AND HER LAST $10,000

Marcie is divorced and the 38-year-old mother of one. She really has to scrape to get by on the $15,000 or so she makes a year carrying plumbing supplies and gluing plastic pipe. Like so many these days, she wandered into the bank looking for investment advice when she got her meager divorce settlement – the $ 1 0K – that represented every nickel she had, if you don't count next week's paycheck.

Instead of putting it in a savings account where it belonged, the bank rep took the far more profitable route of selling Marcie a variable annuity, which promptly plunged in value.

After surrender charges, Marcie lost nearly half her money. At least this 38-year-old avoided – because of the loss when she surrendered – the 10% tax penalty that would have applied for 21 years until Marcie broke 59 ½ on the product the bank rep so carefully chose for her.

The Teacher and the Worthless STACK of Annuities

Beatrice has been a client for many years, now. Her husband Jack used to handle most of the finances, but since he died, Bea has dealt with me directly.

Fortunately, Bea is quite well off. Between Jack's retirement plan and his life insurance proceeds, she will enjoy a very comfortable retirement, and be able to leave her three sons a very substantial inheritance. All of this is prudently invested in no-load funds which my firm manages using our exclusive ISIS® process.

So, where's the annuity story? When Bea finally retired from teaching, she brought me information on a bunch of products she'd never told me about before. Probably, she did not know herself what she had, had stuffed all the paper in a box, and only was motivated to have me untangle the rat's nest by the seminal event of her retirement.

For whatever reason, there we finally sat, with a pile of annuities contracts, annual statements, and spiffy brochures covering my conference table. One by one, I arranged the paper by product, putting the statements she had with the respective annuity policy. After a few minutes, a chilling pattern began to emerge.

Every policy was worthless.

Each had been surrendered within a year or so of purchase, and the surrender proceeds transferred to another TSA policy.

Although Bea was contributing money each year, values continued to plunge, as the surrender charges whacked down the value with every churn.

Obviously, the agent profited from each switch, but Bea's once-princely TSA balance had been whittled down to a mere $20K or so by the mid-90's, fifteen years into this game.

Then, the agent switched tactics: he had Bea cash out the last annuity and put the proceeds into a high commission viatical product. You remember those, where life insurance policies on the terminally ill were bundled and pawned off as investments? Then better AIDS therapy came out, and viaticals died, instead of the AIDS patients who had sold their life insurance policies.

Like a good knight, the agent got Bea out of the viatical with only a modest 25% loss and had her plunk the shriveled remains into what turned out to be an illegal, unregistered bond issue, for a company which has since gone belly up.

And there, at the end of my review of this virtual library of documents, lay on the table the worthless smudge-mark that represented decades of Bea's toil and saving for retirement. It reminded me of an old life insurance industry joke: "The definition of estate planning? Estate planning is the orderly conversion of estate assets into commission dollars." That's exactly what happened here.

The agent who stole all this, by the way, still has a current life insurance sales license, and continues to peddle product. Bea asked me to call him, but not go so far as to help her prepare a formal complaint or chase him to court; she's just not the suing type. The agent – who had merely changed corporations, not stripes – basically told me to sue him if I did not like what he had done. He brazenly even gave me his lawyer's name and number! When I asked if he'd be willing to disgorge the commissions he had "earned" on the bad product he's sold Bea, he refused, pleading his own problems.

I really wish that Bea had pursued this, if only to protect the hundreds of thousands of others this parasite may yet bilk. At least she did not wind up needing the money she's saved for retirement.

But I wonder how many other teachers are cheerfully welcoming shoppers to Wal-Mart in their old age, because of him, and others like him?

GEORGE AND THE 3% "MISUNDERSTANDING"

George has been a client for a while, recently retired, and has plenty of money to get through retirement, though he worries about it all the time. It turned out that George had purchased a small (for him) index annuity before coming to us, which he thought he had a pretty good handle on until he came to one of our "Got Annuities?" workshops.

When George got home, he started digging. When he had been sold the annuity, the agent told him that he was guaranteed to get his share of the market return, or 3%, whichever was greater, each year. Thumbing through his statements, he was shocked to find that his annuity showed no gain whatsoever for the prior contract year.

Puzzled, George calls the insurance company, who merrily explained to him that that guaranteed increase was *cumulative,* not *annual.* Which is to say that since George's share of the market gain the first year (1999, the last booming bull year before the bear market beginning in 2000) was something like fifteen percent, he already had received something like five years of guaranteed return before the insurance company was on the hook again. And wasn't it an amazing product? Wouldn't he like to buy more?

Now George is a shrewd man and had made his fortune in the financial arena. He understands the difference between cumulative and annual. And what the salesman sold him was not what the contract delivered.

Thankfully, the amount in this annuity is small change to George, and he'll just wait it out, and chalk if up to experience. At least he has good reason to say no when the agent calls looking for fresh commissions, as he does monthly. George sure is lucky, he says, that he didn't trust this "rascal" with more of his money.

On learning all this, George promptly called me to pass it on, so I could pass it on to you.

HE'LL BE 99 WHEN HE'S FREE

An engaging 84-year-old, Bill showed up a lunch workshop just after Thanksgiving, and had brought all his paperwork with him. Like so many others, Bill had sensed that "something just wasn't right" with his investments, and just on the opportunity for professional help when he saw a "Got Annuities?" workshop ad.

It turned out that Bill and his wife, Amy, had just purchased a new index annuity for 150K, almost all of their money. With a 15-year surrender period, Bill will be 99 before he gets out of the penalty box. But the product has strong guarantees, the salesman said: in fact, Bill and Amy are guaranteed to break even in ten years, when Bill's 94. If they needed the money now – like to pay for an operation for Amy – the surrender charge is something like $30,000. Worse still, the agent involved had convinced them to surrender an essentially identical index annuity to buy this one, incurring something like $40,000 in surrender charges on that one!

But here's the real kicker: Amy's four years younger and has a statistically much longer life expectancy than Bill, being younger and a woman to boot. In recognition of this, the agent said, they should make Amy the annuitant, which is what they did. Of course, what this really means is that if Amy dies first, the surrender charges are forgiven, but if Bill dies first – *which is clearly the way to bet* – Amy is still stuck with the sky-high charges!

Why would the agent set things up so that what the customers wanted to avoid – and the agent pointed out – would actually happen? Can you guess? Hint: a one-word answer, beginning with "c."

That's right, commissions! Try singing it to the tune of Fiddler on the Roof's "Tradition." Commissions, *commissions!* ***Commissions!***

Sorry. It is likely that the agent made Amy the annuitant either because 1) the insurance company reduces commissions after a certain age for the annuitant, or 2) the insurance company will not issue the product for annuitants past a certain age, and Bill was too old to serve as the annuitant.

The reason for this is simple: all annuities, being annuities/life insurance contracts, are designed to annuitize or pay death benefits at some point in the future. That's what makes them annuities. The older the annuitant is, the shorter the time before this inevitable event.

The shorter the company can expect to keep the money, the less they will pay in commissions to get it. So, Bill and Amy got exactly what they did not want, and what the agent said he would help them avoid, just so the agent could get paid an estimated $23,000 off the dwindling nest egg of these sweet old folks.

There are obviously a number of potential violations involving this sale – inappropriate, poorly explained, twisting/churning, material misstatements regarding annuitant selection – and data is still coming in on this case.

But Bill and Amy are likely to complain, and stand, I think, a good chance of getting their money back, plus the surrender charges on the product they were twisted out of.

JOHNNY AND THE ANNUITY HE DIDN'T HAVE

This one's not really an annuity story, but probably sets the stage for a new book, "Got Life Insurance?" "Got Whole Life?" or something like that.

Johnny is a professional in his mid-40's who does quite well. He came to a workshop to better understand the annuities he *thought* he had.

When we sat down and read his contracts, it turned out to be far worse than he had feared. What he really had was Variable Universal Life insurance ("VUL"), a cash value life insurance product that allows one to risk cash value by investing in mutual fund-style sub accounts (which, like their annuities counterparts, tend to be on the hard-to-get-disclosure but very expensive side). Not that variable life does not have it's place – like the last-to-die kind for estate tax planning in insurance trusts for the elderly wealthy who care – but John was definitely not it. He had been paying something like $3,000 a month – 36K a year – into what the agent told him was a "term life/annuity combination." The reality is that he had VUL with zero cash value (because of exorbitant charges and commissions, and poor fund selection/performance) after over $100K in premiums! Just to clue you in, commissions to the field on this sort of product generally run something like 100% of the first year's premium – maybe $36,000 in this case – which goes a long way towards explaining why cash values in pure life insurance products take so long to develop.

Worse still, instead of getting the amount of insurance he needed to protect his family by buying maybe a million of cheap term for hundreds a *year,* he was spending thousands a *month* and underinsured. And the major cash flow of $3,000 per month that should-a, could-a been invested for Johnny's-and-wife's financial security and retirement, to say nothing of the kid's college funding needs, was dancing at the edge of the life insurance bonfire, instead.

We suggested that Johnny apply for an appropriate amount of cheap term insurance and dump his expensive VUL if approved at reasonable rates for the term. The freed cash flow should then be directed at the family's real goals. We offered to help the couple prepare a complaint if they wanted and the facts warranted; they declined – as many do, for some reason taking responsibility for being hoodwinked in areas they know nothing about and rely on those holding themselves out to be experts.

The agent probably still has whatever the $36,000 commission bought him, but Johnny and Mary would just rather forget the whole thing.

HE WENT TO THE BANK FOR A CD...

We'll close with this sad and amusing story which kind of sums up the modern state of the annuity's minefield.

Walter is a soft-spoken 83-year-old who popped up at one of our workshops. He said he came in so we could tell him just "what in the dickens I have."

It seems Walter had gone into a branch of a huge, national bank looking to put $1 00K or so – most of his money – back into a CD, like he had done most of his life. After all, *banks* are where they have bank *accounts,* right?

Of course, once we got the paperwork out of the bewildered Walter's shaking hands, we were not surprised to tell him that he owned an annuity, with a seven-year surrender period.

Walter will be ninety when the surrender charge goes away, but the contract and/or applicable law may force him to annuitize before then, forever locking his principal away from him – and his family.

And if he dies before all his money's been paid out, well, of course, the insurance company gets to keep that. It's in the contract.

While I wrote much of the following in the late 90's as part of a book proposal, the information remains quite instructive for those who wish to learn more.

HUGE PROFITS FOR INSURANCE COMPANIES

Why would the insurance industry pay so much in commissions?

First, a little history.

Conceptually, the life insurance industry makes money in a pretty straightforward way: you buy insurance and send in premiums over years or decades, and if you don't die (most of you won't on the timetable of most policies) the companies invest the money and keep a very healthy portion of the profits on investing your premiums. In actual practice it gets (by design?) wickedly complicated, but that's the basic mechanism. In the words of David D'Alesssandro, once-CEO of John Hancock, in his book, Brand Warfare: "In some ways, life insurance *is* a very cold business, like bookmaking or loansharking. We bet you'll live longer than you're willing to risk, and then we loan out – or invest – the money you give us at an attractive rate of return." This methodology applies with a vengeance to deferred annuities, with the added bonus of virtually no insurance risk to the companies raking the cream off the returns on the annuity premiums given to them.

But let's show some compassion: the last few decades have been hard on the life insurance industry, what with a steady decline in sales of incredibly profitable – and usually grossly overpriced – "permanent" life insurance products like whole life and universal life, increasingly disloyal and mercenary salespeople, and the onslaught of class action suits to settle rampant misleading sales tactics across the country, and spanning many years.

It's rough. Competitively priced term insurance – which in my humble view is all the vast majority of us need – is a relatively low-margin product: profits are low, commissions are low, the dollar amounts for all, customers and companies, are quite small. The term business is very competitive, and the product easy for the consumer to grasp and shop, unlike cash value insurance. Fair profits can be had, but excessive ones are kind of hard to orchestrate, since term is so doggone easy to understand. No cash value, no loans, no surrender values, no "bonus interest", no smoke, mirrors, or peas under mattresses or shells. Simple: you pay x, and you get y.

A bright spot in this change for the honorable life insurance industry has been annuities. Some of these data are dated, but they make an important point.

As far back as the early '90's, "investment income and annuity premiums account(ed) for roughly 60% of the total income of U. S. life insurance companies," according to The Institute of Business and Finance. More than half. And this number is probably growing as margins on "real" life insurance products continue to be squeezed by consumer enlightenment. It is quite possible that the percentage of insurance companies' profits derived from annuities is far higher today.

Annuities have exploded in popularity; some would say largely driven by commission-baited sales pressure and seem to have become a dominant investment form on the financial landscape. How dominant?

Variable annuities – the kind often described as "mutual funds in an insurance wrapper" – had grown to represent about one *trillion* dollars – that's one million times one million – of investment capital by 2001. That was about *two- and one-half times* the amount invested in the long-term US Government securities known as Treasury Bonds for the same period, and there was an awful lot of money, both here and abroad, invested in T-bonds.

Two- and one-half times that much in variable annuities alone, plus the billions piled on billions of dollars in the much more obscure "fixed" annuities marketplace. When we add this in, the total soars to $1.8 trillion – $1,800,000,000,000 – which was more than ten percent of the entire national debt! And the number was growing as of 1999 by almost 18% – over three hundred billion – per year.

Let's talk about the kind of profits that would drive these companies to pay such commissions to acquire the business. I'll use data from the variable annuities part of the business, because I have the numbers handy, and because government disclosure requirements for these securities products make the information a lot easier to get. Data on the fixed products is much harder to ferret out, making analysis far more difficult. Readers take note – equity index products are not securities, and the SEC disclosure rules don't apply!

First, we'll take the life insurance charges which are part and parcel of any annuity, being life insurance contracts, after all. The insurance for deferred annuities can be mostly weak and undependable – since in most cases the death benefit is really just a withdrawal of your investment – your own money back! – but for now, let's just look at the cash flow these beasts provide for insurance companies. A typical life insurance charge – called a *mortality* charge – is 1.25%, those these seem to be creeping up at frightening rates. It doesn't seem like much until you do the math. You need to hunt through the prospectus or contract to find out what these are for sure.

Of course, the real world tends to be more complicated, and insurance companies do face longevity risk – the risk of people living longer than expected and receiving annuity income past normal life expectancy. This applies when insureds actually use annuities for the reason they were originally designed – to convert assets to pension-like income. This does impact potential profits, as do other aspects of these very complicated insurance contracts.

If we assume an average mortality charge of 1.25% on an asset base of one trillion, we get annual premium flow of twelve and one-half billion dollars, which looks like this: $12,500,000,000. There may be some death benefits paid out of this, but as we will see later in the report, they may be so nominal as to be trivial.

But wait, there's more!

In addition to the insurance charges, the insurance companies' "markup" the underlying mutual funds from what you would pay if you bought them directly by something like .75%, and often much, much more. Again, it doesn't' seem like much, but adds up to another seven and one-half billion dollars on an asset base of one trillion.

That number looks like this: $7,500,000,000. Added to the mortality estimate, that makes twenty billion dollars. Per year. That's $20,000,000,000, or twenty thousand times one million. It's a lot of dough, and it's just the tip of the iceberg of the annuity empire. We haven' yet even touched fixed annuities, or the newer "equity index" varieties that have been skulking about for a decade or so. If we double the number to estimate the other products very roughly, that's 40 billion a year. $40,000,000,000 in revenue they never have to bill for, or clearly tell a single customer they charge. We need to borrow a word from the life insurance industry and make clear that I have merely *illustrated* what the total revenues might be using the assumptions I've outlined.

The actual number may be larger or smaller, and the analysis has been pretty simplistic – and again the data is dated.

On the other hand, for some products like variable annuities, costs have actually gone up, what with riders, mortality, underlying fund costs, admin and policy fees, and so on – so it is not at all unusual to see total costs pushing 5% a year on some product – almost always under the radar, and nearly never accounted for on statements or other regular notice. I don't know about you, but in this economy a 5% shave off the returns is a very big deal! If the basic return was 10% you would get 5%. If it were 5% you would get 0%. If it were 0% you lose 5%. And if it were a 10% loss, you would lose 15%.

Back to insurance company potential profits. Any way you slice it, it is clear we are talking about a mammoth number. These billions of dollars flow in, year after year, as long as the contracts stay in force.

And usually with no advice, no real management of the money from the consumer's perspective, which is ultimately up to customer, who probably believes the agent, or some elves are watching the money carefully, but that's often an illusion. That's another very important point – if you thought the agent or someone in the home office is actually managing your money to your objectives, you better look again, because the odds are overwhelming this is not the case, whatever the agent may encourage you to believe. As a non-fiduciary "advisor" they have no obligation to put your interest first or provide any other service besides showing you a product you are responsive to kick the tires and read the disclosure on.

Is it any wonder that the insurance companies are willing to front high commissions to tap into a forty-billion-dollar-a-year cash flow? So, forget all that talk about clients first. They may say it, and maybe even believe it, but in too many cases don't act or charge like it, and in many cases can't legally do it anyway.

Insurance company profits pay big commissions that motivate salespeople from stockbrokers to bankers to financial planners to credit unions to push this stuff. Companies first. Need that cash flow! Commissions for salespeople second. Gotta motivate 'em! Move that product! Customers get what they get, which is usually confused and underserved – or outright disserved – in a blissfully ignorant way.

The beast has a number, and it is humongous. The sheer size and nature of the annuities market may amaze you. Billions on billions – thousands of billions, actually – are parked in these hard-to-understand products. Annuities have become a ubiquitous feature of the financial landscape in the United States.

Tens of millions own them. Many consumers don't understand them. Even now, outside of the industry, it seems a little-known fact that annuities are, by definition, life insurance contracts. Regulation is spotty and left to the individual states' departments of insurance: there is no Federal regulation of the life insurance industry, a status which the industry has doggedly and expensively lobbied to maintain for the best part of a century. Given that the products are poorly understood and imperfectly regulated, the potential for abuse – both in pricing and sales practice – is too high. Not that there are not fairly priced annuities with little or no commission load and reasonable insurance and management fees, though even these are poorly accounted for to those who own them. But there is enough of the loaded stuff, and far too much of the super-loaded stuff, to make an informed person concerned.

These contracts are far more pervasive than all but a few insiders know. Nearly *every* pension, lottery payout, and lawsuit "structured settlement" is funded by an annuity contract, for which a life insurance company is paid. Teachers, hospital workers, and other "403" (these numbers refer to the Internal Revenue Code section describing taxation of specific plans) groups have had as their primary retirement vehicle TSA's or "tax sheltered annuities" for decades. A majority of government-sponsored "457" deferred compensation plans and pensions are funded by annuities. A large percentage of "401(k)" and other corporate-sponsored retirement plans are annuities-based. There are dozens of other platforms on which these products are sold, from IRA's at the local bank or credit union, to "tax-shelters" (not really) to the wealthy and middle class. Life-insurance agents – since the 1980's enthusiastically joined by brokers, financial planners, bankers, CPA's credit unions, and many others – have been convincing individuals to plow savings and investments into these products for decades.

Due at least in part to the lack of Federal oversight, it is difficult to research total industry statistics to determine just how many dollars are tied up in annuities, and how many people have ownership interests in these contracts. I provide piecemeal hard data from several sources. But it's clear that we are talking about many, many millions of people, and *trillions* (1,000,000,000,000's) of dollars. The magnitude of the dollars controlled by insurance companies in annuities is truly staggering. The Variable Annuity Research and Data Service (vards.com) indicates that 2000 year-end assets controlled in *tracked* variable annuities contracts (not all contracts) alone was $973 billion for the insurance companies it *follows* (not all companies). Factoring for the 10% of companies not included by VARDS gives an asset estimate of $1.08 trillion dollars in this one sort of annuity alone.

Consumer dollars continue to be funneled into variable annuities contracts at a dizzying pace: for the 25 companies tracked by VARDS, 2000 year-end "premium flow" was $138 billion, representing an approximate growth rate for the year of 17%.

The American Council of Life Insurers (acli.com) is another industry group, which reports on and for some 80% of US life insurers, and purports to have comprehensive data (though even they must estimate) on annuity totals. For *all* annuities (including the "fixed" sort which are pure life insurance contracts without the securities elements which make variable annuities "variable") they reported 2000 yearend total annuity assets at $1.8 trillion, and a'98-'99 (the last year for which I had data when I wrote this in the 90's) asset growth rate of *17.8%,* which, if used to extrapolate the 2000 number, would give *another* third of a trillion dollars for 2001. ACLI reports that there were at the end of 2000 some 73 *million* annuities contracts "in force" (active).

These numbers are stunning:

$1.8 trillion - $1,800,000,000,000 – tied up in annuities policies, a number so astronomically large as to elude meaning. Let's put it in context: this number was so huge as to exceed 10% of the United States national debt around that time! ($17.7 trillion). That's nearly $10,000 in annuities assets for every adult – citizen or no – counted in the 2000 Census (about 197 million). And with 73 million annuity policies out there, we're talking about nearly three contracts for each adult human living in the United States.

Of course, the concentrations – both in contracts and dollars per household – are certainly far higher in "mainstream" America, those who are citizens and above the poverty line.

Market penetration of annuities products is clearly deep. They are pervasive, and very poorly understood.

These products are overwhelming owned by individual consumers, perhaps being largely shunned by institutions due to high costs, oppressive taxation, and, frequently, very high commissions. They are owned by individual savers of every stripe, from minimum-wage hospital workers in their TSA plans, to millionaires who buy on the advice of brokers and bankers (perhaps because annuities pay higher commissions than other investment and savings products: a $50,000 commission on a $500,000 is not unusual, and the commissions can go much higher – I've seen as high as 25%, or $125K on $500K on a case I saw in the 90's).

These vast pools of consumer capital are parked in what are very complicated products that nearly no one – sales agent or purchaser – seems to completely understand, and which enable a host of obscure means for insurance companies to hang on for continued revenue to the assets by effectively – through complicated contract provisions, surrender charges, and high taxation – discouraging access by their owners, and to handsomely potentially profit (if we estimate hidden insurance charges and fees at 2% of assets, that's $36 *billion* in annual low-maintenance revenue for the industry) in ways which are onerous to uncover, and which seem never to be even remotely accounted for to those who own them.

Many of you who own these products might wonder about just what you bought and have a nagging suspicion that something may not be quite right. You may have vague uneasy feelings about them, perhaps intuitively guessing that they are not the best products for your needs, but lacking the information required to unravel these amazingly complicated products so that you can examine your suspicions.

And the booming collective voice of the commission-driven annuity pitchmen drones like a dike against a flood tide, drugging the uneasy feelings, and keeping the dark pool of anonymous annuity capital growing by hundreds of billions per year.

I wrote much of the forgoing some time ago, and my views on annuities have since become a bit more circumspect. As I mentioned in the beginning of this report, annuities provide a service – guaranteed lifetime income – that nothing else does, and properly applied serve a critical role in financial planning for many people. That said, too often I have seen products purchased for the wrong reasons – expensive guaranteed income riders for clients who had high pension income and no need for annuity income, to cite a recent example – that my original buyer beware message is as important today as it was a decade ago. If you have – or may need – these complicated devils, do yourself a favor, and consult with someone who truly understands them, and your needs, to up the odds of a good and cost effective fit.

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