

Beware Annuity Sales Pitches

A Position Paper on Annuities

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Unfortunately one backlash of a bear market is the salespeople that prey upon fear and greed in a new manner. People disappointed in stock investments will listen to all sorts of ideas and schemes in an attempt to get more return. One area of abuse is annuities (an insurance product), including “charitable annuities”, which is listed as one of the top ten scams by the North American Securities Administrators Association (NASAA). For a list of the current top ten scams, go to:

http://www.nasaa.org/nasaa/abtnasaa/display_top_story.asp?stid=307

From time to time, I will sell annuities. Applied in the right situations for the right purposes they are viable and sometimes excellent financial tools. However, in today’s environment, sales are being made which compromise the integrity of the product and appeal to fear/greed in much the same way some stockbrokers took advantage of the excesses of the stock markets in the late 1990’s. I just received a solicitation to sell an annuity paying 10.15% for the first year and they will pay me 5% to sell it. The headline was “Hot Annuity.”

Here are some of the pitches and the problems with them:

- 1) **Claim:** “There are no loads or expenses.” **Truth:** Under the heading “No Free Lunch”, all financial products have costs. Fixed rate annuities include costs associated with design, administration and sales (commissions to the agent). Often a salesperson receives a higher commission to sell an annuity than to sell a mutual fund. Also, most annuities have surrender charges that can last up to 15 years. In addition, the rates quoted may have time periods less than the surrender charge period. In the past insurance companies have been known to pay very low rates later in the contract to make up very high rates paid at the beginning. Note: If the product is a variable annuity, which has choices among stock and bond funds, each fund has expenses just like mutual funds and the insurance company often has additional expenses on top. The average variable annuity has higher overall expenses than the average mutual fund.
- 2) **Claim:** “Locking in a guaranteed income for life will make you more secure.” **Truth:** Right now interest rates are at 40-year lows. Likewise, average payouts on immediate annuities are low. If interest rates and inflation rise (which is likely) you could be stuck on a fixed income with much less purchasing power in the future. This is “secure”? Remember, with the classic immediate annuity, you get interest plus a return of principal. When you die, the insurance company confiscates the remaining principal. Believe me, they have calculated these annuities so that most people will die before the payments exceed the total return for the insurance company.
- 3) **Claim:** “We’ll pay you a guaranteed 10% for _____.” **Truth:** The higher the return promised, the higher the risk or the higher the surrender costs later. You need to think, here. Inflation is running 2.5-3%. T-Bills are paying 1.7%. FDIC guaranteed CDs are paying 2-4%. High quality corporate bonds are paying around 4-4.5% tops. Quality mortgages are paying 5-6%. “Junk” bonds of less stable companies are paying 6-9%. Now how can the insurance company be paying 6% guaranteed after their design, advertising, administrative and commission costs and not be taking more risk than a company promising 5%? A wise consumer should be skeptical. Over a five-year period the insurance company may be paying the agent 5% or more plus have another percent per year in costs. That means they probably need to make at least 8% to 9% over five years to break even or make a profit on your money. Now tell me how they can do this totally “risk free”.

- 4) **Claim:** “It’s 100% guaranteed.” **Truth:** If it is a fixed rate guaranteed annuity, the guarantee is only as good as the company issuing it, i.e. an insurance company. Usually there is no “guarantee”, only the promise of the assuring company. If the insurance company goes bankrupt, you might not get all of your money back. Annuity holders may be delayed months and even years before getting any money back and they often got back less than the total principal and interest promised.
- 5) **Claim:** “There is no market risk.” **Truth:** On the face of it, this may seem true. There is not a direct price fluctuation associated with stock and bond markets. But there is “investment” risk. The insurance company is an entity that must make money to survive. Simply put, it must make more money than it spends or it will get into financial trouble. An insurance company can go bankrupt just like other companies. If you are buying an irrevocable “immediate” annuity to pay you income for life or a “period certain”, you better be 100% confident that the insurance company you do business with will still be in business in 10 or 20 years.

These cover the more straightforward annuity issues. However, there are many more complicated sales schemes involving annuities. You should be very aware of how these products work and exactly why they are suitable for your particular situation before buying them.

Here are some of the best reasons for buying annuities:

- 1) Fixed Rate Guaranteed Annuities: As a tax-deferred alternative to CDs where you can wait until there are no surrender charges, the insurance company is large and sound financially and the rates over the average life of the annuity have a good chance to be better than CDs.
- 2) Variable Annuities (allow investment in stock and bond funds within the annuity): Where the built-in death benefit is important for estate preservation reasons. Variable annuities often have a provision that pays your heirs the principal of your investment if you die even if the markets go down.
- 3) Variable Annuities: Where you want a product that combines fixed rate guarantees with stock and bond options under a single product.
- 4) Immediate Guaranteed Annuity (pays a guaranteed fixed income for life or for a period of time, often with a survivor option): When interest rates are high and it seems prudent to lock them in. When spendthrift personality issues warrant a cash flow that prevents the annuitant and/or beneficiary from invading principal.
- 5) Immediate Variable (“Unitrust”) Annuity (percentage income with a variable investment base in stocks and bonds allows for potential future increases in income.): Where future purchase power is a concern and principal is to be protected from spendthrift personalities.
- 6) All tax-deferred annuities: When all other tax-favored investments have been examined and you want to still defer taxes in a non-qualified (non- retirement plan) vehicle.

Reasons NOT to buy an annuity:

- 1) Variable annuities as alternatives to mutual funds or stocks. Expenses are often higher. Taxes are at full ordinary income rates up to 38.6% at withdrawal where mutual funds can generate capital gains taxed at maximum 20%.
- 2) Fear of stock markets. If you are a long-term investor who wants some growth to protect against inflation, running to fixed annuities right now is not a good answer. You should either stick with an allocation to stocks for the long haul or at least keep money in cash or shorter-term bonds and wait to invest when the markets show better signs of recovery.
- 3) Promises of high initial rates. Just like greed got people in trouble in the stock market, greed can get people in trouble with “conservative” investments.
- 4) To fund short-term needs, i.e. cars, houses, vacations or even college educations when withdrawal would be prior to age 59 ½ (unless the college aid benefit formula is so advantageous it is worth the withdrawal penalties).

If you have interest in annuities, please don't hesitate to call me. I will try to help you determine their suitability for your situation and how they might best be applied.

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