**Annuities: Finding the Right Tool for the Job**

Annuities can solve a number of different problems for clients. It is important, however, to understand the specific problem of the client and then match the right type of annuity to fix the specific issue the client wants to address. Following is a brief discussion of the various kinds of annuities that are available and what needs these different annuities are meant to address.

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| *When the Client Needs a Known Income Stream*  For the client who requires a certainincome stream commencing within one year, an immediate annuityis an almost intuitive choice. Providing income— certainas to amount, duration, or both—is what an immediate annuity does***.*** But first we need to ask a key question: For how longwill the income stream be required?  If the need is for an income for life, an immediate lifeannuity makes good sense. It is the only financial instrument that can guarantee a specific amount of income for as long as the recipient lives. It allows the purchaser to manage the risk that the asset base that is used to create the payments may not earn an adequate rate of return, or may not be large enough to provide enough payments for life (i.e., the risk of outliving one’s assets). Some immediate annuities can be structured so that annuity payments will increase each year by a specified percentage. This is sometimes known as the COLA (cost-of-living-adjustment) option. Unfortunately, many insurance companies do not offer such an option in their immediate annuity portfolios.  Similarly, if the need is for an income specified for a period of years, an immediate period certain annuitymay be an appropriate choice. It, too, manages the risk of an unknown future rate of return over the time period, and the risk that the asset base, or the dollars used to create the income stream, may not be sufficient to produce the income required.  One risk often cited by critics of immediate annuities is that the buyer has locked in current interest rates. This criticism is generally voiced during periods when prevailing interest rates are unusually low. How valid is this criticism? In the authors’ opinion, it has merit, from an investmentperspective. The interest rate used in the calculation of the annuity payout factor—the number of dollars, per thousand dollars of purchase payment that the annuitant will receive each period—is, indeed, locked in. Should prevailing interest rates rise over the period of time during which annuity payments are made, those annuity payments will not reflect that rise. However, the authors feel that from a risk management perspective, this criticism is misdirected. If the goal is to ensure an income level, the relevant risk is whether the dollars invested to produce that income can do so with certainty. A rise in prevailing rates would not present that risk, but a decline would*.* To transfer that risk from the annuity buyer to the insurance company, the buyer must incur a cost. Locking in the annuity interest rate is part of that cost.  It should be noted, though, that the changes in interest rates used in immediate annuity calculations over the past two decades have been far less dramatic than the changes in interest rates for short-term instruments such as savings accounts and certificates of deposit. While it is true that the purchaser of an immediate annuity in January, 2014 is locking in an interest rate lower than would have been used for someone the same age and sex in, say, January, 1982, the difference is not nearly as great as one might think. By the same token, if interest rates should trend sharply upward in the next 10 years, the locked in rates 10 years hence will probably not be substantially greater than the current ones.  *When the Client Needs a Guaranteed Rate of Return*  When a specific minimum return on investment and preservation of principal is required to accomplish a particular goal, an immediateannuity makes no sense because it does not preserve principal. The income payments from an immediate annuity, while they may be larger than might be achievable from alternatives, are not just a return oninvestment, but a combination of return onand return ofinvestment. However, a deferred annuity offering a multi-year interest rate guarantee may well provide a solution. The risk of getting an inadequate rate of return is managed by transferring it to the insurance company issuing the annuity. This provides a total or minimum rate of return guaranteed to equal or exceed the return required. However, it is important to note that there is a lack of liquidity costassociated with these annuities*.* This is because the insurance company makes its guarantees assuming it will have use of the money used to purchase the annuity. Typically, a deferred annuity contract does not become profitable for an insurer until after it has been in force for several years due to commissions, other issuing charges, administrative costs, deferred acquisition costs, taxes, and reserve requirements. If the annuity owner elects to surrender or take withdrawals from the annuity in the early contract years, he will usually be required to pay a surrender charge. The amount and terms of this vary considerably from contract to contract.  Recently, many variable deferredannuities have been marketed with guaranteed living benefits*.*The structure and provisions of these policies vary greatly, but it should be noted that the guarantees provided are typically notequivalent to the guaranteed minimum rate of return of fixedannuities, and usually require annuitization, minimum holding periods, or other conditions for the guarantees to be effective.  *When the Client Needs a Better Nonguaranteed Rate of Return*  With the exception of fixed annuities with multi-year current rate guarantees, or so-called CD annuities, no deferred annuity guarantees the current rate of return for more than a year at most. Although, all fixed annuities offer a guaranteed minimum rate of return, variabledeferred annuities generally do not offer anyguarantees of return or of principal, except where the fixed investment account is used or as provided by optional riders. That said, we should bear in mind that most other long-term investments do not offer such guarantees either. For clients who require a guarantee of principal and are willing to accept a current rate that may change, deferred fixed annuities mayoffer better returns than certificates of deposit or individual bonds. The interest rate historyof many fixed annuities has exceeded that of CDs, although there can be no assurance that this will hold true in the future.  When comparing the interest crediting rate of a deferred annuity with that of an alternative, the diligent advisor will point out not only any applicable surrender charges, but also the early distribution penalty which applies to withdrawals taken prior to age 59½, unless an exception is available. Those are essential elements in any sound risk management decision. So, too, is the fact that earnings in deferred annuities are not taxed until distributed.  *When the Client Wants and Needs Income Tax Deferral*  Tax deferral is perhaps the most advertised and promoted advantage of deferred annuities. Earnings are not taxed until distributed, either to living contract owners or beneficiaries. The advantages of such deferral are well-recognized. However, the costof such tax deferral, granted by Section 72 of the Internal Revenue Code, is a requirement in the same section that all distributions from annuities be taxed at ordinary incomerates. No capital gains treatment is ever available under current law.  *When the Client Needs a Guaranteed Payment in the Event of Death*  An often overlooked feature of deferred annuities is the right of the beneficiary to receive a guaranteed payment, or a payment determined by a guaranteed formula, in the event of death. This payment may not occur until the distant future, but upon purchase of the contract the owner knows exactly what the payment will be or how it will be determined.  When is this important? When the client requires that a certain amount be available upon death, regardless of investment performance in the meantime. This guarantee allows an annuity owner to manage the risk that inadequate investment performance will cause a smaller amount to pass to her beneficiaries than desired, regardless of actual investment performance over the time period until death. The authors strongly believe, however, that, when the need for such guaranteed death benefit is a primary concern, life insurancegenerally represents a far more efficient solution, if available.  *Summary: The Annuity as a Tool*  The guarantees that the annuity-tool provides allow clients and their advisors to solve certain problems and to meet certain needs. Specifically, it allows us to meet those needs despite risks that might cause us to fail. Thus, at its most fundamental level, annuities serve as tools that allow us to manage risks—specifically, the risks that:  **distributions** from an investment will be inadequate to meet specified goals;  **earnings** on an investment will be inadequate to meet specified goals; and         the **amount available to heirs**, from the investment, will be inadequate to meet specified goals.  In reality, annuities are nothing more than risk management tools which allow us to accomplish certain needs and goals with certainty— or at least increased likelihood— because of the underlying guarantees that they hold.  *Determining When a Risk Management Tool (Annuity) is Appropriate*  In all cases, the annuity tool solution will have a cost associated with it—the cost of the annuity and the guarantees that it provides. Because of these costs, the solution provided often will not be the solution with the highest expected value or projected return on investment. However, the decision to accept a lower expected value, or net of costs, in exchange for a higher, or entirely guaranteed, probability of success is a risk-return tradeoffthat can, and should, be examined and made on a case-by-case basis. In many instances, when presented with both options, the client will choose the option most likely to succeed, not the one with the highest expected return.  It is also important to remember that, in the search to maximize the probability of success, it is entirely possible that the client will not actually need to utilize the guarantees provided by an annuity. Annuities manage risks of loss; there is no guarantee that such losses will occurin thefirst place***.*** Annuities offer purchasers options to utilize certain guarantees; they do not requirethe exercise of those options. Thus, it may be that a guarantee within a client’s annuity is never actually put to use. Nonetheless, owning the annuity may very well have still been the right choice. That the guarantees may never be put to use does not mean the cost of those guarantees was a waste. Your house may never burn down, but it is still prudent to maintain your homeowner’s insurance and pay premiums for years. Doing so buys you a guarantee that you will not lose the entire value of your house, and may produce ancillary benefits such as allowing you to obtain a mortgage. In any event, it can provide you with invaluable peace of mind, and the ability to better enjoy your life knowing that a particular risk had been transferred—insured—away. |