Separating Truth & Myths about Fixed Annuities

Addressing 10 Perceptions (or Misperceptions) about Annuities

Dedicated
FINANCIAL SERVICES

The world of finance is full of perceptions and misperceptions about annuities. These ideas have many sources: actual facts, personal experiences, stories from individuals who have owned annuities or what they've heard from the experiences of others, as well as information provided by financial professionals who may have their own biases (their own experiences and the limited financial instruments they offer). The conflicting and incomplete information about annuities means most people don't understand them. In fact, annuities are perhaps the most controversial financial instrument offered in the marketplace.

As an overview, annuities are a broad category of financial instruments classified as fixed (with no direct investment in holdings that can lose money) and variable annuities (that can lose principle due to investment risk). Annuities can offer an array of features designed to meet needs for growth, income, long-term care, or a death benefit. Annuities may be an option that can help some people meet specific financial needs, but only if the right annuity product is applied to the right set of circumstances. By lumping all annuities into one category, it is unlikely you will identify the specific annuity that is best suited for your particular situation.

Please suspend your preconceived notions about annuities—whether they are positive or negative—and engage in an impartial look at annuities offered by a Certified Financial Planner™ Practitioner with more than 30 years of experience in the financial services profession who offers annuities and financial products that compete with them.

Let's take a look at common perceptions about annuities and explore whether they are based on truth or a myth.

PERCEPTION: ANNUITIES PROVIDE LOW GROWTH

"Low" growth is a relative term. When we use relative terms, we have to be careful we make appropriate comparisons: "low" growth compared to what? Let's start by identifying the objective of the annuity. Some annuities are intended to provide lifetime income or a death benefit or be targeted to help with long-term care costs. For these annuities, growth is not a relevant measure because they are not intended to be used as an investment. When growth is the intended objective for an annuity, the interest fixed annuities earn should be compared to other safe alternatives, like CDs, annuities actually provide excellent growth. It is true their expected return is not as high as stock which are relatively risky investments and therefore not an appropriate point of comparison.

PERCEPTION: ANNUITIES HAVE HIGH FEES

Conversely, the vast majority of fixed annuities offered in the market do not have any fees. This is true of fixed rate annuities and most index annuities with growth tied to the stock market. Some carriers offer consumers the option to earn a higher interest rate by selecting an interest allocation that does have a fee. By and large the only fees charged by fixed annuities are for optional riders including income and death benefit features, which consumers will pay for when they are specifically looking for annuities with those benefits. Variable annuities, (a different class of annuity products) do have relatively high fees including administrative fees, mortality and expense charges and investment fees. None of these fees are charged by the base product offering of virtually all fixed annuities.

PERCEPTION: ANNUITY OWNERS PAY BROKERS HIGH COMMISSIONS

It is true that brokers receive commission to sell annuities, but the commissions are paid by the annuity companies as their cost of doing business. The annualized commissions brokers earn over the surrender charge period of an annuity are typically less than the annual commissions securities-licensed brokers would earn selling mutual funds over the deferred back end load period, or corresponding front load commission. Also, fee-based portfolio advisors have a much higher compensation opportunity to earn their fees (often at a higher annual percentage than annuity commissions) for the entire length of their relationship with clients. Ironically, securities-licensed brokers and fee-based portfolio advisors who offer financial products that complete with fixed annuities are avid proponents of the perception that annuities pay high commissions.

PERCEPTION: ANNUITIES ARE NOT SAFE

To the contrary, fixed annuities are low risk investments due to their relative safety. While the value of stock and bond investments in investors' variable annuity accounts have investment risk, the value of fixed annuities is ensured by the annuity company as part of their general obligation. To protect their policyholders, annuity companies are required to have reserves that exceed their financial obligation for the annuities they issue. The underlying investments held by the annuity company, the financial security of the annuity company and tight government regulations and oversight are the reasons fixed annuities are low-risk.

PERCEPTION: ANNUITIES ARE NOT LIQUID

It is undoubtedly true that annuities have limited liquidity (owners can typically withdraw up to 10% of their account value per year, after the first anniversary), but there is much more to consider. The three most important characteristics of a financial instrument include safety, performance (growth or income) and liquidity. There is no vehicle that provides all three liberally. To secure the combination of safety and performance that annuities offer, they need to be less liquid. Increasing liquidity by using other vehicles would require taking on investment risk or reducing anticipated returns. With proper planning, a consumers' liquidity needs should be met across their entire portfolio of assets—not by each individual holding.

PERCEPTION: ANNUITIES ARE NOT SUITABLE FOR RETIREES

The issue or suitability of instruments is based primary on financial objectives, not a stage of life. Each specific individual has to weigh their needs and desires against the pros and cons of each financial instrument when deciding how to make their portfolio. When people retire, they generally want less risk. Annuities are low risk but have the additional benefit of offering higher interest potential than other low-risk financial instruments. Yes, there are some negatives like limited liquidity and surrender charge periods However, annuities are a good choice if the attractive features of an annuity outweigh the negative feature of limited liquidity. For those younger than 59½, there's an added consideration. They are subject to a 10% income tax penalty on interest withdrawn from annuities (like IRAs), and they may be more interested in higher risk vehicles that offer a higher growth potential. Still, there are relatively young consumers who have a risk comfort level consistent with that of retirees—due to fear of investment risk or perhaps an inability to work. The lifetime income features of annuities may be attractive to those in the younger population interested in retirement income who are not entitled to pensions.

PERCEPTION: ANNUITIES ARE HARD TO UNDERSTAND

The complexity of annuities varies across the broad range of choices. Annuities like those that pay a specified interest percentage or provide a specified payment for a stated period of time are simpler. Other annuities can be more challenging to understand—particularly those with interest results that fluctuate year-to-year based on the performance of various investment options and those with riders that offer additional benefits. You as a consumer should never purchase any financial instrument or make any purchase that you don't understand the details of. Fixed annuity companies require their financial representatives to be properly trained to sell their products and monitor the suitability of each product placed. Government regulations protect consumers by allowing them to cancel their annuity policy and have their funds returned after they purchase an annuity and are afforded time to review their contract.

PERCEPTION: ANNUITIES SHOULD NOT BE PLACED IN AN IRA ACCOUNT

This argument is based on the tax-deferred interest feature of annuities which seems "redundant" when annuities are funded with IRA money which is already tax-deferred. Conversely, an IRA is the best account to fund an annuity because the limited liquidity feature of an annuity aligns with consumers' reluctance to be taxed when making a withdraw from an IRA—regardless how it may be invested. Consumers are better advised to place less liquid money into an annuity than to be incentivized by the tax-deferred features of annuities, particularly if they expect to take sizable distributions from the account. (Side note: consumers need to be aware that the tax-deferral feature of an annuity should be managed so it does not create a large potential tax liability if the interest is allowed to accumulate and is not periodically withdrawn.) Looking at the overall risk profile of a portfolio, an important tax benefit of funding IRAs with no-risk annuities is a larger percentage of high-risk stocks can be placed in non-IRA accounts and be taxed at capital gain tax rates. Since stocks held in non-IRA accounts are taxed at the lower capital gain rate than the ordinary income rates if they are held in an IRA, purchasing annuities with IRAs could provide a potential overall tax savings to consumers.

PERCEPTION: YOU HAVE TO LIVE A LONG TIME TO BENEFIT FROM AN ANNUITY

A long-life expectancy is a relevant consideration for annuities that provide lifetime payments, since payments cease and the value of the annuity vanishes upon the passing of the individual on whose life the payments are based (the 'annuitant'). Income annuities are generally inappropriate for individuals with a short life expectancy. Some income annuities provide additional benefits if the owner needs assistance with the daily activities of living associated with long-term care or requires a nursing home confinement. These policies will provide more benefit to owners the longer they live, but even with a shortened lifespan resulting from an illness, some income annuities can provide a much higher payout than owners paid into them. The benefit of a long life is not tied to growth annuities like it is to income annuities.

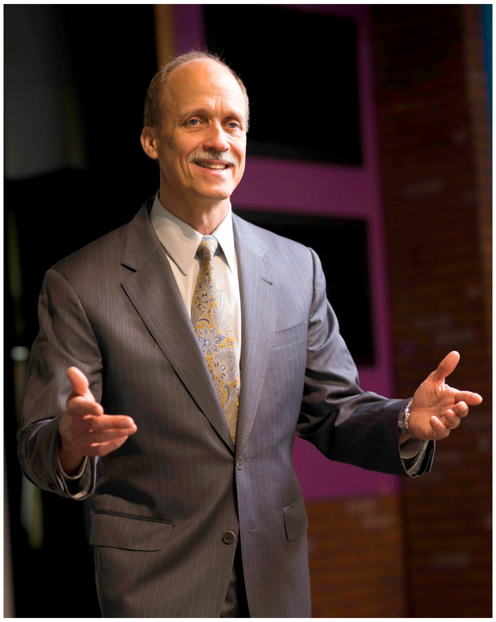
PERCEPTION: WHEN THE OWNER DIES THE ANNUITY COMPANY KEEPS THE MONEY

There are two broad classes of annuities: growth and income. Annuity companies cannot "keep" your hard-earned money regardless which of the two you may have. The account value of growth annuity is paid out upon the owner's passing. Income annuities have a greater variety of death benefit arrangements. Some income annuities pay out the remaining account balance in a lump sum or continue payments to beneficiaries for a stipulated period of time after the owner's passing. There are other income annuities specifically set up as lifetime income annuities. Because of their purpose, to provide income for life, then there is a provision that payments will stop upon the owner's passing. In these contracts, an individual consciously exchanges a lump sum of money for an income and no longer has an "account balance" (similar to a pension). In these arrangements the annuity company is not "keeping the owner's money" because at the time of the transaction, the owner of the annuity chose to exchange the lump sum for income. At the time the money became the property of the annuity company, the company assumed the risk associated with paying the annuity owner throughout a very long life.

Hopefully that clears up a bit of the foggy misperceptions around annuities. However, unless you're a trained professional, you probably still have a bunch of questions. That is why you need a competent and committed professional to help you understand if annuities are right for you and which specific features of annuities are best for your particular needs.

Our History, Background and Mission:

Dedicated Financial Services believes the greatest benefit of assets is not simply their accumulated value but how they can help our clients Maximize Your Retirement™ by being aligned with whatever it is in life that matters the most to you. We call this Process "Bringing Your Money to Life™," which serves as our company motto. Dedicated Financial Services is a full-service financial planning firm prepared to partner with you however you need (providing investment management, income planning, tax analysis, risk neutralization and legacy planning services). We would be happy to walk you through financial planning strategies that will help you meet your Life Goals, Hopes and Dreams™.



Len Hayduchok, *President*

The Dedicated family of companies was founded in 2002 by Leonard "Len" Hayduchok, a graduate of the Wharton School of Business and Biblical Theological Seminary (now known as Missio Seminary). As a Certified Financial Planner™ practitioner with over 30 years of experience in the financial services profession Len enthusiastically fulfills his fiduciary obligation to act in his clients' best interest.

Len is a frequent contributor to major financial media and applies proven financial strategies using proprietary methods. Len has developed unique planning formats and original terminology to provide his clients greater clarity in a financial world subject to bias and confusion. One of his numerous accomplishments is the Theology of Money™ model that helps individuals who are spiritually minded consider their Core Soul Needs™ when planning and making financial decisions.

Len and Joyce have been married for over 30 years and have four adult children: US fighter pilot, businesswoman, health care professional and computer scientist.

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