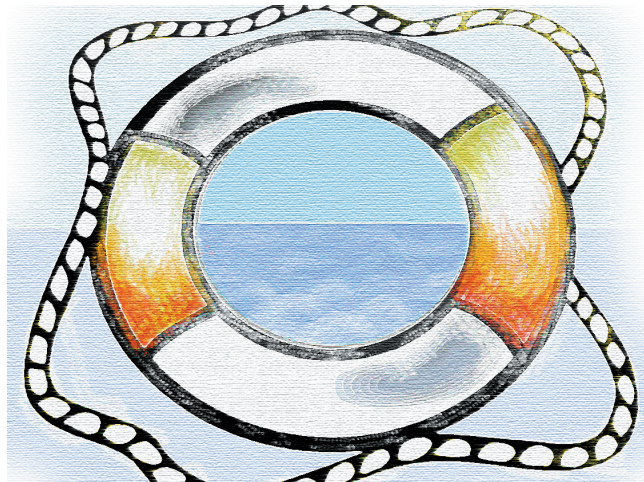


Annuities: The Good, the Bad and the Ugly

By Peter Katt

Annuities seem to be more popular than ever, if insurance industry and general financial media focus on them, and annuity promotion spam I receive, are any indication. This likely isn't due to individual investors awakening to the advantages of these packaged tax-deferred investment gems. Much more likely is that this is driven from the supply side.



generally ranging from one to five years.

Variable annuities allow the investor to choose from a family of subaccounts that include geographic, sector and broad index stock funds. They also have a

fixed account. Some companies only offer variable annuities, and investors in these who want only the fixed variety simply use the fixed account within the variable annuity.

Equity index annuities (EIA) promise a capped participation in equity returns with the guarantee that no losses will be incurred. As such, although the promotion focuses on the equity participation, equity index annuities are a hybrid fixed, not variable, annuity and should be compared with fixed annuities.

Types of Annuities

Deferred vs. Immediate Annuities

A deferred annuity accumulates value on a tax-deferred basis, whereas an immediate annuity distributes income until the death of the annuitant, with perhaps a guaranteed period for payments that could extend beyond the annuitant's death. Ten years is a typical guaranteed period. A deferred annuity can be exchanged, on a tax-free basis, for an immediate annuity once a given amount has accumulated.

Fixed, Variable and Equity Index Annuities

Fixed and variable annuities can be either deferred or immediate; equity index annuities are only the deferred type.

Fixed annuities earn value at prevailing interest rates. They cannot suffer losses. Typically, the interest rate will be guaranteed for a period of time, such as five years, after which a new rate will be established for the next guarantee period,

Annuity Tax Characteristics

All deferred annuities postpone ordinary income taxation on earnings and gains until a future event.

Withdrawals from deferred annuities are taxed on an interest-first basis, and subject to a 10% early withdrawal penalty when taken prior to age 59½. This makes them unsuitable to investors who need access to the funds prior to retirement.

Immediate annuities define a portion of each payment

as ordinary income or tax-free return of principal, depending on the cost basis involved.

Upon a deferred annuitant's death the annuity's gain is subject to income taxes, unless the spouse is the beneficiary in which case the deferral continues until the spouse's death when the gain is subject to income taxes and the entire value is subject to estate taxes, depending on the size of the estate.

There are problems with transferring deferred annuities to trusts. Because of this their value is greatly eroded in estates large enough to be subject to estate taxes. In such circumstances it is almost always better to exchange the deferred annuity for an immediate annuity and purchase life insurance that is owned and payable to an irrevocable trust, using the annuity income to pay the premiums. Depending on annuitant ages, whether single-life or joint immediate annuity and life insurance are used and when the second death occurs, the immediate annuity/life insurance combination can double the net value of the deferred annuity (taking all applicable taxes into account).

Variable Annuities

Variable annuities are flawed because they convert capital gains into ordinary income and have considerably higher expenses compared with comparable mutual funds. For this reason, they are not the best choice for most investors.

However, for aggressive traders, especially in combination with market timing, the ability to move often among various subaccounts without any current taxation may make variable annuities ideal. Of course, anyone using these accounts for this purpose should test their approach using various simulations extending over a long period of time before moving ahead with such variable annuity investing.

As lots of positive variable annuity articles attest, marketers' use of bells and whistles on these products has created enough of a distraction to avoid dealing with the capital-gains-

to-ordinary-income problem. These creative features include: various death benefit riders; certain guaranteed account balance and withdrawal options; and guaranteed annuitization rates. My examination of each of these features and their costs suggest they don't offset the tax disadvantage.

Bottom line, except for aggressive trading and timing strategies that would substantially benefit from doing so without incurring taxes, variable annuities are not a worthwhile investment choice because of their adverse tax characteristic.

Pension Plan Similarity

The same conversion of capital gains into ordinary income criticism can be noted for tax-deferred pension plans as well. As a macro investing planning issue, it is probably wise to concentrate fixed-income investments in tax-deferred plans and equities in taxable accounts.

However, because the tax deductions associated with tax-deferred plans are so beneficial, maximum contributions to these plans should be made and this can cause a large percentage of an investor's assets to reside inside the pension plans. Under these circumstances, an investor's preferred allocation between fixed-income and equity investments should take precedence over this capital-gains-to-ordinary-income issue, making equity investing within a pension plan an appropriate choice.

Equity Index Annuities

Equity index annuities offer reduced equity participation with protection against losses. A typical equity index annuity has a current 6.5% cap on equity participation and a 3% guarantee if it is held for a minimum number of years, usually around seven.

As noted, equity index annuities should not be compared with variable annuities regardless of the term "equity" in their title. Instead they should be compared with fixed annuities. The level of equity index annuity caps will be related to interest rates, not

stock prices.

My own testing shows that equity index annuities have no investment return advantage compared with a fixed annuity. Equity index annuities tend to have larger commissions associated with them. Larger commissions do depress the overall yields, but more important, larger commissions are usually associated with higher surrender charges for longer periods, making them less liquid and less flexible. There isn't any outstanding reason to avoid equity index annuities, but I don't see any advantage over using fixed annuities.

An EIA Alternative

In examining the equity index annuity concept, it occurred to me that an interesting alternative is available to investors looking for equity participation but also wanting to eliminate losses.

Selecting a specific time period, an investor can apportion a percentage of the funds to a fixed-income instrument and the rest to equities such that the earnings on the fixed-income portion will grow during the specified period of time to equal the total investment, making the equity account determine how much gain is achieved. If this is being done via a qualified plan, corporate or government bonds can be used and perhaps an index mutual fund.

If the investment funds are non-qualified, it might make sense to use a fixed annuity for the fixed-income portion to enhance the deferred yield.

Let's say the total investment is \$100,000 and the time period is 10 years. Assuming a 5.5% fixed-income yield, if \$58,540 is invested in the fixed-income component, it will guarantee the original investment of \$100,000 in 10 years with the balance of \$41,460 invested in equities.

Using standard random testing techniques and assumptions, there is a 39% probability that the equity portion will be worth less than the original \$41,460, bringing the overall pretax yield below 5.5%. This means there is a 61% probability it will be greater than 5.5%. More precisely, there is a 30% probability that the

overall yield will be 8%, a 21% chance it will be 9%, and a 13% probability of 10%.

Annuity Payment Purchases

Certain financial firms have stepped up their marketing efforts to purchase immediate annuity payments for lump-sum amounts. Several times during the past few months national publications have asked me to review and opine on marketing materials and case studies of such transactions.

None of the case examples provided a financial advantage to annuitants. Since I would expect the marketing materials to show as much consumer advantage as possible—with actual transactions being of lesser value to consumers—I conclude that these firms are counting on their greater financial math acumen and consumers' relative ignorance to make these deals at considerable profit.

Except for investors in desperate need of cash, I doubt the sale of annuity payments is a good idea.

For those who do need to raise cash, shop the sale of annuity payments around to enhance the value.

Immediate Annuities

Investors who wish to exchange a lump-sum amount—whether from a deferred annuity or otherwise—for guaranteed lifetime income are immediate annuity candidates.

The obvious disadvantage is giving up the principal, including the ability of leaving it to heirs.

Immediate annuity purchasers in poor health should use companies that are willing to underwrite annuitant applicants. Poor health shortens life expectancy and this increases immediate annuity income payments. Poor health purchasers should not purchase immediate annuities without this type of underwriting.

Immediate variable annuities can also be acquired whose income fluctuates with the performance of the subaccounts selected. Fluctuating income undercuts the main attraction of immediate fixed annuities. The conundrum is that while immediate variable annuities may be attractive to sophisticated investors, they probably don't want immediate annuities in the first place. The variable approach to immediate annuities may be too clever by half.

Conclusion

An analysis of the deferred annuity scorecard pretty much eliminates all but deferred fixed annuities as useful investment vehicles for most investors, but insurance companies aren't really promoting these types of annuities.

Except for one type of investor, variable annuities are not attractive because they convert capital gains into ordinary income.

Equity index annuities don't have any particular drawbacks, but are slightly less attractive than fixed annuities. And an investor-built equity-index-annuity-like combination of fixed-income and equity funds should produce a larger up-side with the principal guaranteed than the insurance-company-packaged version.

Investors with large estates should probably avoid deferred annuities, and if they already own one, should consider replacing it with an immediate fixed annuity and trust-owned life insurance.

Immediate fixed annuities do the job they are intended for, which is to provide guaranteed lifetime income in exchange for an investor giving up principal. However, immediate variable annuities should probably be avoided. ▲

Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance advising firm located in Kalamazoo, Michigan (269/372-3497); www.peterkatt.com.