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10 MYTHS ABOUT ANNUITIES

INTRODUCTION

Why buy an annuity? You buy an annuity because it does what no other investment can do: "provide guaranteed income for the rest of your life no matter how long you live," says Walter Updegrave, editor of RealDealRetirement.com, a site offering retirement planning advice.

This makes annuities popular retirement planning vehicles. Annuities can provide additional tax-sheltered ways to save for retirement if you've already maxed out your 401(k) and IRA. Since annuities have no contribution limits, you can save to your heart's content.

And since your annuity will provide guaranteed income later on, you may be able to take a more aggressive investing strategy with your other assets.

Despite their benefits, annuities have become widely misunderstood. Indeed, over the years some common myths about annuities have become accepted as fact. Here we debunk 10 of those myths, so you can make better decisions about your financial future.

MYTH #1: ANNUITIES ARE A 100% SAFE INVESTMENT.

You know the old aphorism: the only things certain in life are death and taxes.

Annuities don't fall into those categories – which is the reason, when shopping for an annuity, you'll often see something like the following caveat: Annuity guarantees are backed by the financial strength and claims-paying ability of the issuing company.

So far, the claims-paying ability of companies has been exemplary. In the nearly 200 year history of annuities in the United States, no annuity owner has ever lost money, even during the most difficult economic eras such as the Great Depression.[1] One reason for this track record is that the insurance industry is highly regulated and companies are required to hold a certain amount of reserves to meet liabilities.

The bottom line is, when buying an annuity, consider the financial strength of the insurer. You can learn about the financial strength of companies through the four major insurance company rating agencies in the United States: A.M. Best, Moody's, Standard & Poor's, and Fitch. Stick to insurers that are highly-rated and you'll have good reason to feel confident in an annuity.

1. Source: "Are Annuities Safer than Mutual Funds?" – David White & Associates: https://www.dwassociates.com/blog/are-annuities-safer-mutual-funds

MYTH #2: EVERYONE SHOULD OWN AN ANNUITY.

While annuities have a place in many investors' retirement plans, they don't work for everyone. Sure, they generally offer minimal downside risk, a potential tax deferral, and the ability to receive guaranteed income for life, but your individual situation may call for a different investment approach.

For example, if you are ultra-wealthy and aren't worried about running out of income, you may not need an annuity. Or, if you have enough money from Social Security and other retirement assets, you may not need an annuity, either.

In addition, most financial professionals wouldn't recommend annuities if you were a recent college graduate or a young professional. Those groups usually have either a higher risk tolerance or less money to put toward an investment like an annuity. Likewise, an annuity may not make sense if you know you have health problems that make it unlikely you'll reach your life expectancy, unless you have a spouse you want to provide for.

But if you're healthy and you want the security of a stream of income you can't outlive, or you want to provide for your spouse or heirs, you may benefit from an annuity. If you do decide to buy an annuity, do so through a financial professional – this isn't recommended as a do-it-yourself task. Make sure you understand exactly what you're getting.

MYTH #3: IT'S A BAD TIME TO BUY ANNUITIES WHEN INTEREST RATES ARE SO LOW.

Most of us think annuities were a much better deal when interest rates were much higher, for example, in the 1980s. But Professor Alicia Munnell of the Boston College School of Management thinks otherwise. Professor Munnell says an annuity is worth more during lower interest rates.

It's no secret that, on average, you are likely to live longer nowadays than your parents did. With increasing life expectancies, today's retirees need their income to last for many more years than was true until now.

Unfortunately, for the better part of this decade, we have also faced historically low-interest rates, which makes relying solely on interest to cover your expenses difficult at best.

In a recent article by Hersh Stern, he said, "Some individuals think they should wait until next year when interest rates will be higher. So, their reasoning goes, if I wait for interest rates to rise, I'll receive a larger monthly payment because I'll lock in a higher rate, plus I'll be that much older.

There are, however, several problems with this line of reasoning.

First, you could be in for a long wait. Imagine if you were back in 1990 when interest rates were 8%. You'd have a memory of how high rates were just five years earlier, in 1985. They were 13%.

Do you think you would have locked in an 8% annuity rate in 1990? Or, would you have thought, "An 8% rate is pretty low. I'm going to wait for rates to move back up to 13%."

John Wooden, the famous UCLA basketball coach, said, "You play with what you have, not with what you wish you had."

Source: ImmediateAnnuities. Don't Be Fooled By These 5 Annuity Myths. May 15, 2021.

Source: ImmediateAnnuities. Is An Annuity Worth More When Interest Rates Are Low? May 21, 2021.

MYTH #4: THE INSURANCE COMPANY WILL KEEP ALL OF MY MONEY WHEN I DIE.

This is true only for a very limited number of annuities, so-called "life only" immediate annuities. Almost all other types of annuities are designed specifically to provide a payout option to your beneficiaries upon your death.

These options include:

- Life With Period Certain: When the annuitant dies, the beneficiary receives payments for a fixed number of years.
- Joint & Survivor: The contract designates multiple annuitants — often spouses — and payments continue until the last surviving person dies. With some contracts, payments are reduced upon the death of the first annuitant.
- Amount Certain: The contract specifies a fixed amount that will be paid to the beneficiaries after the annuitant dies. The length of the payout depends on the initial amount of the annuity and the size of each payment.

It's also worth noting that some annuities contain a provision known as "spousal continuation." In this case, if the beneficiary is the annuitant's spouse, the individual assumes all the rights of the original annuitant. He or she chooses when to withdraw funds from the annuity and has the ability to select new beneficiaries.

Be sure to work with your financial professional and discuss the beneficiary options available to you for each type of annuity you're considering.

MYTH #5: ANNUITIES ARE ONLY FOR RETIREES.

Annuities may be popular with retirees, but they could also be useful for pre-retirees as well. Although immediate annuities tend to be the more common choice among retirees, deferred annuities are more common when saving before retirement.

With these annuities, you can grow your investment tax-deferred, then turn it into an income stream at some point in the future. You can choose from two types of deferred annuities:

Deferred variable annuities have investment options that are very similar to mutual funds. You can typically make unlimited contributions and control how you allocate among investment options.

Deferred fixed annuities include single premium deferred annuities (SPDAs), which are similar to a certificate of deposit (CD). You are guaranteed an interest rate for a specific period of time, typically 3 to 10 years. These fixed annuities are backed by the issuing insurance company rather than by the FDIC.

Because of this, "It's important with any annuity product to make sure you're investing with a highly rated company," says Tim Gannon, vice president at Fidelity Investments Life Insurance Company. "A good way to tell is by checking with a rating agency like Standard & Poor's or Moody's. These are independent rating agencies that conduct regular reviews of an insurer's financial strength and ability to pay its contractual obligations."

MYTH #6: THERE IS NO POINT IN BUYING AN ANNUITY FOR INCOME BEFORE RETIREMENT.

That's not true because some annuities can assist you in planning ahead for retirement, especially if you want to help protect your future income from market volatility and, if you choose, help protect against in$ation.

If your retirement is 10 years away or less, you're probably worried that a drop in the market could erode the savings you've worked hard to accumulate. One type of annuity that stands out for its ability to grant you some peace of mind is a deferred income annuity (DIA).

When you purchase a DIA, you select the future date on which your payments will begin, providing guaranteed income for the rest of your life no matter what the market does. Because they are designed to create future income, DIAs provide the greatest advantage if you don't need to access the money until you reach your selected income start date.

You can lock in a cash $ow that starts on the future date you selected when you purchased the annuity. At age 58, to create a $1,000 monthly lifetime income payment beginning at age 70, you would invest approximately $135,000 today. If you waited until you were age 70 to purchase an annuity, you would need to invest more than $200,000 for the same level of income.

DIAs also enable you to plan for in$ation by offering a cost-of-living adjustment (COLA). When you purchase the contract, for an additional cost, you can select to have your income increase annually by a percentage, typically 1%–3%. This COLA adjustment takes effect on each contract anniversary after you begin receiving income, but not during the deferral period.

Work closely with your financial consultant as you build a comprehensive retirement income plan to determine whether DIAs are appropriate for your personal situation.

Source: "5 Common Annuity Myths" – Fidelity Viewpoints, 5/4/2020: https://www.fidelity.com/viewpoints/retirement/facts-about-annuities

MYTH #7: I CAN CREATE LIFETIME INCOME FROM MY RETIREMENT ACCOUNTS.

Your 401(k)s and IRAs lay a solid foundation for a secure retirement, but they can't guarantee you income for life. Because you can't predict the markets, you can't be sure that you won't outlive your investment portfolio. Other than Social Security and pension plans, only annuities guarantee a stream of income that you can't outlive.

If you don't have a pension, and relatively few workers do, you can create your own pension plan through an annuity contract with an insurance company. Along with your Social Security benefits, you'll have a second stream of income that is guaranteed never to run out during your lifetime.

"What people may not realize is, once you have your essential expenses covered by guaranteed lifetime income, you gain peace of mind and the freedom to pursue the things you love in life," says Tom Ewanich, vice president and actuary at Fidelity Investments Life Insurance Company. "Additionally, you may invest your remaining assets for growth, rather than worrying about how to preserve and stretch your portfolio for the rest of your life."

Just be aware that once you purchase a single premium immediate annuity (SPIA) or a deferred income annuity (DIA), you generally lose access to these assets after the "free look" period — a brief period of time immediately after purchasing a contract when you can cancel the contract and have your money refunded. For this reason, you should work with an experienced financial professional to help ensure that an annuity is right for you.

MYTH #8: ANNUITIES OVERVALUE RISK PROTECTION AT THE EXPENSE OF RETURN.

This is not strictly true because there is a group of annuities that seek to grow your money as much as they seek to protect it. One of them is an indexed annuity, also known as a fixed-index annuity. This annuity's income payments are tied to a stock index, such as the S&P 500. Indexed annuities perform well when the financial markets perform well.

Like any investment, index annuities have their pros and cons. They have the potential of higher returns without the risk of losing your money, but they are complicated and can be difficult to understand.

PROS

- When stocks in your index, such as the S&P 500, increase in value, the value of your contract increases.
- The added increase in yields may serve as a hedge against in$ation.
- If the stock market underperforms, you don't lose money.
- Index gains are locked in.
- May provide better rates than certificates of deposit.

CONS

- The gains of your contract will be capped and won't re$ect the entire increase in the value of stocks.
- The cap in the increasing value may be reduced in the later years of your contract. In addition, the percentage of the gain you may receive in the index value may decrease.
- As with other types of annuities, you face surrender charges for early withdrawal.

Because they are complicated, index annuities should be approached with caution, with the assistance of a knowledgeable financial professional.

MYTH #9: ANNUITIES ARE TAX-FREE.

Annuities are not tax-free. They are "tax-deferred," which means you don't pay taxes on the money while it's in the annuity. Like a 401(k) or IRA, you only pay taxes on the money when you withdraw it.

If you fund your annuity with pretax dollars, called a "qualified annuity," then everything you withdraw will be taxed at your ordinary income rates. If, however, you used after-tax dollars to fund your annuity, called a "nonqualified annuity," you won't be taxed on the portion of your withdrawal that represents a return of your original principal. Only your earnings will be taxed in a nonqualified annuity.

Nonqualified annuities use something called the exclusion ratio to determine how much of your withdrawal is principal and how much is earnings. The exclusion ratio is designed to spread the return of your principal out over your actuarial lifetime.

MYTH #10: ANNUITIES ARE BAD BECAUSE YOU'LL GET HIT WITH A CHARGE IF YOU SURRENDER THEM EARLY.

It's true that most annuities have surrender periods, and early withdrawal will result in a penalty. But that fact doesn't make annuities a "bad" investment or detract from the value they are designed to offer – which is safety and a reasonable guaranteed return. An early surrender charge is just something you need to be aware of before you buy an annuity. CDs too have penalties for early termination.

If you don't cancel an annuity before the term is up, you won't be hit with an early surrender charge. An annuity is meant for money you won't need for a while. If you're concerned about the length of the surrender period, look for an annuity with a shorter period.

What if you unexpectedly need money during the surrender period? You may have a couple of options:

- First, many annuity contracts let the owner take a partial withdrawal, typically up to 10% of the accumulation value each year, without penalty. (The withdrawal of earnings counts as taxable income.)
- Second, you can usually annuitize the contract — turn it into a stream of income — without penalty.

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