Rebuttal to ‘Don’t Buy Index Annuity Article’ on AARP

Brent Welch | August 21, 2014 |

In the May 2014 AARP magazine, Allan Roth set the tone for his article “Don’t Buy It” with a picture of Leonardo DiCaprio, star of the movie *The Wolf of Wall Street*. In the film, DiCaprio plays a dishonest, immoral and unethical investment banker. This “Wolf of Wall Street” ended up in prison for the rest of his life, convicted of felony charges, racketeering, extortion, and stealing money from the general public. He was a wicked and completely dishonest criminal, much like Bernie Madoff.

Roth suggested that there were five investments you should never buy:

1. Alternative Investments
2. Time-Shares
3. Equity Indexed Annuities
4. Private and Non-Traded Real Estate Investment Trusts (REITs)
5. Oil Drilling Partnerships

He said that equity indexed annuities, known as fixed indexed annuities (FIAs), were among the most complicated investments he had examined. If an investment you are considering cannot be understood by an eighth-grader, he argued, you should not invest in it. He asked the question, “Does it seem more plausible that the thick disclosure documents are there to protect you – or the insurance company?” Roth concluded that you should never buy an FIA.

The fact that they are complicated does not make them a bad product; it just means that a prudent investor should educate himself or herself about the FIA, so he or she can make an informed, educated decision. In fact, I would bet many investments are not understood by eighth-graders, but again, this is not what makes an investment a poor one.

In my opinion, Roth insulted his readers by telling them they could not comprehend what they were reading. As in every profession, while there are some “wolves,” there are also many reputable advisors, and many are advising investors to include FIAs in their portfolios. FIAs may not be appropriate for every investor, or for an investor’s entire portfolio, but they do have their place and can be a nice complement to help create a well-diversified portfolio.

I am writing this article as a rebuttal to Roth’s article. His article was filled with misinformation, missing facts, false allegations, wrong conclusions, slander, and in my opinion, sensational fear-mongering. My article from this point forward will be a statement of defense for the fixed indexed annuity. I will attempt to list the pros and cons of such insurance products, educate you about them in detail, and help you make smarter choices with your money.

Annuity Questions

You may say you hate annuities, but do you hate Social Security? After all, isn’t Social Security a form of an annuity? Do you hate guaranteed pensions? According to ssa.gov, there are 55,132,000 Americans receiving Social Security benefits today. Do you know anyone who has refused those benefits? Doesn’t everyone love receiving back a portion of the enormous pile of tax money they paid over their working years?

Since people are living longer, don’t you think we need more guaranteed lifetime income? The average American is living until about 78.2 years.[1] If you are 58 years old now, your average life expectancy is 85 for females and 82.7 for males.[2]

The stock market may take two hits of up to 50% in the next decade, according to John Bogle, founder of the behemoth mutual fund company Vanguard.[3] In light of our present uncertain stock market, guaranteed lifetime income can provide financial security as the foundation of a confident retirement plan. Isn’t lifetime guaranteed income attractive during a time when the stock market could plunge 50% twice in the next decade?

If you are retired and taking a 5% distribution from your retirement nest egg and that pile of money takes a 50% hit, you would then be taking out a 10% withdrawal rate, and that is unsustainable. Of course, past performance is no guarantee of future results. All investments have risks, including loss of principal.

Annuity Facts

For the same reason that you might have disdain for an insurance company, you may want to make them your friend. And, an insurance company can guarantee lifetime income for part of your portfolio. Those thick disclosure documents are obviously there to protect the insurance company, but if they are insuring your guaranteed lifetime income, doesn't the insurance company ultimately protect you? You insure your home, don't you? How about your car? Isn't your nest egg an even larger asset? Yet, you don't insure it. Why not?

Here are the facts:

1. Insurance companies have higher reserve requirements than banks.[5]
2. Insurance companies have to comply with strict investment government policy guidelines.[6]
3. One reason some people hate insurance companies is that they seem to always make money. When things get tough for them, they simply raise your premium rates. This is bad if you're paying money into an insurance company, but if you have money invested in the insurance company or its products, this can be a good thing. During very unstable times, the profitability and safety of an insurance company make it an attractive place to invest some of your hard-earned money.
4. Interest rates are on the rise! As interest rates rise, bond values can fall. The 30-year bull market in bonds may now be over. Janet L. Yellen, chair of the Federal Reserve Board, said she will continue to raise interest rates.[7] This is not good for bond owners, especially open-ended mutual fund bond owners. Maybe it's time that you guaranteed some of your fixed income investments to FIAs as a bond alternative.

5. The stock market has outperformed the bond market. According to Ibbotson and Morningstar's famous chart called "Stocks, Bonds, Bills and Inflation®," large company stocks have averaged 10.1% and small company stocks 12.3% from 1926 to 2013.
6. FIAs can participate in the upside movement of the market to some degree, without the downside risk. This allows one to participate in potential stock market growth without the horrific roller coaster of stock market losses. My question to Roth is this: Wouldn't you rather tie the rate of return for your fixed investments to the stock market, instead of interest rates? FIAs can capitalize on the returns of the stock market, with no downside loss when the stock market plunges.
7. Zero is your hero. When the stock market loses money, your FIA earns zero. That means that when the stock motor resumes its upward movement, you participate in a portion of the upside potential of the market from the point at which you earned zero. This is a tremendous benefit during a bear market.
8. Annuities can provide a higher income payout as you get older. The longer you wait to receive guaranteed lifetime income, the higher your payout ratio typically becomes.
9. FIAs often provide guaranteed income for both spouses. That's right: The guaranteed income may continue for as long as the surviving spouse lives. The life expectancy table for two lives is much longer than it is for one. That means you could be able to meet your fixed expenses with guaranteed fixed income for the rest of your life. For example, the average 65-year-old male will live to 83.3, but if he is married, the surviving spouse will live to 89.8 years on average.[8]
10. Some FIAs can provide an income doubler for health care costs related to long-term care for those that qualify. Some FIAs provide additional income for you or your spouse in the event you cannot perform two out of six Activities of Daily Living (ADL). These ADLs include bathing, eating, dressing, continence, toileting and transferring.
11. With all FIAs, upon the owner's death any remaining cash value will be transferred to the owner's heirs. The amount of money you put in, plus what the market has given you, will pass to your heirs upon your death. Often, surrender charges are waived when you die. This

means that in the unfortunate case that you die early, your heirs can receive something. This may be better than Social Security or a life-only income option from your defined-benefit pension, where nothing passes to heirs upon your death.

12. Some FIAs allow you to participate in the stock market, which can help you keep pace with inflation. Some contracts allow you to have potential increases in income down the road if the stock market gains exceed your withdrawal rate. To some degree, the FIA acts as an inflation hedge since the gains are tied to the stock market.
13. FIAs can work well for the conservative investor. If you’re more concerned with capital preservation than you are with capital growth during your retirement years, you may want to consider an FIA to help provide for your guaranteed lifetime income.

Annuity Pitfalls

The small print and pages of disclosure often include documentation that outlines the following annuity pitfalls. If you are an informed investor who carefully weighs out annuity facts versus pitfalls, you might still be interested in an FIA for part of your retirement portfolio.

Here are a dozen annuity pitfalls:

1. Contingent Deferred Sales Charges (CDSC). These sales charges are a penalty for surrendering your annuity contract before the CDSC time frame expires. Some FIAs have surrender charges of seven, 10, or 12 years, or longer. This means that your money is not liquid. FIA money should be used to fund your guaranteed lifetime income, not for an emergency fund or some other short-term investment.
2. The Market value adjustments (MVA) may be an additional penalty on top of your surrender charge or CDSC percentage due to bond market losses due to rising interest rates. MVAs can also be positive. Much like the losses you experience when you sell a bond during rising interest rates, your FIA may also hit you with an additional penalty above the CDSC charge. Just be aware that this is another reason why the FIA product should not be considered liquid. This should be looked at as an income generator, not a capital growth accumulator alone.

3. A cap rate is a limit to the upside potential of a stock market index. For example, a cap rate may be a monthly or annual cap. Let's say that the average monthly cap rate in a bull market was, 3%. That means that even if the stock market earns 10%, your account credit would be capped at 3% growth rate. You may decide to add a guaranteed income rider that may provide an income stream that you may never outlive.
4. Spread rates are a performance fee charged on the index. Let's assume that the spread rate charged is 1, 2, or even 3%. There must be a gain in the "uncapped" index for the spread rate to be charged. If the index lost money or was flat during the time period measured, then the spread rate may be zero. This is another way that insurance companies get paid on these types of contracts. That means that your spread rate is a performance-based fee that is debited from your account only if you make money. All FIAs are different and have different rules surrounding cap and spread rates. Please read all the disclosure documentation to clarify the charges that you could possibly pay before your index return is credited.
5. Guaranteed income rider charges. These charges could be 0.95% each year, or even higher. This charge covers a guaranteed income rider that provides income you can't outlive. When you add the guaranteed income for life rider, you will have to pay this extra fee. Note: If the value of your index growth exceeds the expense that you pay, it may be a wise product for you and your family.
6. If you live too long, there could be no principal left to pass on to your heirs. Once your money withdrawals exceed the deposit plus gains, when you die and your income ceases, there is the possibility of having no money left to pass on to your heirs.
7. Insurance company bankruptcy potential. If your insurance company goes bankrupt, what happens? The state reinsurance pool specifically insures your account to a prescribed limit. In the state of Wisconsin, your author's home state, a $300,000 insurance pool protects WI annuity owners.
8. Bonus recapture. If you received a bonus when you purchased the FIA and you surrender your FIA during the CDSC period of time, you may have to forgo a portion of the bonus when you cash surrender the policy. For example, if you received a 10% bonus when you

took the contract out, you may have to give up a part or the entire bonus that was credited to your account, in addition to the CDSC and MVA charges. However, if you stay with the insurance company beyond the CDSC period of time, you could be able to keep your initial bonus that was credited to your account.

9. These insurance contracts are not monitored like stocks, bonds, ETFs or mutual funds. FIAs are insurance products, not securities products. Not all agents selling FIAs are as highly trained as those who also hold their securities licenses, and the FIA industry is not as concerned with compliance as the securities industry. In addition, the insurance industry is known for having its share of aggressive salespeople. So be aware of a pushy salesman, and distinguish between advisors looking at your overall financial picture and those who are just selling a product.
10. Rates of return mirror those of the bond market and not the stock market. In the bond market you can expect to earn 3 to 4%. In a safe FIA, the same average return may be obtainable. Investing in a more moderate FIA can stretch your projected growth rate to 4 or 5% per annum. Projected growth strategies may provide a rate of return of 5 to 7%.
11. Once your FIA investment is made, it is a long-term strategy. You don’t have the flexibility to change your investment from week to week or month to month, or maybe even year to year. Whatever index you choose, you must stay with that index through the ups and downs of the market to participate in the growth potential of the market. Even though this might be seen as an annuity pitfall, it can also be an advantage. Because these investments are not as liquid, they provide the insurance company the opportunity to invest longer-term and receive a potentially higher ROI on insurance company reserve funds.
12. Annuities are taxed as ordinary income. Even though FIAs are tied to the stock market, they are taxed more like the interest paid on a CD account. The FIA is always tax-deferred, however, for as long as the income gets reinvested. 1099s will not be issued when you are accumulating money within the tax-deferred FIA account. Once you begin withdrawing money for your retirement it will be taxed as ordinary income, not at a capital gains rate.

We Guide, You Decide

Be careful and read all of the facts about FIA products. Every situation is different and needs to be analyzed individually. This article is not meant as legal, tax or investment advice. This article has been written to help you make better decisions. We opened up this article talking about Roth's usage of *The Wolf of Wall Street* to demonize FIA agents. I think it's now clear though that not *all* FIAs are bad, and not *all* agents selling them are people you should run from. Most are honest, well-respected advisors who have an investor's best interest in mind.

If what Roth is recommending is a passive asset-allocation strategy, then I would suggest that a buy, hold and hope strategy is not very appealing. In my opinion, hope is not a strategy, and it certainly is not appropriate to depend upon hope to generate retirement income. In the near-pension-less society we live in, at a time when Social Security is now becoming known as "Social Insecurity," and with medical advancements keeping people alive to much older ages, guaranteed lifetime income can be a beneficial addition to many people's retirement plans. Don't be afraid of the facts and details that surround these products. Read them and find a trusted advisor who will help you understand them. Once you're educated, much like the eighth-grader who can make an informed decision, you can decide how much you want to put in an FIA.

Through my 30 years of experience, I have learned what consumers are looking for these days, and when you're using an FIA, or combination of an FIA along with protected growth strategies and inflation hedges, you may have a very good comprehensive retirement plan for your future. With the help of a trusted advisor, make your decision and become even more confident about your future with some guaranteed income for life.

References:

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