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Caution flag is up when considering purchase of an annuity

ON INVESTING
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Perhaps no financial product is more controversial than annuities. At best, an annuity is an insurance offering that provides a guaranteed stream of income that you cannot outlive. At worst, it is a high-cost way to earn subpar investment returns.

Some people love annuities, citing their ability to provide lifetime income without the risk of stock market fluctuations. They are also marketed as tax advantaged, a claim I would dispute.

Others hate annuities, noting their high costs, lack of transparency, illiquidity, the potential for surrender charges and penalties and higher tax liability.

Adding to the controversy, there are different categories of annuities, and contracts are not standardized. There are immediate fixed annuities, variable annuities, and deferred income annuities. Even within the same category, the characteristics of different contracts can be quite disparate, making for some useful products and others that seem abusive.

There is often criticism of the insurance industry for their sales practices regarding annuities. "Caveat emptor" if you decide to purchase an annuity, but we'll discuss the various types and when they may be most appropriate.

Immediate fixed annuities can make sense for retirees who may not have enough money to carry them through their lives. For example, if someone retires with $100,000, but needs to draw $10,000 annually to meet their living expenses, there is a risk they will run out of money before too many years. Investing in the stock market to earn higher returns may not make sense in this case since the volatility of stocks could result in losses, further reducing the amount of time the portfolio will generate income. A fixed annuity, however, will provide a set amount of monthly income for as long as the person lives.

An immediate fixed annuity may not be able to generate all the income someone needs for retirement, but it does create a stable, dependable source of funds.

Variable annuities are another type of annuity, but unlike the previous category, are neither immediate nor fixed. Variable annuities are purchased for a lump sum or periodic purchases over time. That money is put into investments such as stocks and bonds that hopefully will generate positive returns that can be drawn out in the future. Additional features, such as guaranteed return rates can also be applied to these types of annuities.

While there are probably supporters of these types of products, I can't think of a situation where a variable annuity makes sense. If you need guaranteed income, an immediate fixed annuity may be appropriate. If you want investment gains from stocks or bonds, then you ought to buy them directly. But, to merge the two objectives seems to create inefficiencies and high costs that can easily be avoided.

I have heard the argument that a variable annuity with a guaranteed return rider makes more sense than investing in stocks directly and not having any downside protection. On the face of it, that seems wise. However, when you consider that these types of variable annuities often incur costs of 3 percent or more annually, and that their investment choices, at least that I have seen, underperform the overall stock market in most cases, I can't get the math to add up.

Also, most long-term investors do not really need guarantees. Short-term market volatility can be uncomfortable, but over time the stock market has moved in the right direction. To me, it is not worth paying a lot of money to avoid losses when, in all likelihood, I won't incur losses anyway.

Even worse, the guaranteed returns generated by variable annuities are usually only available if you stay in the annuity forever. If you decide to sell your annuity, you will get the market return on the annuity, rather than the guaranteed return. That might be OK, but if you are paying 3 percent annually in fees for underperforming investments, your market returns might not look so hot.

In my view, variable annuities are sold because of the attractive commissions they generate for insurance agents. I struggle to find many redeeming qualities for investors.

On the other hand, the last category of annuity, deferred income annuities, could be a game changer in the world of financial planning. Retirees face significant challenges as they think about how to manage their money through their retirement years.

Interest rates are quite low currently, making future bond market returns likely to be below historical averages. Stock market valuations are quite high, so future stock market returns will probably be lower than expectations. And, with medical advances, it is likely that we will live longer than we anticipate. This means we will earn lower returns, but need to make our money last longer, a dangerous combination.

One innovative approach to that is to buy "longevity insurance." Putting money into a deferred income annuity today, but deferring any income draws until the future, could guarantee that you won't outlive your resources. For example, a 55-year-old person could put money into a deferred income annuity that secures an income stream starting at age 80.

One of the biggest challenges in financial planning is that we don't know when we are going to die. So we either spend too much and run out of money, or we underspend and don't enjoy our lives the way we could. However, if you knew you had monthly income starting at age 80, you could put a plan in place that optimized your financial growth and spending habits between ages 55 and 80. You might also be able to invest more aggressively, knowing there is a safety net of future income if things don't work out.

Regardless of the type of annuity you might consider, the amount of income an annuity will produce depends upon a number of factors, such as the age of the person buying the annuity, the current level of interest rates and the addition of any extra features. Since payments are often fixed, the impact of inflation should be considered. And, as with any industry, there are good products and bad. Be sure to do your homework before you sign on the dotted line.

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