Industry Brief: Annuities 5-Part Series

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Summary

The origins of the Annuities industry date back to the eighteenth century in the United States, but it was not until 1912 that the concept of retail, or "individual" annuities were made available to the general public. Annuity growth from that point on was steady, but annuities really accelerated in earnest in the 1930s. Concerns about the overall health of the financial markets prompted many individuals to purchase products from insurance companies. During the Great Depression, insurance companies were considered stable institutions that could make the payouts that annuities promised.

Since then, a lot has been written about the industry, both favorable and not so favorable. Certainly, with the almost complete eradication of the defined benefit pension plan, annuities have been designed to fill that void whereby financial professionals are using this tool to provide guaranteed income for life as a piece of the overall portfolio construct. However, the industry has been under attack by those who consider the cost of these protections too high (e.g. fees, surrender charges) and aggressively criticize the industry.

This report is a 5-part series looking across the industry from different perspectives. They include the Industry, the Consumer Perspective, the Agent Perspective, the Criticisms, the Future.

Part 1: The Industry

This report provides a definition of annuities, product types and why these products are important to life and annuity companies and clients. This report will also be distinguishing between fixed and variable annuities, as well as other product types. This foundational report sets the stage for the subsequent chapters.

Author

Don Desiderato
Founder and CEO Mantissa Group
d.desiderato@mantissagroup.com

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Annuity History

Annuities often carry preconceived notions, both good and bad. Some advisors see the importance that the various types of annuities can provide, while others feel that they can be restrictive and are not ideal. What many don't know is that annuities, while popular today, have actually been used for many years dating back to the Roman times. These were contracts known as "annua". During these times, Roman citizens would make a one-time payment to the "annua", and in return they would receive lifetime payments made once per year.

Annuities made their way to the United States in the 1700s but started to grow in popularity in the early 1900s. This was due to concerns about the overall health of the financial markets. During the Great Depression, individuals purchased annuity products from insurance companies because they were perceived as stable institutions that could make the consistent payouts that were promised. These early annuities offered a guaranteed return of principal and offered a fixed rate of return from the issuing company during the accumulation period, and when it was time to withdraw from the annuity, an election could be made to choose a fixed income for life or payments over a pre-determined number of years.

Since these early times, annuities have grown in popularity and use, especially for those who have retirement on the top of their mind.

Why Investors Buy Annuities

There are several reasons to buy annuities given the available tools in today's retirement landscape. A primary reason investors buy annuities is to provide a steady income stream while in retirement, and it is our opinion that this factor is the strongest reason to consider. Annuities can guarantee a regular income stream upon retirement, often times for an individual's lifetime as well as their spouse (if elected).

In addition, most annuities also allow for investment earnings to grow tax-free until distributions are elected. This can be particularly attractive for younger investors purchasing deferred annuities since they will be able to contribute for many years with tax-free compounding interest.

From the issuing insurance company's perspective, there are ways they structure annuities to offset risk. Many annuities do have fees and surrender charges that can get quite expensive.

For example, variable annuities have administrative charges as well as mortality and expense (M&E) fees. These are intended to cover the costs and risks of insuring the assets as well as the living benefits contained in the contract. Also benefiting the insurance company is the length of time they have in order to invest the money. In many cases these insurance companies will have decades to utilize the annuity premium(s) in a way that will benefit the company in the long term.

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Annuity Types: Fixed vs Variable

($ billions)

Year	Variable	Fixed	Amount	Percent change from prior year
2014	$140.1	$96.9	$237.0	3.1%
2015	133.0	102.7	235.7	-0.5
2016	104.7	117.4	222.1	-5.8
2017	98.2	105.3	203.5	-8.4
2018	100.2	133.6	233.8	14.9

(1) Based on LIMRA's estimates of the total annuity sales market.
Source: U.S. Individual Annuities, 4th Quarter 2018, LIMRA, 2019.

NOTE: Individual variable annuity sales in the United States rose 2.0 percent in 2018, after falling 6.2 percent the previous year. Fixed annuity sales grew much faster, 26.9 percent in 2018, after falling 10.3 percent in 2017.

The two most popular annuity classes are fixed annuities and variable annuities.

Fixed annuities are primarily intended to provide a reliable source of retirement income with minimal risk. The annuitant will receive a specific amount of money every month for either the rest of one's life, or a fixed payout period such as 5, 10, or 20 years.

Variable annuities are different in that they are considered a security under federal law and are subject to regulation by the SEC and FINRA.

Variable annuities provide a return that is based on the performance of mutual funds that have been selected to be held within the annuity.

Both types of annuities have value to individuals depending on each person's circumstances. For example, with many companies no longer offering defined benefit plans for retirement, a fixed immediate annuity will often times be a suitable replacement to provide a reliable source of lifetime income throughout retirement. Variable annuities also offer this ability for lifetime income, but for those who are looking for potential growth from their money, a variable annuity may be a suitable option.

Other Annuity Product Types

A third, newer type of annuity is an indexed annuity. An indexed annuity offers the features of a fixed annuity with the added possibility of investment growth dependent on how investment markets perform. At its core, it is essentially a fixed annuity that guarantees a minimum return in addition to any rise in the market index the annuity it is tied to (e.g. S&P 500). If the value of the index goes up, the account value will receive a return based on that value. If the value of the index goes down, often (not always) the account will receive a guaranteed minimum interest rate. All of this means that while the upside is limited, the gains are locked in on the anniversary date of the contract.

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The protected growth opportunity without the risk that a variable annuity carries is attractive to many. Unlike a variable annuity, once interest is credited, it can never be decreased due to market volatility.

Annuity Accumulation vs Payout (Annuitization)

It is important to understand the differences between the accumulation and payout (called annuitization) periods. The Annuity *accumulation period* is the period where contributions are made to the investment, with the intention to build up their savings and the value of their portfolio. The money contained in the account or the value of investment capital continues to build over time until the point when ready to access the funds. The length of this period may be specified at the time it is created, or may depend on when an individual is ready withdraw funds.

When it comes to annuity payout, or annuitization, the primary factors that go into the calculation are the current value of the account, a person's age, the expected future inflation adjusted returns from the account's assets, and life expectancy based on life expectancy actuarial tables. Another factor is spousal benefits. Having provisions where a spouse continues receiving payments upon the primary annuitant's passing will impact the payout amount as the annuity is expected to pay out over a longer period of time.

Concluding Thoughts

Depending on who you ask, there will likely be a variety of opinions on the value of annuities. There certainly are criticisms, especially around the fees and surrender charge associated with annuities. Individuals and advisors, when determining if it is an appropriate product, should carefully consider all factors.

It is our opinion, however, that annuities can provide immense value in the context of retirement planning. As alluded to earlier, with many employers solely offering defined contribution plans (401k for example) as opposed to defined benefit plans (pensions), annuities can have a prominent role in retirement planning. The social good of ensuring that retirees do not outlive their retirement savings cannot be overstated.

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About the Author

Don Desiderato is a former insurance industry Fortune 100 CIO executive and founder of Mantissa Group LLC, a strategy consulting firm serving the CIO executive and their extended leadership teams. Don is a recognized industry expert, and a deeply experienced senior technology executive helping leaders with their **technology strategic plans,** as well as simultaneously focusing on **leadership development and culture**.

About Mantissa

Mantissa Group provides business and technology strategic consulting services. Mantissa supports the Chief Information Officer executive and their leadership teams, with a focus on CIO engagement as a business leader. Mantissa has practical experiences supporting leaders with **technology strategy, executive coaching, leadership development**, and relevant **research** for technology organizations.

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