# 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 good and not so good. 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 the protections too high (e.g. fees) 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, Criticisms, the Future.

## Part 4: Criticisms

The annuities industry in the United States provides an important set of solutions for retirees, primarily accounting for retirement income needs. However, the industry has been heavily criticized from retirement planners or organizations who compare annuities to other investment vehicles. This report documents these criticisms and attempts to place them in the proper context.

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## Criticisms of Annuities

Throughout this series we have highlighted annuities as a valuable retirement planning product, but the industry is not without criticisms. There are numerous commonly articulated criticisms, and it is important to understand them to have a holistic view of annuity solutions, and to place the industry in the proper context.

One common criticism is that annuities have high **fees and commissions**. According to readily available research, annual annuity fees are higher than they would be in a typical managed money account, and depending on product, can approach 2 – 3 percent annually. These fees allow insurers to provide unique *living benefits and riders*, however. These benefits can come in the form of guaranteed lifetime income, continuation of payments to one's spouse for their life (survivorship benefits), and more. Annuity contracts also include fees for *mortality and expense* as well as *subaccount fees* for variable annuities which are invested in accounts similar to mutual funds.

Critics also cite the **tax disadvantages** of annuities. While a retiree may not pay taxes on an annuity during the accumulation or growth phase, once distributions begin, they will be taxed at a higher rate than traditional investments. Annuity gains are taxed as *ordinary income* as opposed to *long-term capital gains*. This mainly negatively impacts wealthier individuals who are in the top tax bracket. The top tax bracket is 37% (in 2020). However, the rate for capital gains is at a much lower percentage of 0, 15, or 20%.

One more noteworthy criticism is a penalty for **early withdrawal**. Withdrawing from an annuity before reaching the age of 59 ½ years of age will result in a significant penalty of 10%. When considering an annuity as an investment, that penalty could erase the gains which has been earned and even lower the initial principal. When an annuity owner is beyond the age of 59 ½, they typically have the benefit of free annual withdrawals, but that is normally capped at a certain percentage. If an annuitant exceeds the percentage of allowable withdrawal, the annuitant will likely pay a penalty.

Finally, **surrender charges** assessed by insurance companies is a criticism perpetually leveled on the industry. A surrender charge is a type of sales charge (some call it a commission) paid if you sell or withdraw money from an annuity during the surrender period, which is a set period of time that typically lasts six to eight years after you purchase the annuity. Surrender charges will reduce the value and the return of your investment. Surrender fees act as an incentive for investors to maintain their contracts and reduce the frequency of early withdrawals.

## Annuity Critics

Criticisms of annuities are most notably made by a few well-known groups or people. One company that is particularly critical of annuities is *Fisher Investments*. Fisher cites many of the negatively perceived criticisms of annuities that were highlighted in the previous section. They also point to how annuities can

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be extremely complex and difficult to understand; thus many retirees really do not understand what they are purchasing.

*Suze Orman* is another critic of annuities. In addition to citing many of the points discussed in the previous section, Suze regularly cites how they are poor investment vehicles, viewing mutual funds as a more suitable alternative in many cases. She seems to mainly find the value of an annuity to be circumstances where a retiree wants guaranteed income during retirement years and do not want to take much risk. Her bottom line seems to be that while there are some situations where they make sense for an individual, there are more instances where they do not, and there are other investment vehicles that can be a better "bang for your buck."

> *"In the end, however, not very many of us should be investing in annuities at all. Yes, as we've seen, there are reasons why they sometimes make sense, but there are even more reasons why they mostly do not. Please be careful, as for the most part even though this is not an investment that will devastate you, this is also not an investment in most cases (SPDAs excluded) that will give you the biggest bang for your buck"*
>
> *- Suze Ormon public website*

While we certainly do feel it is important to understand the "drawbacks" to annuities, understanding them in the overall retirement planning context is particularly important. They are not *always good* or *always bad* but should be purchased to serve a retirement purpose (e.g. guaranteed income stream) and should always be considered when compared to other options. Benefits and drawbacks should be understood, and the *reason* for an annuity purchase should be crystal clear. One should always consider what benefits the purchase of an annuity can bring while at the same time understanding all the features, fees, and expenses to be paid.

## Alternative Approaches

There are those who believe that having a "properly" invested portfolio and withdrawing a specific percentage (e.g. 4%) every year is a sound alternative approach for retirement income. Some financial advisors believe that retirees can adjust this amount for inflation annually, and according to an article from Forbes, have approximately 80% chance of being able to do so for the rest of their lives. One approach to determining a safe withdrawal rate is to run *Monte Carlo* simulations. According to Investopedia, Monte Carlo simulations are models used to predict the probability of different outcomes in a process that cannot easily be predicted due to random variables. Monte Carlo calculations are often built into sophisticated retirement calculators or embedded in software used by financial advisors. A safe withdrawal rate is planned to keep purchasing power constant when adjusted for inflation annually.

Using this approach gives a person control of their own money with maximum flexibility. In this scenario, if markets perform better than the 3% that most inflation adjusted annuities pay, that is an added benefit when compared to annuity returns. One can withdraw more money than is projected annually and more

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than the fixed amount an annuity would pay. This approach allows for more control over the rate of spending.

Another alternative product is a *managed payout fund*. A managed payout fund is a diversified pool of investments designed to generate a consistent annual income. They are like *target date funds* (TDFs) in that they invest in a mix of assets including diversified equities and bonds. The main difference, however, is that managed payout funds are designed to pay out distributions to retirees on a regular basis. This vehicle can be used to generate an income that is likely, *but not guaranteed*, to last a lifetime.

Finally, many of these alternative scenarios assume a reasonable market rate of return, which can be a challenge during significant market downturns.

## Annuities: Investment or Insurance Product?

One of the biggest criticisms of annuities is that they are not a great investment vehicle. Many of the criticisms tie back to how you can get more value out of other investment products that have flexibility, greater liquidity, and lower fees associated with them. It is the belief of the insurance industry that this is missing the point of an annuity. If maximizing *investment return* is the goal of the individual, an annuity is likely not the most appropriate product to purchase. When a person looks to an annuity and is deciding which type may be the right one for them, they are likely at a point in their life where assuring their money will last for the rest of their life is more on the forefront than trying to increase their wealth.

> *"Ultimately, the most important outcome is that you reach your investing goals. On the surface, annuities may seem like a safe bet, especially during times of market volatility. However, they often have significant drawbacks that aren't readily apparent to the average investor"*
>
> *- Ken Fisher, Annuity Insight: 9 Questions Every Annuity Investor Should Ask*

Depending on the annuity product, a person can still earn an investment return on their money and find some guaranteed growth. Many financial advisors feel that the consumer should view the modest growth as an added benefit on the money they have earmarked to be used to generate a guaranteed income stream in retirement. It can be difficult to switch from the mindset that one has carried for most of their adult life, trying to *grow their wealth* as effectively and efficiently as possible, to *generating income*. With an annuity purchase, you are now buying something that answers the question that is top of mind at this phase in one's life. That question is how to make sure they can *maintain their quality of life without the worry of outliving their money in retirement* and be comfortable spending that money without the risk of it running out. That is what insurance companies claim an annuity can insure against.

Fear, comfort, and security are the emotions felt by many retirees. *Fear* that they will run out of money in retirement, *comfort* knowing that while they do not have a traditional pension plan, they have an annuity that behaves like one, and *security* knowing that the retiree and their spouse have a guaranteed revenue

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stream for their lives. These emotions often come into play when considering an annuity and are inevitable factors when considering a purchase.

## Concluding Thoughts

Understanding the valid criticisms and perceived drawbacks to annuities is essential to making an informed purchase decision. Customers in this digital age are demanding information and transparency. We believe that it is up to insurance companies to *simplify* how they lay out the product offerings to make clear all the *features*, the main *purpose* it looks to address, *fees, benefits,* and *limitations*. Having full transparency into what is being offered to the retiree can go a long way in providing piece of mind, and also alleviate much of the anxiety that can come with such a substantial purchase. A purchase like this is likely the largest lump-sum a person has spent outside of the purchase of a home.

We believe the criticisms cited earlier, while quite relevant, must be balanced against the point that annuities are primarily insurance products and not necessarily investment or growth products. Some annuities are meant to help accumulate savings to be used in retirement and others are strictly meant to guarantee income either immediately or at a later date. Creating more awareness around the key benefit of guaranteed lifetime income should be the primary goal of insurance companies.

While it is hard to quantify how much, the industry also recognizes that an annuity investment can be tied to emotions. Retirees normally experience *fear*, the need for financial *comfort*, and *security* as emotions that can drive their retirement decision making. Knowing that the strength of an insurance company's balance sheet can provide them income for life, a retiree is often willing to forgo alternative approaches (even knowing it may be "better") knowing that an that an insurance company will provide a guaranteed retirement income stream.

Finally, financial advisors play an important role in sifting through the benefits and criticisms of annuity products. Each purchase decision is highly personal, unique, and filled with different risk appetites of the retiree population.

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## About the Author

**Don Desiderato** is a former Fortune 100 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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