Annuity Basics

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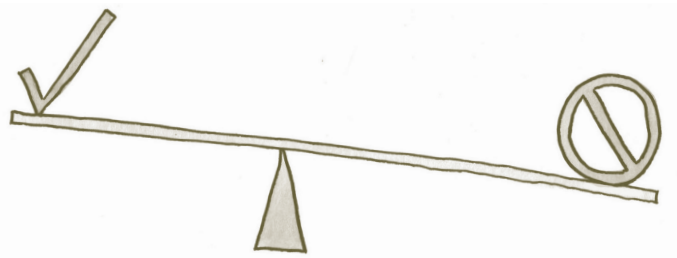
I often hear the word "annuity" used in conversations with RMB clients as we discuss the large array of investment types that exist. While annuities have been available commercially for almost 100 years, they have evolved over time. An annuity can serve as a viable solution for certain investor needs, but many investors are unfamiliar with the details surrounding them. This article will focus on helpful tips and provide information about the structure and function of annuities in today's market.



Background on Annuities

Generally, an annuity is a contractual agreement you make with an insurance company that outlines an exchange of funds over a specified term, depending on the type of annuity contract that is selected. Typically, you give a lump sum of cash to an insurance company and, in return, that company promises to repay you over a period of time. The amount you receive will depend on the terms selected within the annuity and the growth achieved over time. The concept behind this is straightforward, but the universe of annuity providers is vast and includes various types of annuities.

For starters, an annuity income stream can come in two basic formats: immediate or deferred. An immediate annuity is set up to begin payments immediately after the annuity is established. The established (or predetermined) annuity term can last for a certain period of time, over your lifetime, or even over multiple people's lifetimes. A deferred annuity doesn't make payments to you until a later date. In the case of the deferred annuity, you may have the option of funding the annuity with regular premium payments as opposed to a lump-sum deposit. Both structures can be set up to earn some rate of return on your contribution.[1]

Types of Annuities

Within both immediate and deferred structures, there are three main types of annuities:

Fixed Annuity

With this type of annuity, the insurance company agrees to pay you a fixed return rate on your principal amount. This guarantees that your annuity will pay at least the specified amount and is protected as long as the insurance company is financially sound.[1] The amount you receive in income will depend on the terms of the agreement, including when you begin receiving payments.

Variable Annuity

This type of annuity gives you more control over the investment return by allowing you to choose from a selection of investments, which are typically stock and bond subaccounts (similar to mutual funds). A variable annuity can be appealing based on its potential for greater long-term capital growth, in comparison to a fixed annuity.[2] Variable annuities are typically used with a deferred payout structure, allowing the annuity value to grow during what is called the "accumulation phase." When you are clear of any early withdrawal penalties and ready to receive income payments, you would receive payments of your principal amount plus an additional amount representing returns from the underlying investments.[3] Variable annuities are regulated by state insurance departments and the federal Securities and Exchange Commission.[1]

Indexed Annuity

These are a type of hybrid annuity that carry features »

of both a fixed annuity and a variable annuity. An indexed annuity will pay an interest rate that is tied to the performance of a common index, such as the S&P 500 or the Russell 1000. At the same time, these annuities provide protection if the index doesn't perform well by either setting a "floor" value that the annuity can't decline below or guaranteeing some minimum return rate.[2] This gives you the benefit of greater return potential than a fixed annuity, but with less risk than a typical variable annuity. However, the annuity provider will normally also limit your upside participation in the underlying index, so it's important to understand your annuity's true growth potential.

Benefits of an Annuity

Because annuities can be somewhat complex and come with fees that are regularly higher than a typical bond or stock fund, we have to consider why investors seek them out.

Defined Income Stream

One reason is that annuities are a way to provide a steady flow of income that is guaranteed by the issuing insurance company. A fixed annuity might be particularly appealing for investors seeking to fulfill a specific monthly income need or someone who does not wish to carry the burden of making investment decisions themselves to support their income needs. Some annuity features will even allow access to increased funds if the investor has unanticipated needs such as costly healthcare issues. By placing the onus on the annuity provider to make income payments, the investor simply has to maintain his/her budget around the income payments.

Tax-Deferred Growth

Another benefit an annuity provides is tax-deferred growth, which can be valuable to investors who may already pay a lot in taxes. Tax-deferred growth means that the earnings produced by the underlying investment(s) in the annuity are not taxed to the annuity holder on an annual basis. Instead, taxes are deferred, similar to the function of a retirement account like an IRA, until the annuity begins paying income to the holder. The extent to which annuity income will be taxed depends on whether it is considered a qualified or nonqualified annuity. According to Zacks Investment Research, "Calling an annuity 'qualified' or 'nonqualified' does not refer to a product feature but instead indicates the account owner's eligibility to deduct contributions from future income tax returns."[4] Specifically, a qualified annuity would imply that the annuity is held within a tax-favored plan such as an IRA, 401(k), or 403(b). Contributions made to a qualified annuity may provide a current income tax deduction. The money will accumulate without tax liability until income is withdrawn from the annuity during retirement. At that point, it will be taxable. On the other hand, a nonqualified annuity is purchased outside of a retirement vehicle or tax-favored plan.[4] Therefore, any money you put in the annuity is considered an after-tax contribution. Tax liability for investment earnings is deferred, as with qualified annuities, but the amount that you contributed is not taxable.[1] Whether a qualified or nonqualified annuity, an income payment received prior to age 59.5 would normally result in a 10% penalty.

Cost of an Annuity

While there are some benefits to using annuities, their considerable expense can have a huge impact on their ultimate value. The types of fees you might pay when purchasing an annuity could include:

- Mortality and expense charge and administrative fees
- Surrender charge, if distributions occur during a penalty period[3]
- Underlying investment fees, when investing in a variable annuity
- Benefit riders, such as an inflation protection rider, can be very costly

When you consider the cost of the annuity, plus the subaccount fund fees, and the high likelihood that the annuity has at least one benefit rider, it's possible you could be paying more than 3% in total fees.[5]

In summary, annuities can play a helpful role for certain investors. They can be an effective way to reduce market risk by locking in a return rate in a fixed annuity or limiting downside risk in a fixed index annuity. »

They can provide a steady income stream for those who are unable or unwilling to deal with the complications of managing investments themselves. With the various products available, investors can still participate in market returns, but with some added level of comfort and tax deferral. Added features help customize an annuity to satisfy certain needs/concerns, such as inflation, longevity, caring for a person with special needs, or providing for a spouse.

It's important to understand the rules, cost, and penalties of an annuity before investing. Having access to penalty-free funds when needed is an important consideration when deciding whether to purchase an annuity. With the tax-deferred growth aspect of annuities, there are also tax implications that may not always be favorable to an investor. Examining the total cost as compared to other types of investments is also important, as fees will erode your investment earnings. In RMB's experience, we have found that annuities are not cost effective for most clients, but there are certain circumstances where they may be applicable. Be sure to consult with your advisor so that you can make an informed decision. ■

1 *"What Are the Different Types of Annuities?" Insurance Information Institute, accessed November 18, 2016, http://www.iii.org/article/what-are-different-types-annuities.*
2 *"Ultimate guide to retirement – Annuities," CNN Money, accessed November 18, 2016, http://money.cnn.com/retirement/guide/Annuities/?iid=EL.*
3 *"Variable Annuities: What You Should Know," U.S. Securities and Exchange Commission, last modified April 18, 2011, https://www.sec.gov/investor/pubs/varannty.htm.*
4 *"What Is the Difference Between Qualified & Non-Qualified Annuities?" Zacks Investment Research, accessed November 18, 2016, http://finance.zacks.com/difference-between-qualified-nonqualified-annuities-1948.html.*
5 *Karen Hube, "Top 50 Annuities," Barron's, May 27, 2013, http://www.barrons.com/articles/SB50001424052748704895304578495341390213604.*