CHAPTER 2.7

MYfH 7: "I HATE ANNUITIES, AND YOU SHOULD TOO"

The Fed chiefs largest assets last year were two annuities.

—"Fed Chairman Bernanke's Personal Finances Are No Frills," USA Today, July 21, 2008

LOVE 'EM OR HATE 'EM?

I came across an online ad that read "I hate annuities and you should too." The typical internet "hook" promoted a free report on how annuities are terrible investments and that a strategy using stocks and bonds is a much better approach for long-term growth and security. Of course, the advertiser was readily available to sell you his expert stock pickings for a fee. What's not mentioned in the bold print of the ad is that the advertiser is an active-approach stock picker. And as we've already learned from experts Warren Buffett, Jack Bogle, Ray Dalio, and David Swenson—as well as academic research results—active management is ineffective in beating the market on a consistent basis. Their results are inferior to a simple index, which usually has fees that are 500% to 3,000% cheaper, with greater performance. This marketing strategy often works, though, doesn't it? Compare yourself with what's perceived as a terrible product, and suddenly yours doesn't look so bad.

But not everybody hates annuities ...

On the flip side, I was blown away to find that the former Federal Reserve chairman Ben Bernanke, arguably the most influential man in finance at one point, certainly appreciates the use of annuities in his personal finance plan. Bernanke had to disclose his investments before becoming chairman of the Fed. The disclosure showed that he held a relatively low amount of stocks and bonds, while his annuities were his *two largest holdings*. My immediate thought was, "What does he know that I don't?"

So which is it?

Are annuities the best thing since sliced bread or just a deal that is good for the insurance company and brokers selling them? The answer? It really depends on the type of annuity you own and the fees the insurance company will charge you. Let's explore.

During the process of writing this book, I was searching for the world's most respected minds to explore the best ways for readers to lock in a guaranteed lifetime income stream; a paycheck for life without having to work. After all, isn't this why we invest in the first place? As I conducted my interviews, Dr. David Babbel was a name that was continually "rising to the top" during my research. If you recall from the last chapter, he is the Wharton professor with multiple PhDs who advised the secretary of labor on two studies on target-date funds.

In early 2013 he presented his own personal story in a report on how he debunked the advice of his Wall Street buddies, who encouraged him to let his investments ride and hope for more growth, and created a lifetime income plan. So instead of risking a penny in stocks or bonds, he used a series of guaranteed *income annuities*, staggered over time, to give him the safe and secure retirement he wants and deserves—a lifetime income plan. The annuities he used also gave him a 100% guarantee of his principal, so he didn't lose in 2000 or in 2008 when the market crashed. Instead, he was comfortably enjoying his life, his wife, and his grandkids with complete peace of mind that he will never run out of money.

I flew to Philadelphia to meet with Dr. Babbel for a "one-hour" interview, which turned into four hours. His strategy, which we will highlight in the "Create an Income for Life" chapter, was powerful yet simple. And the "peace of mind" factor really came through, as I could see the freedom his strategy afforded him. I left with a completely different view on annuities! Or at least certain kinds of annuities.

He was very clear that "not all annuities are created equal." There are many different types, each with its own unique benefits and drawbacks. **There are ones you should indeed "hate," but to lump all annuities into one category is to thoughtlessly discriminate against the only financial tool that has stood the test of time for over 2,000 years.**

THE JULIUS CAESAR INSURANCE COMPANY

The first lifetime income annuities date back 2,000 years to the Roman Empire. Citizens and soldiers would deposit money into a pool. Those who lived longest would get increasing income payments, and those who weren't so lucky passed on; the government would take a small cut, of course. One must render to Caesar what is Caesar's!

The Latin word *annua* is where we get our word *annual*, because the original Romans got their income payment annually. And, of course, that's where the word *annuity* comes from! How's that for "exciting" water cooler trivia?

In the 1600s, European governments used the same annuity concept (called a tontine), to finance wars and public projects (again keeping a cut of the total deposits). In the modern world, the math and underpinnings of these products are still the same, except governments have been replaced by some of the highest-rated insurance companies, including many that have been in business for well over 100 years; insurance companies that stood the test of time through depressions, recessions, world wars, and the latest credit crisis.

But we must be careful when it comes to the different types of annuities. Annuities were pretty much the same over those last 2,000 years. There was just one version: the Coca-Cola Classic of financial solutions. It was a simple contract between you and an insurance company. You gave them your money, and they promised you a guaranteed income or return on your money. And after you made your contribution, you got to decide when to start receiving income payments. The longer you waited, the higher your income payments. And the day you bought it, you had a schedule that showed the exact payment, so there was no guessing.

IS IT PROGRESS OR JUST CHANGE?

Over the last 50 years, annuities have evolved into many different types compared with the original ones offered by Caesar. Sometimes evolution is a good thing. Other times we end up a mutant!

It's safe to say that there are more poor products out there than good ones. As Jack Bogle says, "I remain a recommender of the annuity conceptually, but you'd better look at the details before you do anything." So let's cut to the chase. Which should you avoid?

VARIABLE ANNUITIES ARE INVARIABLY BAD

In 2012 over $150 billion worth of variable annuities were sold. To put that in perspective, $150 billion is just a hair below Apple's gross revenue for 2012. Variable annuities have evolved into the commission darling of many large brokerage firms. So what the heck is a variable annuity? In short, it's an insurance contract where all of the underlying deposits are invested in mutual funds (also known as sub accounts). Yep. The same mutual funds that underperform the market and charge insanely high fees. But this time the investor buys them inside of an annuity "wrapper." Why would anyone want to invest in mutual funds through an annuity? Because annuity products have special tax benefits, and the money inside can grow tax-deferred, just like a 401(k) or IRA. This arrangement is especially attractive, the pitch goes, if you have already maxed out your 401(k) or IRA limits and have extra capital to invest. But now, instead of just paying excessive fees for underperforming mutual funds, there are *additional* fees for the annuity itself.

FEES ON TOP OF FEES

So what's the appeal? Why would someone buy mutual funds wrapped inside an annuity just to avoid taxes? Most variable annuities guarantee that even if the account goes down, your beneficiaries will receive at least the total amount you invested originally. So if you put in $100,000, and the mutual funds drop in value to $20,000, your children would still get $100,000 when you die. That doesn't sound like such a bad deal until you realize that you just bought the most expensive form of life insurance available.

Earlier, in chapter 2.2, we outlined the laundry list of fees you will pay to own an actively managed mutual fund and how these fees can dramatically drag down your performance. To recap, the total of all the fees (expense ratio, transaction costs, soft-dollar costs, cash drag, sales charges) will average approximately 3.1% per year, according to *Forbes* (if held in a tax-deferred account such as a 401[k], IRA, or variable annuity).

That's $3,100 per year for every $100,000.

But we ain't done yet.

When you buy a variable annuity, not only are you paying the fees listed above but also you have *additional* fees paid to the insurance company. There is a "mortality expense,"? which according to Morningstar averages 1.35% per year, as well as administrative charges that can run somewhere between 0.10% and 0.50% per year.

Let's add 'em up:

Average mutual fund costs= 3.1% (according to *Forbes* article),
Mortality and expense= 1.35% (average),
Administrative cost= 0.25% (average).

A grand total of 4.7% per year, or $4,700 for every $100,000 you invest! And this money comes off the top before you make a dime.

Said another way, if the fund returns 4.7%, you didn't make anything! All of these additional fees all to avoid tax on the gains? Heck, after all the fees, you probably won't have much gain, if any, to pay taxes on!

PAINTED INTO A CORNER

Even though most people lose money in these variable annuities, they feel locked in and afraid to pull out their money because of the death benefit guarantee (the guarantee that their heirs will get back the original deposit amount). And there are usually heavy surrender charges, so the insurance company might charge you for leaving the party early.

Are there any exceptions to the rule? Only two that experts tell me are worth considering in so far as one needs the tax efficiency. Vanguard and TIAA-CREF both offer extremely low-cost variable annuities with a list of low-cost index funds to choose from. They do not charge commissions, so there are no surrender charges if you want to cash in.

NOT YOUR GRANDPA'S ANNUITIES

In chapters 5.3 and 5.4 of this book, "Freedom: Creating Your Lifetime Income Plan" and "Time to Win: Your Income Is the Outcome," we will clearly examine traditional income annuities as well as a relatively new type of annuity (the *fixed indexed annuity)* that provides some of the highest and most compelling income guarantees of any financial product, while also providing 100% principal protection. By the time you are done with this book, you can have the certainty and peace of mind of knowing that every month when you walk to your mailbox, you will be receiving a paycheck (that you won't have to work for). And we can accelerate your path to financial freedom if we can eliminate taxes on your lifetime income payments. How, you ask?

By taking a portion of our money and combining the power of a Roth IRA with the power of a lifetime income annuity. **This means that no matter what the government does with tax rates, you can rest assured that the entire amount you receive is spendable income. That's right: a legal and secure tax-free lifetime income, with no moving parts or worries about market volatility.**

The purpose of this chapter is not only to tell you what to avoid but also to warn you about getting sucked into the marketing myth that *all* annuities are bad. The only reason why I'm not going into more detail on the power of annuities is because you first need to understand where to put your money: asset allocation. And understanding asset allocation will help you know when and where annuities make sense for you.

THE SOLUTION

If you have an annuity, regardless of what type, it's always beneficial to get a review by an annuity specialist. You can reach out to an annuity specialist at Lifetime Income (www.lifetimeincome.com), and he or she will perform a complimentary review, which will help you:

- discover the pros and cons of your current annuity,
- determine the actual fees you are paying,
- assess whether or not the guarantees are the highest available, and
- decide whether to keep it or get out of your current annuity and "exchange" for a different type of annuity.

If you have an annuity that you find is not great, there is a feature called a *1035 exchange*. It requires some simple paperwork to move a cash balance from one insurance company to another **without being hit with a tax penalty.** But you must be aware that your current annuity might have "surrender charges" if you haven't owned the annuity for long enough. It may make sense to postpone an exchange until there are low or no surrender charges. Also, you may be forfeiting the death benefit guarantee.

Stick with me here, as there is just one more truth we must uncover! The last and final illusion is one that insiders are most aware of: the myth that you have to take exorbitant risks to make great returns.

Let's unmask Myth 8....

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7. Fees, included in certain annuity or insurance products, that serve to compensate the insurance company for various risks it assumes under the annuity contract.