

# How New Are Today's Annuities?

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Are the annuities that are being sold today on an after-tax basis directly to individuals basically the same old programs that went out of favor ten to fifteen years ago? What about the annuities that are being sold to employers as "guaranteed" investments to be included in the organization's self directed investment programs like 401(k) or 403(b) plans?

Before we answer these questions, consider why annuities are making a comeback of sorts. In some circles, a traditional variable annuity product (see below) never really disappeared. In the world of qualified retirement plans with over 10 million dollars in assets, however, such vehicles have long been seen as costly insurance products. They have been replaced with less expensive mutual funds, or other types of securities that very often produce better returns for the plan participant investor.

The resurgence of annuities came about for several reasons. (1) The 2008 and 2009 securities market meltdown caused a real crisis of confidence in the stock market. Investors on Main Street simply distrust Wall Street - and who can blame them? (2) People are more worried than ever before about out living their retirement nest eggs. Some retirement planners now believe that a portion of a person's retirement portfolio needs to be in a product that hedges against longevity, and literally cannot be outlived. (3) Insurance carriers have developed a litany of supposedly "new" annuity products with some very interesting bells and whistles. Indeed, these new designs have a lot of sales appeal. But as the old expression goes, buyer beware. Or perhaps, in this instance, the buyer mainly needs to be aware! Here is a very short primer on annuities.

Annuities are contracts between a person or persons and an insurance company, and may be classified in a number of ways. For example, with regard to federal taxes, annuities are classified as either qualified or nonqualified. To be qualified, an annuity must be purchased as part of, or in conjunction with, an employer-provided retirement plan (most commonly a 403(b) Plan), or an individually provided qualified retirement arrangement, such as an IRA. If all the necessary legal requirements have been satisfied, contributions made to qualified annuities should be wholly or partially deductible from the taxable income of the individual, or by the employer. On the other hand, a nonqualified annuity is not part of an employer sponsored qualified retirement program. Nonqualified annuities can only be purchased by an individual or entity. Contributions to nonqualified annuities are often provided with executive deferred compensation, and are typically made with after-tax dollars. Today it is not uncommon for a Secular Trust (an after-tax Rabbi Trust) to be paired up with a nonqualified annuity product. It should be noted that dollars used to purchase a nonqualified annuity are not deductible from an individual's gross income.

Another classification for annuities depends on the type of investment and/or type of payout. The oldest type of annuity is a fixed annuity, which, in its simplest form, provides a stream of payments that never changes over a lifetime. Fixed annuities come in many flavors. They can be indexed



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for inflation and/or they can provide an annuity stream for both the holder and spouse. Most of these add-ons come at additional cost.

Variable annuities, by contrast, have investment subaccounts that resemble mutual funds. The income these annuities pay is not fixed, and will rise and fall with the underlying investments.

New to the field are equity-indexed annuities, which look like a hybrid of fixed and variable. They are tied to an index, typically the S&P 500. The annuity will benchmark the index, but limit its effect, both on the downside and upside. The downside limit is the lowest amount the contract will pay, which could be as little as nothing. The limit to the upside is called the participation rate. If the S&P 500 goes up 8% in a year, and the participation rate is 75%, the rate earned will be 6% ( $8\% \times 75\% = 6\%$ ). In addition to the participation rate, another type of limit is known as a cap. Assuming a contract has a cap of 10%, if the S&P 500 rises over 26%, as it did in 2009, gains are limited to 10%. On the other hand, if the S&P 500 goes down 37%, as it did in 2008, the holder will still receive the minimum rate of return.

What are the pros and cons of annuities? Annuities that come with interest rate guarantees are very appealing in unstable times. Financial planners, as well as individuals who desire to protect against a loss of principal, have been using immediate fixed annuities for years, to buy a pension for clients who do not have defined benefit pension plans. In addition, deferred fixed annuities that trigger at a client's age of, say, 80 or 85, can serve as a protection against running out of money in old age.

Annuities are not a panacea, however. Some annuities have surrender charges that can persist for as long as 10 years. Other annuity contracts carry very stiff financial penalties if they are surrendered after only a few years. Annuity contracts contain a lot of fine print, so you need to read every word of it to know what you are getting. Also, annuities can be three to four times more expensive than a typical securities investment. For example, equity-indexed annuities can cost 3% or more a year; the average expense ratio of all 26,458 mutual funds monitored by Morningstar is 1.32%, or less than half of that. Finally, it is important to understand that annuities are backed by the good faith and credit of the insurance carrier that issued the contract. In other words, an annuity is only as good as its issuer. If an insurer gets into financial difficulty and is unable to meet its contractual obligations, the money invested in it might be at risk.

In summary, annuities, particularly fixed and equity-indexed varieties, can provide both stability and protection in an uncertain world, but:

- You do need to understand the costs
- You need to know the surrender charges or penalty fees for changing your mind
- You must read the fine print
- You should check the ratings of the issuing companies from the ratings agencies - S&P, Moody's, Fitch, A.M. Best



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