

ANNUITIES: FRIEND OR FOE



TIPS

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Annuities can be helpful tax favored investment vehicles and retirement income tools. However, there are times they may not be helpful, and it is important to understand how to determine their positive quality.

Useful Features: Annuities can be used for either accumulation or distribution. As an accumulation annuity, contributions grow on a tax-deferred basis. Transfers from one account to another within the annuity do not trigger taxes on gains. Annuities are either fixed, indexed, or variable. Fixed annuities credit an interest rate based upon a rate of return driven by the general asset account of the insurance company providing the annuity, where in most states those assets are limited to primarily low risk, fixed income assets. Indexed annuities credit returns based upon the investment results of specified indices, such as the S&P 500. However, the full return is restricted a variety of ways such as caps on how much of the index return is credited or thresholds where only the return above a certain amount is credited. We have

also seen where in many cases the S&P Index used by the annuity is actually the S&P 500 "P" index that is based only upon the price of the index, not the S&P 500 "T" index that is based upon total return including price growth and dividends. Variable annuities have actual separately managed accounts available within the annuity that allow diversified investing in stocks, bonds, and fixed income assets.

Distribution annuities are also called immediate annuities where a lump sum of money purchases an income stream that is usually guaranteed for life with a minimum number of years if the buyer should decease unexpectedly. It can also provide joint income to two people with a payment continuing to the survivor of the pair. 401k plans are now required to list guaranteed retirement income options which are usually immediate annuities.

How to Measure Quality: Accumulation annuities often have many additional fees that reduce the rate of return. A management fee including mortality expenses can be anywhere from .25 percent to 1.50 percent. Additional riders may have additional charges. Separately managed accounts in variable annuities may invest in mutual funds that have fees plus the separate insur-

ance company account can also charge a fee. The combined cost can often be over 2.00 percent. We usually look for annuities that have no more than a total for all fees of no more than 1.50 percent.

Distribution annuities can be analyzed by having your advisor review the IRR (Internal Rate of Return). An annuity that can deliver \$6,000 a year for the rest of your life if bought with \$100,000 may seem like a six percent return at first glance. However, if the buyer only lives from 65 to 83 (average mortality for U.S. males), only \$108,000 is received over 18 years. That's eight percent over 18 years or just barely a positive return.

Risks of Combined Accumulation & Distribution: We warn all of our clients to watch out for accumulation annuities that offer returns dependent upon your ultimate conversion to a distribution annuity with them. Many have reduced annuitization factors that make up for the perceived high accumulation returns. The best approach is to usually accumulate funds in one annuity, and then use those funds to purchase a distribution annuity separately.

We welcome any inquiries you might have on analyzing annuities. Our website is www.cgiadvisors.com and I can be reached at bpalmer@cgiadvisors.com or 610.854.1420.

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