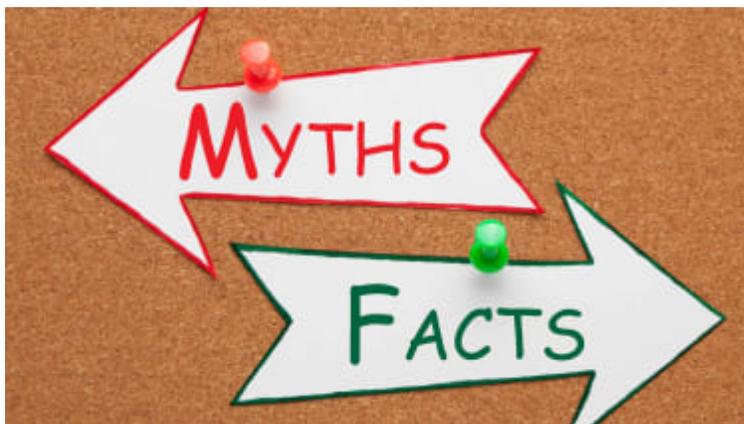


Myth Busters: Examining the Facts about Index Annuities

Don't fall for the hype that screams that annuities are too expensive, too complicated and poor performers. Before you turn your nose up at them, take a moment to learn a little more about annuities. You may discover one that is a great option for you.

by: Phil Simonides, CFP®

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For years people have wondered about the use of annuities in their investment and retirement portfolios. In 2019 alone, total deferred annuity sales topped \$221 billion, of which a record \$73.2 billion were considered fixed index annuities. The increased attraction can be traced to what index annuities offer investors: downside protection coupled with the potential for upside returns associated with various indices.

To learn more about annuities, potential investors often Google and read articles written by firms that do not sell them, which tend to be filled with dramatic language and scare tactics that can obscure the facts. This approach to understanding annuities is what has allowed some common myths to grow over time. The reality is that there are many different types of annuities, and the issues identified in the public domain pertain to some types of annuity programs, but not all of them.

Like a prescription used in medicine, it's important for all investment vehicles to be used in the right situation by the right person, and for any downsides (similar to potential side effects of prescription drugs) to be understood before proceeding.

Today we will address several myths about index annuities (also known as indexed or sometimes equity indexed annuities) and apply a more fact-based review of their pros and cons than what is widely available on the internet, particularly through ad-sponsored Google searches.

Myth #1 – Annuities Are Bad



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Annuities as a type of asset (or contract/policy to which they are often referred) are neither good nor bad. Annuities are simply a tool that can be used in investing to accomplish a specific purpose. There are as many tools in the hardware store that you don't need as there are annuity strategies. But as in any project, selecting the right tool makes achieving one's goals easier. Selecting the right investing tool, including the use of certain annuity strategies, is best when guided by a professional.

There are many kinds annuities, some cheaper than others, some with specific features that an investor may want and others that they may not need or want. While it is good news that there are many different types of annuities, the bad news is that they are frequently bundled together. This has the effect of treating them all the same as a form of investment strategy by those who do not understand them, are not licensed to represent or sell them, or who simply prefer that they did not exist.

The wrong kind of annuity in the wrong situation is the main issue. For example, sometimes fixed annuities are presented to those who have a very long time horizon before retirement (25 years or more) and they may be too conservative for investors whose risk profiles may require more aggressive upside options. For this reason investors need to check the facts and get advice on what may be best for them, preferably from people who are licensed to recommend them vs. various at-large journalists.

Myth #2 – Other Options Can Do What Annuities Do Just as Well



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The single biggest issue with this myth is that other options could do what some unique annuity programs offer, but at nowhere near the low cost that is widely available to retail investors inside of an annuity. Many index annuities today provide a unique set of desired benefits that are simply not replicable by an individual investor for the cost at which index annuity providers can offer them.

For example, one of the main benefits of many index annuity programs is the ability to guarantee no loss of principal on the original invested amount. Other than cash, very few programs exist that can do this. With index annuities, you cannot lose your principal, which is contractually protected by the full faith and credit of the issuing company.

This is not the case, for example, for bond mutual funds and ETFs in a rising interest rate environment.

To offer such a promise, the issuer of the annuity program must purchase options on the underlying investments, which tend to feature indexes of various kinds, as well as cash. These options are not cheap, but when purchased in bulk for an entire program versus for any one investor, considerable economies of scale exist which allow very cost-effective access to these annuity strategies.

Myth #3 – Annuities Are Expensive



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To some extent this has already been addressed. Specifically, there are some annuities that are considered expensive compared to their alternatives, and some that literally have no upfront or ongoing cost to investors. Many of the latter do have penalties for early withdrawal, which are called surrender charges. These tend to reduce over time and eventually disappear in most programs available for today's investors.

For example, say an individual put \$300,000 into a contract with a surrender charge of 8%. If they did not have other liquid funds and soon after ended up needing money, most contracts allow the first 10% to be removed at no charge. So they could pull out \$30,000 without a penalty. But if they needed \$50,000 for an emergency, approximately \$20,000 after the free withdrawal amount would incur the 8% surrender penalty to the tune of approximately \$1,600. Not the end of the world for an emergency, but good to be prepared for at the outset.

When compared with similar strategies over specified time periods, in many cases, the annuities being evaluated are cheaper than alternative investments that charge upfront or ongoing fees. For example, the costs of a classic separately managed account — which might have combined fees of 1.35% every year — over time could add up to more than what an investor would pay for an annuity, even after accounting for assumed surrender charges down the road. This cost comparison is a fairly simple calculation that is patently misunderstood by both the public and many who write about the cons of annuities.

Myth #4 – Index Annuity Returns Are Not Attractive



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Like almost every financial strategy offered, this depends entirely upon what they are being compared to. If you compare some index annuity strategies to a pure S&P 500 type index (or similar investment) in an up market, it is likely they will not compare favorably. But to get the rewards the S&P offers, you must be willing to accept a high degree of risk — something you could avoid with an annuity.

When annuities' returns are compared to cash on the other hand, they will often seem significantly better suited to produce some upside, including even those with caps on returns, for the same virtual safety associated with a no-loss-of-principal asset class. Unlike cash, of course, they are meant to be held longer term and if not, may incur some surrender charges.

Like everything else in financial services, the true costs of this are easily comparable and rarely if ever acknowledged by those who categorically denounce annuities. The favorable cost comparison is especially true for many of today's index annuities, which is likely one of the reasons why 2019 was a record year in fixed annuity sales.

Myth #5 – ‘I Can’t Get Money Out of Annuities for 10 years’



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While it is true that many index annuity programs have a 10-year declining surrender charge schedule, this does not mean you cannot get your money out. As we’ve said, most programs today offer the ability to remove 10% of the annual contract value yearly with no surrender charge or fee. They also offer the ability to remove any required minimum distributions (RMDs) for free as well, even if those RMDs should happen to exceed the 10% free withdrawal feature. But the real kicker is that for those who are still concerned about liquidity — even though surrender charge costs are nowhere near what they might imagine — they can now purchase liquidity riders for a small annual percentage that drastically reduce surrender charges, in some cases to zero, depending on the withdrawal and timeframe need. This feature removes one of the last criticisms regarding liquidity and the costs associated with it.

The riders are, of course, not free, which makes them part of the discussion with a qualified and licensed professional to choose what is in the best interest for each individual investor. The same is true in the medical profession, where doctors are the ones who should be prescribing things to their patients, specific to their profile, versus online resources, whose qualifications cannot be reviewed.

Myth #6 – Annuities Are Too Complicated



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Like anything designed to protect downside, most index annuity programs use algorithms to manage the weightings of their underlying indexes on a daily basis. Annuities may seem too complex for the average individual to understand at first glance, however illustrations that include the impact of guarantees can be compared by back-testing based upon historical index performance. These illustrations tend to demystify the impact index annuities can have on an investment portfolio, and accentuate the benefits of safety in volatile markets.

As with all investment options, there are trade-offs. However, if protecting principal while providing upside is something an investor needs or wants, an index annuity may be the best option out there. Consult a financial adviser who is licensed to represent and sell index annuities before crossing them off your list, and pay attention to the facts. Myths will never help you achieve your financial goals, but solid advice certainly can.

<https://www.kiplinger.com/retirement/annuities/601969/myth-busters-examining-the-facts-about-index-annuities>

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