Why are Annuities a Poor Investment Choice?

Abstract

Don't be fooled by salesmen into playing a risky game of Wall Street roulette by investing in an annuity.

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"Know what you own, and know why you own it."

Peter Lynch

"Spend each day trying to be a little wiser than you were when you woke up."

Charlie Munger

"The individual investor should act consistently as an investor and not as a speculator."

Ben Graham

The Basics: what is an annuity?

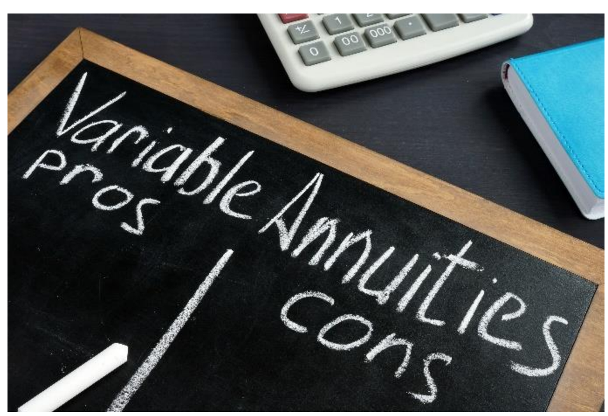
An annuity is a deal made between you and an insurance company in which you make a lump-sum payment to the insurance company, and in turn they provide you with regular disbursements today or in the future. The reason people buy annuities is to provide a steady stream of income in the future, usually during their retirement.

When you initially purchase an annuity, you can decide at any later point in time, to convert your annuity (insurance/investment combo product) into a stream of lifetime income – this is call "annuitizing". To "annuitize" is an important concept to understand. The basic idea was originally designed so that any investor could create their own pension plan – save money now and get back a portion of that savings every month after retirement, for the rest of the investor's life. Just like a pension plan, for an extra fee, or a reduced benefit, the investor can choose to have the annuitized stream of income last for just his/her own life, or include their spouse, and even include their children (all for extra fees or reduced benefits). Once an annuity has been annuitized, it is no longer an investment, but simply an insurance product that is paying monthly. So, after annuitization, it is just a bet on life span as mentioned above.

Since only 4% of all annuities are ever annuitized, the rest of this paper will look at what the insurance salesman is selling PRE-annuitization.

There are two major categories of annuity and each has many minor categories. The two major categories are "Fixed" and "Variable".

A Fixed Annuity is very similar to an interest bearing savings account. These days, banks don't pay much interest on deposits, but annuities still do pay some interest. The problem with annuities is that they also have high fees, and the fees could eat away the interest paid if the investor is not careful. In other words, the general principle here is that the more "benefits" your annuity offers, the more fees you will pay. Because a Fixed Annuity is like a savings account, it trades upside investment potential for downside investment protection, offering extremely limited returns. Variable Annuities will offer a little more upside, but often have extremely high fees. For example, if the market were to rise 15%, your annuity may only earn you a 10-12% return. However, if the market were to fall 15%, your annuity will still lose you money – the amount it loses in the downturn will be proportional to the amount of fees you pay to get "benefits" such as protection



(pay higher fees every year, lose less in a downturn). Or, if you die, the annuity will still pay you a relatively high death benefit due to the insurance component.

So what are the dangers of investing in an annuity?

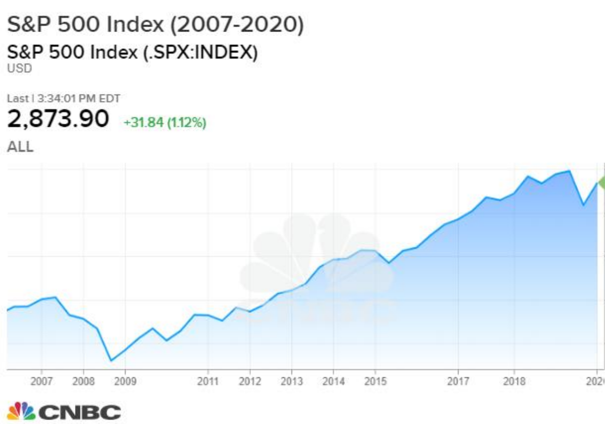
There are a myriad of reasons why annuities make a poor investment choice. Let's take a look at what drives these decisions, from a top level, without getting bogged down in riders and extra fees.

1. When you buy an annuity, you are gambling that you will live longer than the insurance company predicts. Based on their projections, the insurance company is estimating how much longer you will live because they get to keep the rest of your money if you were to die before they pay out the entirety of your annuity. Yes, you read that right. If John Doe were to purchase a 20-year annuity at 60 years old for $200,000, but passed away at age 75 before he could recoup the final 5 years worth of annuity payments, then in most cases the insurance company would keep the remaining value of his investment. Based on how much John Doe paid for his annuity, the insurance company would keep $50,000 of his money because he lived shorter than their projections. Essentially, the insurance company is betting that you won't outlive their projected life expectancy with the hope that they will not have to pay out the entirety of your $200,000 investment. Thus keeping the remaining amount for themselves.

2. Annuities will include something called a surrender period: the time frame in which you cannot withdraw funds from your investment without facing a steep penalty. Often these periods are 7-13 years long. Withdrawing your money before the end of the surrender period will result in a surrender charge that can be as high as 10-15% of your investment. Due to these severe penalties, you will not be able to touch your investment for years after you purchased it. This type of illiquidity is extremely dangerous. In life, situations are constantly changing and not being able to touch a significant chunk of your money because it is tied up in an annuity is very risky. Imagine a scenario where you spend $300,000 of your savings on an annuity, and then a situation comes up where you need some of that money back. Unfortunately, under the contract of this imaginary annuity, you cannot touch that large sum of money for

another 7-13 years without facing a steep 10-15% penalty on any withdrawals. Illiquidity is probably not what you had in mind when you were thinking about "safety" and purchasing a "safe" investment product.

3. The returns on annuities are downright horrendous. Salesmen will sell you on purchasing their product using fear tactics and stating things like "you don't want to risk your money in the volatile stock market. Remember the 2008 recession?" While the salesman has a good point about the 2008 recession, you must be careful about how much emphasis you put onto downside protection. The salesman is banking on the fact that most investors are more afraid to lose money than they are happy to make money. Don't let the salesman fool you. If you were to invest your money in the S&P500 at the top in 2007 right before the housing market collapse, you would be up an astonishing 91% only 10 years later. The reason the percentage isn't lower is because of how much the market soared since the Great Recession. As investors, we need to keep our minds centered with the correct emphasis on upside potential and not be fearful in over-stressing downside potential, thus handicapping returns.



4. Annuities pay extremely high commissions to salesmen, possibly higher than 7 or 10%, and have disguised fees hidden within their contracts. Due to these high commissions, the annuity salesmen are incentivized to sell you the annuity no matter what, as opposed to doing what is in your best interest. In 2016, the US Department of Labor passed a new law requiring all brokers to act as fiduciaries- that is, acting in their client's best interests over their own. Upon the passing of this law, annuity sales dropped 8% and then another 18% in the first quarter of 2017. Variable annuity sales dropped 22% in 2016. The reason for this could be for the several items I've outlined above, or could also be due to the ridiculous fees disguised in annuity contracts. Variable annuities buy stock and bond funds that charge high fees. Combined with insurance fees, rider fees, contract fees, and other creatively named fees, your returns are significantly hampered. You would be much better off simply buying the stocks and bonds yourself and avoiding the ridiculous fees altogether.

Top 10 Writers Of Group Annuities By Direct Premiums Written, 2019

($000)

Rank	Group/company	Direct premiums written	Market share (1)
1	Voya Financial Inc.	$11,462,576	14.5%
2	TIAA	8,998,442	11.4
3	Prudential Financial Inc.	6,871,485	8.7
4	Athene Holding Ltd.	5,228,572	6.6
5	MetLife Inc.	4,834,403	6.1
6	Nationwide Mutual Group	4,512,953	5.7
7	Principal Financial Group Inc.	3,916,406	5.0
8	Great-West	3,902,623	4.9
9	Lincoln National Corp.	3,848,475	4.9
10	OneAmerica Financial Partners	3,552,190	4.5

(1) Based on U.S. total, includes territories.

Source: NAIC data, sourced from S&P Global Market Intelligence, Insurance Information Institute.

5. When you purchase an annuity, you have to physically sign a contract from the insurance provider. These massive contracts are laden with confusing legal jargon, hidden meanings, and complex fees that are intended to be difficult to understand. Purchasing an annuity to serve as income during your retirement is a large commitment, and understanding what you are committing to is absolutely necessary. Insurance companies will provide you with a hefty contract that is meant to confuse you. They are anticipating that you will not read the contract, and if you do, that you most likely will not understand its complexities. You must be fully aware of all the possible penalties and fees included in your contract. Oftentimes, an investor may take some action that will incur a penalty on their investment without realizing the consequences of their actions. In some circumstances, the insurance company will intentionally seek to deceive you in your contract. They will provide several different values of your investment, without telling you that the surrender value is the most important (how much can I get NOW if I want to cash in my investment). It is imperative you do not get misled by an annuity contract, especially when a large sum of money is at stake.

Summary

All told, annuities are the most expensive investment product on the market yet continue to provide terrible yearly returns. Annuity salesmen are highly incentivized to sell you an annuity because of the high commissions they receive, so they will try to persuade you into making a few hundred-thousand-dollar mistake. You would not let fear make most of your life choices, so do not let fear make your investment choices either. Throwing $200,000 on black at the roulette wheel is not a smart investment decision, and neither is gambling against the insurance company on your own life expectancy.

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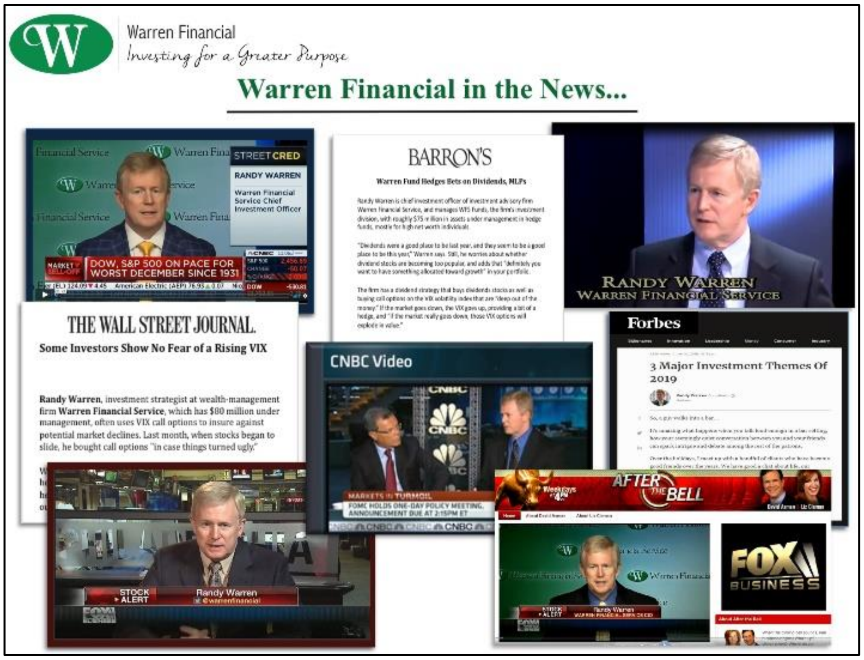

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