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Understanding the Annuity

Complicated financial product should get investors' scrutiny

Leslie Mann Special to Tribune Newspapers
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People give him a funny look when he admits he has one, said Shane Fischer, 37, of Winter Park, Fla. It's a trap, they warn him. The fees will eat you alive. And besides, aren't you too young?

But Fischer, an attorney, did his homework before he bought the product that he concedes has upsides and downsides: an annuity.

"The advantage is my money can grow tax-deferred and I can put more into it," said Fischer of his annuity. "The disadvantage is I would pay a penalty on my gains if I took the money out before I'm 591/2, but I can afford to leave it there."

Single and without kids, Fischer said his annuity "is a forced savings plan. I'm not tempted to get a new car I don't need." He did the math and figured that, despite fees, he will come out ahead by putting some of his savings in an annuity.

A misunderstood financial product, the annuity is routinely trashed by the media. Many syndicated financial analysts, in fact, tell their followers to avoid annuities, period.

One financial planner runs weekly, full-page ads in major daily newspapers that read, "I hate annuities ... and so should you!"

"Much of the criticism is legitimate," said John Robinson, of Financial Planning Hawaii in Honolulu. "Annuities have a lot of warts and keep changing. Even professionals have a hard time keeping track."

Why, then, does Morningstar say annuities are a multitrillion-dollar market?

"Because, for some people, in some circumstances, they're beneficial," Robinson said.

Simply put, an annuity is a contract that says you make a payment or multiple payments (your principal) to an insurance company. You decide how the principal accumulates (annuity-speak for growth), when and how you will make withdrawals (take the money out) and if you want to annuitize (receive regular payments).

If your annuity is immediate, you receive payments right away. If it is deferred, you choose the timing of your payments later.

In a single-premium annuity, you pay into the annuity once. With a flexible premium, you may make ongoing payments.

The annuity is not for the commitment-phobic.

If you take withdrawals prematurely, the insurer hits you with a surrender charge. And, Uncle Sam slaps you with a 10 percent income-tax penalty on your gains if you withdraw money before age 591/2. (Exceptions include disability.)

A variable annuity is a bundle of mutual funds. You can move your money from one fund to another within the annuity, as you do in your 401(k).

Returns fluctuate and you do not pay income taxes on the gains until you take money out.

Like a bank CD, a fixed annuity gives you a guaranteed rate of return for a specified amount of time.

The fixed index annuity is a complicated-as-heck hybrid that is linked to a stock market benchmark like the S&P 500.

"Many baby boomers do not have company pension plans like their parents did, so buying a fixed index annuity is like creating their own," said Jim Poolman, executive director of the Bismarck, N.D.-based Indexed Annuity Leadership Council. "You get a for-sure income opportunity and you can participate in the stock market volatility without suffering its losses."

Although the annuity can be used as a parking spot for retirement money, the planners recommend maxing out your tax-deferred retirement funds — 401(k), 403(b), IRA — first to reduce your taxable income. If you are in a high-income profession like Fischer's, though, you may have more retirement savings than the IRS allows you to sock away in these vehicles, so your other savings are subject to taxes.

Tucked into an annuity, they can be tax-deferred, so you pay the taxes after you are retired, when your income tax rate may be lower.

If you have college-bound kids, an annuity can help protect your retirement money from being gobbled up by the colleges your kids choose, said financial planner Christina Povenmire, of CMP Financial Planning in Columbus, Ohio.

"Many colleges now use FAFSA (Free Application for Federal Student Aid) to determine how much money the family contributes toward college," she said.

Annuities are among the assets FAFSA does not count when tallying your estimated family contribution, she explained. (See fafsa.ed.gov for a sample work sheet.)

"One client had two daughters in college, then inherited money from his mother," Povenmire said. "After he paid off his mortgage, we put the rest in an annuity so it did not affect the girls' financial aid. Now he can use the money for his retirement."

Another feature of an annuity is its death benefit, or the amount left behind for your beneficiary.

It avoids probate court, where records are public, so it provides some financial privacy for your heir or heirs.

"The annuity is progressing at a pace that would make Darwin blush," said Robinson of new product offerings. It's no wonder the consumer can hardly track this changing product, he said, "because even many experienced financial planners cannot."

Before you sign a contract, make sure the insurance company is highly rated by an outside organization like Standard & Poor's.

If you doubt the credibility of your sales representative, check his or her standing with your state insurance department.

If your insurer goes belly-up, state insurance guarantee associations may cover part or all of your claims.

If you invest a substantial amount in annuities, the experts suggest you choose several insurers. "Beware of the salesman who tells you to put all your eggs in one basket," Poolman said.

Compare fees, commissions and charges, which are how the insurance company and salesperson make money.

Talk to your accountant about the annuity's effect on your income taxes.

"Take your time to compare annuity contracts before you choose one that works for you," Robinson said. "But if you don't completely understand it, don't buy it."

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