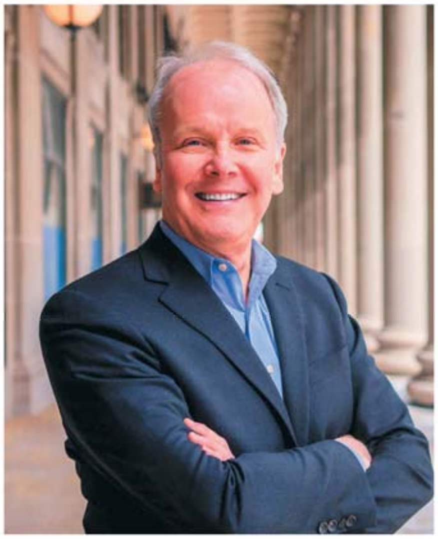

Annuities: Not Your Father's Product

Annuities used to be confusing, costly, and legally complex, but they've evolved into effective and versatile tools for retirement planning.

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When I first started out as a fee-only financial planner in the 1990s, a mentor of mine was fond of saying, "Nobody ever bought an annuity … they were always sold them." And is it any wonder? In those days, the term referred to multiple products that confused consumers with lengthy legal documentation while charging high fees and broker commissions. It was unfortunate, because the basic concept behind an annuity—an insurer agrees to provide lifetime income to a consumer in exchange for a sum of money—has always made sense as a way to reduce one's financial risk. However, as is often the case in the financial services industry, a good idea in theory became a bad one when put into practice.

Still, over the years, technological enhancements, fee compression, and a move toward more transparency in all aspects of financial services have resulted in much better annuity products than existed a generation ago. While there's still confusion among consumers over annuities, I'm happy to report—as a fee-only financial planner seeking low-cost investment products for my clients—that today's annuities are much more consumer-friendly.

So, what's so great about annuities? Annuities are versatile products that can fulfill a variety of needs. Like any financial product, it's prudent to think of an annuity as just one component of a person's holdings, like a certificate of deposit, an equity mutual fund, or long-term disability insurance. According to DPL Financial Partners, an independent insurance broker based in Louisville, Ky., there are four reasons why an annuity might make sense as a financial planning product: It can serve as a source of guaranteed income for a retiree, an alternative to fixed income for wealth accumulation purposes, a method to de-risk an investor's equity positions, or a way to obtain tax-deferred growth for investment assets. Let's examine the first reason: the guaranteed income aspect of annuities. I've learned from years of working with clients that as they approach and attain retirement age, they generally appreciate some income sources that aren't subject to market volatility. For example, Social Security, which may cover less than one-third of a retiree's cash flow needs, is important to most retirees because it's not subject to market risk. Those who are fortunate enough to be covered by a traditional employer-based defined benefit pension plan highly value the steady flow of predictable retirement income those plans provide. For the rest of us, there are annuities.

An annuity can turn a 401(k), 403(b), or any other pool of money into a predictable income stream for the account owner and his or her beneficiaries. In periods of high market volatility, clients appreciate that stability. With that source of predictable retirement income, I believe clients are more likely to invest the rest of their investment portfolio for the long term, which usually leads to greater returns than if the client conservatively invests more of his or her wealth in order to make up for the lack of guaranteed income.

Experts at The American College of Financial Services, Morningstar, and other organizations largely agree that any individual's optimal personal financial capital structure in retirement includes a mix of portfolio assets and lifetime income streams such as Social Security, pensions, and annuities. Anecdotally, I've found that the financial plans that I develop for clients almost without fail predict better outcomes for maintaining and growing wealth when a given amount of cash flow is generated through a guaranteed, predictable source.

Instead of buying an annuity, a person could, on his or her own, build a low-risk investment portfolio that targets a certain level of income. If the portfolio consists of U.S. Treasury bonds, you could even argue that the cash flows are effectively guaranteed. However, this person should plan for full life expectancy and beyond in order to protect against running out of money. This will almost certainly require a larger cash outlay than would be required with the annuity to achieve the same goal of providing lifetime income.

Of course, the devil is in the details when deciding if an annuity is the right option for obtaining lifetime retirement income. However, today's products are available without front-end loads, back-end loads, or contingent deferred sales charges. Depending on the flexibility of investment choices within the annuity contract, there might be rider charges to protect the lifetime income options, but these charges pay for the insurance component of the product, not sales commissions. In other words, the annuity holder is getting something in exchange for the rider fee.

Finally, a word about the guarantees that annuities provide: While there's no federal agency akin to the FDIC to provide insurance for these products, there are agencies in each of the 50 states which provide some level of protection. Most likely, the guarantees will be met by the insurer that issues the annuity, or by a successor insurer if a state must take control of a failing insurance provider.

Annuity products have improved and become more consumer-friendly. They have, in fact, become a recommended source of lifetime retirement income among personal financial researchers and other experts. Even if you've never used or recommended them before, they deserve a closer look.