ADVISOR INSIGHTS

# Why Buy Annuities?

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Ask Morningstar's retirement-methodology team about annuities, and they will offer lavish praise. When they model investment strategies for retirees, they invariably end up recommending big dollops of annuities for those who need lifetime income. The reason, as Morningstar's Paul Kaplan states, is that "self-created longevity insurance is very expensive." Retirees who want guaranteed income—and most do—are best served through a pooled holding.

That theoretical attractiveness hasn't translated to the marketplace. Last year, reports the trade publication Ignites, annuities recorded $204 billion of new sales. In contrast, several trillion dollars flowed into mutual funds and exchangetraded funds. (Net sales were $700 billion, but gross sales—which is how annuity purchases are measured—were several times higher.) If the investment market were a meal, annuities would be a shrimp cocktail.

## First Impressions

Their first problem is their label. Nationwide informs me that there are four types of annuities: 1) variable, 2) immediate, 3) fixed, and 4) fixed indexed.1 Say what? The average American would be likelier to spell "eudaemonic" correctly than to define each of those four terms. (Perhaps the average investment columnist as well; I did not know what a fixed-indexed annuity was before reading Nationwide's piece.) What's more, not only do these four investments confuse potential buyers by sharing the same name, it's a nonintuitive name at that. A bond makes sense. Ditto a fund. An annuity…sounds like an actuary's task.

My suggestion: Switch from "annuity" (a term that only an actuary could love) to "guaranteed income." The latter label lists the two reasons that a retiree would have to buy an annuity. The first is for the guarantee. As stated above, these are insurance payments. The second, of course, is for the income. People might not know that they seek an annuity, but they certainly will recognize that they desire guaranteed income. Give the public what it wants.

Rebranding annuities as guaranteed-income vehicles makes them sound more appealing but does not address the confusion that arises from having multiple varieties of the investment. (In

addition to Nationwide's four groupings, there are options such as inflation-adjusted disbursements or selecting various time periods over which to defer the payments.) I don't have an answer for that difficulty, but the right marketing experts should be able to come up with something.

**Name That Price**!

An even-larger concern is cost. A mutual fund or exchange-traded-fund investor knows exactly how much the management company charges, as the company is required to calculate and publish its expense ratio. The annuity buyer operates in a fog. Most annuities do not carry expense ratios.2 Naturally, they have costs, which cut into investors' income, but the amount of those charges cannot be determined by an outsider.

That uncertainty detracts from the annuity's appeal. What investors do not know might indeed hurt them. In fact, it probably will. As a general rule, when financial products are permitted to bury costs, rather than state them explicitly, they do not come for cheap. When the SEC warned investors a few years back about the risks of structured notes—another financial offering that doesn't have expense ratios—it also cautioned that such notes tended to be "expensive."3

Annuities could change that, if they wished, by calculating and publishing their expense ratios. The process would be trickier than doing so for a fund, because the assets used to pay an annuity wouldn't necessarily be segregated, but the task could be accomplished by allocation. The annuity provider, after all, would know precisely its total costs and precisely its total financial obligations. Thus, at the least, it could publish an average expense ratio for its entire book of business.

**Forty-Nine Too Many**

As insurance offerings, annuities are subject to various state regulations—which, unfortunately, may differ from one state to the next. For example, should an insurance company fail, its annuity owners won't necessarily be left high and dry. As with bank CD owners, the safety of their purchases is guaranteed by a government body, up to a certain level. However, whereas the Federal Deposit Insurance Corporation protects all CD holders by the same amount ($250,000 per bank), the annuity guarantee varies by state.

Fifty sets of regulations is 49 too many. There may be a role for state-insurance departments, with enforcement or in crafting regulations for situations that are unique to that state, but setting individual policies where one national set of standards will do is not one of those roles.

## Beyond Marketing

In sum, to make annuities more attractive, I advise that they be renamed as "guaranteed income" offerings; that they calculate and publish their expense ratios; and that the cacophony of state regulations be simplified into a single, national code. These recommendations, of course, are unsullied by expertise. I did not commission a market-research study on the subject.

That said, I think those proposals are on track. In particular, annuity providers need to address the deep distrust that they have instilled among the most informed buyers. A business school professor emails: "The two words that always come to my mind when I think of annuities are 'rip off.' I don't think that providers will ever publicize an expense ratio because their jig will be up." As word-of-mouth advertising goes, it is hard to do much worse than that.

But what about annuities' investment merits? In this endeavor, I can claim some genuine competence—although the insights are not directly mine, but rather purloined from Morningstar's retirement-methodology team.

## Ground Rules

We'll start by setting aside deferred variable annuities—normally called simply "variable annuities," but I want to distinguish them from "immediate variable annuities." Morningstar's Paul Kaplan recalls in an email a deferred variable annuity conference he attended. "The opening speaker was former N.Y. governor Mario Cuomo. He said that after hearing what a deferred variable annuity is, he won't buy one." While Paul doesn't take investment advice from politicians, he appreciates the governor's view. Deferred variable annuities are neither fish nor fowl—not exactly an investment fund, also not quite an annuity. They often come with high expenses and a bevy of complex features. So, no thanks. There may be a good case to make for a low-cost, relatively simple deferred variable annuity. However, that is not the subject of this column.

Instead, the topic will be the uses of single premium immediate annuities, or SPIAs, which begin their payouts immediately after purchase, and advanced life annuities, which start their payments at some specified future date. The differences in distribution rates between those two versions can be dramatic. Morningstar's David Blanchett tracked down the best current available rates on lifetime annuities for a single 65-year-old male. The immediate annuity pays 6.25% per year. With an advanced life annuity that starts payments in 10 years at age 75, the annual payout balloons to 13.75%.

I use the term "payout" rather than "yield" or "income" because, effectively, these single premium annuities include return of capital in their distributions. Which means that, yes, my

proposed label of "guaranteed income" isn't strictly accurate. Perhaps "guaranteed payments" is a better suggestion.

## The Group's Advantage

The main benefit of an SPIA is straightforward. As financial planner Michael Kitces explains, SPIAs turn an uncertainty into a near-certainty. Forecasting the life expectancy of a single retiree, or even a married couple, is a highly uncertain task. The date may arrive tomorrow or in 35 years. Mapping out the distribution of life expectancies for a large number of people, however, can be done with high reliability.4

Because groups can be modeled with much more certainty than individuals, they can be insured more efficiently. This means that the person who buys an SPIA can achieve a higher lifetime payout rate than he or she can by purchasing government securities—as with, for example, a bond ladder.

Of course, this benefit only remains a benefit if it is priced appropriately. It is certainly possible for an SPIA to carry such high costs that the prospective buyer would be best off forgoing the advantage of pooling with others, because the expenses of doing so outweigh the prospective gains. Happily, that is not currently the case with SPIA pricing; when Blanchett surveyed today's annuity quotes and compared their payouts against what investors could achieve by buying Treasuries, he found that the leading SPIAs do indeed offer better payouts than would a self-insured portfolio. (The reason for the SPIA's higher payout owes to something called "mortality credits"—a topic that I will bypass for this column. For those interested, it is well covered by the Kitces article referenced in the footnote.)

## The Catch

The drawback of SPIAs is well known, major, and oft-lamented: The money disappears upon the purchaser's death. This makes SPIAs ill-suited for those who wish to leave substantial legacies. (Some annuity providers attempt to assuage such fears by bundling death benefits into their offerings, but the costs of such benefits often cut so deeply into the annuity's payout that the product is no longer attractive.) Most retirees, however, do not have that happy problem. Most SPIAs have fixed payments; others have variable payments; and a third, less-common flavor adjusts the payouts for inflation. Morningstar's researchers have no preference among the first two varieties, except to suggest that fixed annuities be used to fund essential purchases, while variable-payout SPIAs (not to be confused with the previously discussed "deferred" variable annuities—see how confusing the industry's terminology can be?) should cover lifestyle consumption. It is probably best to skip the cost-of-living option, as that usually comes at too high a price.

### Longevity Insurance

The final use for annuities—assuming, as always, that they are priced correctly—is for deferred income. Should the retiree live longer than expected, the payments from an advanced life annuity could fill what would otherwise be an income gap. Such annuities take the concept of insurance in a different direction. In the case of the advanced life annuity, the "problem" that is to be insured is the event of living an unusually long life. As problems go, there are worse!

1 "Annuities May Be a Smart Fit for Your Investment Plan." //www.nationwide.com/annuity-investments.jsp
2 The exception being variable annuities, which behave like mutual funds by investing in a specified pool of securities and, thus, carry an expense ratio that is similar in structure to that of a mutual fund—although generally much higher.
3 "SEC, FINRA Warn Retail Investors About Investing in Structured Notes with Principal Protection." June 2, 2011. //www.sec.gov/news/press/2011/2011-118.htm
4 Kitces, M. 2015. "Understanding the Role of Mortality Credits—Why Immediate Annuities Beat Bond Ladders for Retirement Income," //www.kitces.com/blog/understanding-the-role-of-mortality-credits-why-immediate-annuities-beat-bond-ladders-for-retirement-income/ April 1.

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