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5 answers every investor needs to know about annuities

On the eve of the 2014 IMO Summit, NAFA has released a paper that helps advisors educate their clients.

By **Daniel Williams** | October 13, 2014

From Oct. 15-17 many of the major players in the annuity world will gather in Scottsdale, Ariz. at the Westin Kierland Resort & Spa for the 2014 IMO Summit. I will provide live highlights from the conference. In the meantime, here you can find out more information about the event (http://www.nafameetings.com/).

Prior to the 2014 IMO Summit, NAFA sent out a paper ("Answers every investor needs to know about annuities") that can benefit advisors as well as consumers. On the following pages, **NAFA answers (http://www.lifehealthpro.com/2014/09/22/5-ways-regulation-is-affecting-the-annuity-industr)** five of the most important questions you'll ever receive about annuities. These nuggets can be vital in helping producers educate clients and prospects on annuity products.

1. What kinds of returns can I expect with an annuity?

There are two types of **annuities (http://www.lifehealthpro.com/2014/09/22/the-top-10-annuity-sales-leaders-for-q2-2014):** fixed and variable. Variable annuities earn investment returns based on the performance of the investment portfolios, known as "subaccounts," where you choose to put your money. The return earned in a variable annuity isn't guaranteed. If the value of the subaccounts goes up, you could make money. However, if the value goes down, you could lose money. Also, income payments to you could be less than you expected.

Fixed annuities earn interest and not "returns." This is an important distinction because investments earn returns and a rate of return calculates investment losses as well as investment gains. Life insurance and fixed annuities earn interest. Since there are NO investment losses in an insurance product like fixed annuities, the use of "return" is confusing and misleading.

Unfortunately, mixing up these two distinct concepts is a common mistake made by those who don't sell or understand fixed annuities and who, perhaps, make their living selling risk-based investments. With fixed deferred annuities, the insurance company either calculates and determines the interest to be credited based on the insurance company's earnings (for set or declared rate annuities) or based on the positive performance of a market index (for indexed annuities).

The National Association of Insurance Commissioners (NAIC), which regulates **fixed annuities (http://www.lifehealthpro.com/annuities)**, considers both products FIXED annuities, regardless of how interest is calculated. All fixed annuities, including indexed rate and declared rate annuities, guarantee you will not suffer losses because the markets do.

2. Is it true that indexed annuities can limit how much interest I earn?

The main difference between **fixed indexed annuities** (http://www.lifehealthpro.com/2014/10/03/the-insanity-in-indexed-annuity-sales-growth) and other forms of fixed annuities is the way interest is calculated. And, just as you don't receive all of the positive earnings from the insurance company investment portfolio in a declared rate annuity, you do not earn all of the positive index performance in an indexed annuity.

The insurance company must pay for the insurance guarantees of the annuity, as well as the usual and customary company expenses to develop, market and service the annuities sold. Insurance companies use participation rates and caps in indexed annuities to pay for these expenses and ensure profitability.

A participation rate or a cap can be raised up or down, reflecting current market and economic conditions. During strong economic times, these rates and caps will be higher; during weak or negative economic times, they will be lower. This flexibility is advantageous for the consumer: the annuity contract adapts to market conditions while also being protected with minimum guarantees and suffering no losses because the index change is negative.

Sometimes folks that "hate" annuities like to show "hypothetical" performances of an indexed annuity by cherry picking economic cycles or other market variables. But, since indexed annuities have been sold for almost 20 years, we have studies that review ACTUAL interest earnings paid into the annuity contract using a statistical sample of over 300 real-life indexed annuity contracts. NAFA encourages you to read the full academic paper called, "Real-World Index Annuity Returns." (https://nafa.com/wp/wp-content/uploads/2014/09/Real-World_Returns_on_Index_Annuities_March_2011.pdf)

The authors of this study are often called upon to discuss real, historical scenarios, not hypothetical examples using select periods, explaining how fixed indexed annuities actually perform for their owners.

3. Okay, so please explain about the kinds of expenses associated with the annuity?

It is common for those who do not sell fixed annuities and engage in negative advertising about annuities to confuse concepts and features between fixed and variable annuities. Both types of annuities can play a role in financial and retirement planning, but it is important to understand the differences between the two products.

Fixed annuities (http://www.lifehealthpro.com/2014/10/09/retirement-income-planning-with-the-4-box-strategy) have charges (called surrender charges) that are made ONLY when you take money out of the annuity. Most fixed annuities allow you to take a certain amount of money without paying any charges, but if you take more, the amount over the maximum will be charged a penalty. Also, if you terminate your annuity contract early, before the charges have expired, you will pay a surrender charge.

All charges, and under what conditions they are imposed, must be clearly explained in the documents you receive both before and after you purchase the annuity. Fixed annuities may also offer riders that provide additional benefits and features, and you may be charged for those riders. All insurance companies are required by law to fully disclose all charges and under what circumstances they may be incurred. This information must be disclosed both before you buy the annuity and in the insurance policy you receive from the insurance company.

Also, unlike investment products, all **annuity policies (http://www.lifehealthpro.com/2014/09/30/expert-explains-why-people-dont-buy-annuities)** issued come with a money-back guarantee, called a "free-look period," during which time you can return and cancel the policy and receive ALL of your entire premium back. This is an insurance guarantee and consumer protection that investment products do not provide.

4. Can you explain why there are surrender charges?

The **insurance guarantees (http://www.lifehealthpro.com/2014/08/26/4-things-the-annuity-industry-can-do-today)** of complete protection from market losses, income for life, minimum interest, and additional interest above the minimum are not free and are an expense to the insurance company. As with any company, there are other costs of business, including; regulatory compliance, mandated reserving, product development, marketing, and servicing annuity customers. In order to pay for the expenses and the mandated reserves required to remain a solvent and a viable business, the insurer invests the premiums it receives.

However, like any investment, it can only cover the expenses and profit requirements if it retains the investment for a sufficient period, often several years. If an annuity contract is cancelled too early, these expenses will more than likely be greater than their investment returns, and the insurance company will suffer a loss. It is left to the insurance company to determine prevention measures to avoid a loss. All prudent buyers of financial products want their company to operate at a profit.

So, the question becomes, what do you consider the fairest loss prevention method? Some methods assign the cost of offsetting the potential loss to all buyers, whether they surrender their contracts early or not. By contrast, the surrender charge method imposes the burden of repaying unrecovered expenses only to those who caused the loss by not

fulfilling the contractual obligation. There are fixed annuities with no surrender charge and some with 12-year surrender charges — and everything in between.

Surrender charges (http://www.lifehealthpro.com/2014/07/30/how-advisors-shackle-wavering-clients-think-annuit) must be properly explained and understood by the consumer considering purchasing an annuity. Surrender charges are the best tools for ensuring that ALL consumers receive the most competitive interest rate and annuity features possible and that the insurers are adequately protected from a "run on the bank."

5. Is it true that many income riders are beneficial only if the annuity performs poorly and that they require turning my annuity into a stream of income payments?

When you hear or read about **income riders (http://www.lifehealthpro.com/2014/04/23/3-annuity-industry-innovations-you-should-know-abo)**, it is extremely important to understand what information is applicable to variable annuities and what information is applicable to fixed annuities. Variable annuities have market risk, and the value of the subaccounts chosen could go up or down. If they go up, you could make money. If they go down, you could lose money. Also, income payments to you could be less than you expected. By contrast, many fixed indexed annuities have a baseline income guarantee, and you can also utilize performance of the annuity to increase the guaranteed income exponentially.

Fixed indexed annuities available today do not require annuitization on their income riders. These income riders for fixed annuities (typically called Guaranteed Lifetime Withdrawal Benefit riders) provide a guaranteed income stream, typically a percentage of the premium, but the income stream lasts your entire life, even if your annuity account value falls to zero.

Most income riders allow you to turn the income payments on and off or take out the money remaining in your annuity that has not been paid out or withdrawn by you. An income rider should not be confused with annuitization, available in all fixed deferred annuities, which guarantees the amount you will be paid and guarantees that you can receive those payments as long as you live.

The key difference between an **income rider and annuitization (http://www.lifehealthpro.com/2014/04/28/glwbs-and-librs-which-rider-fits)** is that with the income rider you still own and have control of the annuity account value. With annuitization, you convert all value to a promised payment stream.

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