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The Devil In The Details Of Annuities

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Chances are that if you are approaching retirement, you have been contacted to purchase an annuity as an investment vehicle. It has been most likely marketed as a way to get "guaranteed income" or "market-like returns with only a fraction of the risk". However, the reality is that annuities are insurance products that are sold and designed by annuity companies to take your money and earn more than they will pay out to you. The truth is that the majority of the income you will receive is in fact a return of your capital. In this article, we will review the finer points of annuities to make sure they are right for you before you decide to purchase one.

Annuities are, first and foremost, an insurance product designed to reduce risk while also containing quasi-investment characteristics. There are two major types of annuities, fixed-annuities and variable annuities. Depending on an individual's circumstances, these can be more or less appropriate for ones needs. The basic principal is that fixed annuities generally take a lump sum payment, and in return, offer to pay out a fixed amount each month. In contrast, variable annuities offer a payout that varies each month based upon the investment performance of a certain index or investment.

One of the biggest risk with fixed index annuities is the interest rate. Currently, interest rates are historically low, and because fixed annuities are often based on short term interest rates, the same can be said for the fixed yield percentage that annuity companies are offering. Now may not be the best time to lock into these rates with your capital.

On the other hand, variable annuities are often billed as a way to enhance your yield based upon some type of exposure to the financial markets. Yet they are often extremely complicated and intentionally hard to figure out exactly what kind of total return you will actually receive. In particular, index-annuities give the impression that the return you will receive will be in line with the particular stock market index specified in the annuity contract. In reality, these contracts often have clauses that limit the upside potential of the returns, such as putting ceilings on the returns over certain time periods, or not giving the contract holder credit for any dividends that the index component would have paid out. These may not sound substantial, but often add up to a large amount over the life of the contract.

Lastly, and probably most important of all, are the fees associated with these annuity products. Generally, fixed annuities are often cheaper than variable annuities because they are relatively simple. The more complex the annuity, the more room brokers have to hide and disguise fees associated with them. These fees may include, but are not limited to; commissions paid to the selling agent, administrative fees paid on an annual basis, surrender charges in case you want to get out of the contract, mortality expenses to compensate the insurance company for the risk it takes, investment expense ratios for variable annuities, and other fees such as transfer or distribution charges. In total, the fees on a variable annuity can often be well over 4%. As you can see, annuities are often very expensive and are generally not transparent with all their fees.

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In conclusion, there are many different types of annuities. Before determining if they are best for you, make sure you understand the different categories, and know the right questions to ask about the particular annuity you are considering. A good place to start is comparing broker sold annuities to no-load annuities that you can buy directly. No-load annuities will have lower fees, but there are trade offs. Consult with a fee-only, fiduciary financial advisor to see if these are the best choice for you.