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# Life AFTER 50

## Making Sense of Annuities

An expert weighs in on the risks and rewards

by Stephan Peasley



Annuities are often promoted as a great way to fund your retirement dreams. But the first thing you should know about annuities is that they are insurance products. The whole concept of annuities is an invention of insurance companies that sounds great on the surface. But actually, it's just a way to separate you from your money. To be sure, these companies are not deliberately trying to sell you something that will lose you money and some annuities tease you with a small guarantee. But, these companies are helping themselves to your money far more than they are serving you.

So what is an annuity? It is an investment vehicle sold mostly by insurance companies. It is a contract between you and the insurance company in which the company promises to pay you either a fixed income or a variable income. That income could start immediately or be delayed. It could pay you over a few years or your entire life. The investments inside the annuity could grow or shrink. These are the basic provisions of the contract. Make no mistake, it is a contract. And, most of them are highly complicated. Many people fail to read them thoroughly and even fewer understand them. Even the person selling the annuity to you doesn't always understand it in any depth. It is rare that the sales person truly understands the legal document that makes up the annuity. But the sales people do understand the high fees they make.

Most experts think that annuities are not a good choice for the average person. I will go further and say it is a *poor* choice for almost everyone. Besides the high commission the sales person makes, the insurance company typically charges up to 2% per year to hold the annuity. Most of the time there is a holding period of five to 15 years before you can get out of an annuity. Any money the annuity might make will be taxed at your ordinary income tax rate. The gains you make are not taxed as capital gains at the current rate of 15%, but at a far higher rate like the rest of your income. These are just a few of the problems.

If you compare the growth of annuity with the growth of assets in an ordinary stock market indexed fund, you will find over any length of time that the index fund outperforms the annuity. Also, the lower capital gains tax rate, not ordinary income tax rates, applies to the gains in an index fund or stock portfolio.

The argument that the annuity provides life insurance protection is a non-starter. You could buy that same insurance protection with a term life policy at a fraction of the cost and

invest the balance and still be far ahead over most time periods.

What are the benefits of an annuity? I see two, though they are small in comparison to the faults.

One is that the money grows tax-deferred. As the annuity grows in value, you do not have to pay taxes on any of the growth until you take it out. The bad part is, when you do start taking it out you have to pay your ordinary income tax rate, as I said before, rather than the 15% capital gains tax rate. However, maybe you will take it out when you are retired and you are making much less income, so your tax rate is low anyway. I certainly hope not. If that is the case you're struggling to survive.

The second benefit is that generally you are guaranteed not to lose money, at least as long as the insurance company is solvent. This is how these things are sold. The older one gets, the better this feature looks. Risking your money when you are at an age when you cannot afford to is a big consideration. However, many times you cannot get your money out when you need it. And the older you are, the more likely you will need it sooner than later, especially in today's difficult economic times.

There are as many different kinds of annuities, with different provisions, as there are grains of sand. Discovering which particular grain suits you is a monumental task. So monumental, that you are putting yourself too much at risk. I suggest you let the sand lay on the beach; there is no need to pick it up and take it home. Besides, like sand in your clothes, an annuity will only become an irritant.

Steve Peasley is President of KPP Financial, a Registered Investment Advisor based in Dana Point, Calif. Peasley hosts a live radio show called InvestTalk that can be heard in the San Francisco Bay Area on KYOU 1550 AM weekdays at 4:00 PM; in Orange County and Los Angeles on KLAA AM 830 Tuesday - Friday at 6:00 PM, and every Saturday morning at 7AM on Talk Radio 790 - KABC. Contact him at [www.investtalk.com](http://www.investtalk.com) or (800) 557-5461