

Should I Purchase an Annuity?

By: Exchange Capital Management

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Many investors turn to annuities in times of market turmoil to seek protection and stability. However, annuity contracts aren't suitable for everyone and can come with significant restrictions and expenses. Before you schedule a meeting with an insurance salesperson, you need to determine if the benefits are worth the costs.

Is An Annuity Right for Me?

In the past, companies offered pensions that guaranteed income in retirement and transferred the investment risk to the employer. However, the rise of 401(k) plans shifted the burden of retirement savings to employees, exposing them to market fluctuations.

Annuities primarily make sense in two scenarios: you have a hard time sticking to a budget or you're a risk-averse investor whose biggest concern is having a reliable source of income in retirement.

Budgeting: With pensions off the table for the majority of retirees, annuities emerged as a solution to "buy" a pension-like income stream. These insurance contracts offer monthly payments for life, forcing those who are concerned with overspending to stick to a set budget and tailor their spending.

Risk Tolerance: If you're more concerned about market volatility and the thought of taking on risk makes you anxious, an annuity might be worth considering. Think of it as an additional layer of diversification for your portfolio.

Ideally, your portfolio should have a mix of assets such as stocks, bonds, cash, and other investments. When you include an annuity in your portfolio, you are taking some risk off your shoulders and placing it with the insurance company. In doing so and guaranteeing a stable income source, you may feel more comfortable taking on additional risk in other parts of your portfolio, potentially pursuing higher returns.

Who Shouldn't Purchase an Annuity?

If the two scenarios mentioned above don't resonate with you, then you probably shouldn't purchase an annuity. For most individuals, the costs of annuities often outweigh any benefits they may have.

High Fees: Compared to investing in individual stocks and bonds, annuity costs are typically higher due to the complexity of the product. Annuities involve services from insurance companies providing income or death benefits, financial advisors managing the investment, and administrators handling tasks like record-keeping and customer support. All these parties need to be paid, making annuities more expensive.

Here are some common fees you may encounter with annuities:

Administrative Fees: Covers basic account management, usually less than 0.30% of the contract's value.

Mortality Expenses: Compensates the insurance company for the risk it takes on, often ranging between 0.5 - 1.5% of the contract's value.

Investment Expense Ratio: Some annuities may charge an expense ratio for the underlying investments within the annuity. Generally, these range from 1 - 2% and should be no higher than 3%.

Commission Charges: The insurance company compensates the salesperson who sells the product through commission, often paying anywhere from 2 - 8% of the contract's value. This cost is eventually recovered by the insurance company through higher annual trailing fees in the annuity contract. These fees are charged over time to cover the commission paid and other expenses.

Surrender Charges: This penalty may incur if you withdraw from an annuity early or cancel the contract. These charges can be significant, reaching as high as 10% of the annuity's value. Their purpose is to help the insurance company recover the costs they incurred when setting up the annuity, like commission

charges. Typically, the longer you hold the annuity, the lower the surrender charges become. These charges are designed to discourage early withdrawals and create an emotional hurdle that makes it harder to cancel the annuity.

Restrictive Investment Options: Insurance companies often impose restrictions on investment choices within annuities to mitigate risk. One common restriction is not allowing a 100% allocation to stocks or other high-risk investments. The goal is to maintain a more balanced and conservative investment approach within the annuity to protect its value.

Opportunity Cost: If you have a long time horizon and are seeking to maximize your profits, an annuity would not be an ideal choice for you. Long-term investing in the market generally offers greater potential for higher returns compared to annuity contracts. One reason for this is the impact of high fees associated with annuities, which can eat into your overall investment returns.

No Tax Benefits: While some tout the tax deferral offered by annuities, every dollar in an annuity contract will be taxed at ordinary income rates upon distribution. This is a downside because stocks, bonds, and other investments will be taxed at a more favorable rate if held for a year or longer. It doesn't matter if you had the annuity for ten years; it will always be seen as ordinary income in the eyes of the IRS.

Further, an annuity is not considered an investment and will not receive a step-up in basis for your heirs. This could leave your beneficiary with a massive tax burden once you pass.

The Bottom Line

Unless you are extremely risk-averse or need remedial help sticking to a budget, an annuity probably isn't right for you. The costs of these contracts often make them the unwise choice compared to other investments and retirement accounts available. However, this doesn't mean all annuities are bad, it just means you need to make sure the product aligns with your needs and overall financial plan.

If you're considering one of these insurance contracts, always read the fine print before finalizing your purchase. Check out our free checklist to see how an annuity fits within your financial plan.