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Understanding Deferred Annuities

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One of the "hottest" investments hawked in the media today are deferred annuities. A common ad intones "you will never lose any money no matter what the stock market does." Are these good investments?

In a word, no. What you are almost certainly being sold on both the radio and by your broker are insurance products in which you "invest" with after tax money. The funds are then used to purchase either a CD like fixed account with guaranteed returns or more commonly in some variety of stock and bond mutual funds. Sometimes, the returns are linked to the return of the stock market without actually owning any funds (so called index linked annuities).

In every case I have examined, the annuities sold by brokers and through advertising carry very high annual expenses. Their returns are crippled by these expenses and the typical 6-10 percent commissions paid to the salespeople. A strong clue that you are being sold such a product is that it carries a surrender charge (you cannot get your money out for many years without a penalty that runs 6-15 percent.) Some of these policies also have other clauses that make it impossible to have you come out well.

All of these "products" have significant negatives to consider:

All earnings withdrawn from an annuity are taxed as ordinary income (instead of the usually lower capital gains on non annuity investments).

There is the risk of insurance company default. This is not to be taken lightly after the events of the last five years. There are state guarantee funds that usually have a minimum coverage of $100,000, so I'd suggest you not purchase an annuity from any single company larger than that amount.

There is a loss of liquidity. There are often substantial penalties if you try to get your money back once the annuity is purchased. If you may need the money on a faster schedule, then annuities are a poor choice.

If you buy a "guaranteed" fixed rate return annuity, you must then understand the risk of inflation. A fixed long term return with low interest rates in the face of significant inflation will erode your purchasing power very rapidly. There is no getting the money back to re-invest in another way.

The only annuities that I'd consider investigating are those with guaranteed lifetime withdrawal benefits. These (high cost) insurance products at least do guarantee a specific return on your original investment. A typical product today might offer a 4.5-5 percent return on up to double your original investment, but only if you wait a full 10years. You cannot take out the money as a lump sum, but may receive the promised return. I would not call this an investment, but an insurance guarantee on a deposit. You must still deal with all the negatives mentioned above. Despite the advertised 4-5 percent returns, the actual returns are closer to 2-3 percent when you take into account the fact that the insurance company had the use of your money for 10 years or so before you started distributions.

Don't buy a deferred annuity without getting impartial fee only advice.

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