The Navigator

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Fixed annuities are complicated, expensive products that are marketed by insurance companies. While most investors should avoid fixed annuities, only those older investors who want guaranteed, predictable income and want to offset longevity risk might want to consider such products.

Fixed Annuities

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In a prior issue of the Navigator (Fall 2016), we delved into the complex and controversial world of variable annuities. In this Navigator, we tackle the somewhat simpler and less controversial but still very important topic of fixed annuities.

A fixed annuity is a contract between a consumer and an insurance company in which the insurance company agrees to pay the contract owner a set amount of income over a specified period of time in exchange for either a one-time lump sum payment or series of payments over time. A fixed annuity contract transfers market risk, interest rate risk, and/or longevity risk (the risk of outliving one's assets) from the contract owner to the insurance company.

Who Should Not Own Fixed Annuities[1]

Due to their many negative characteristics, fixed annuities are only useful tools for investors with very specific circumstances.

In our estimation, fixed annuities are inappropriate products for individuals who meet the following criteria:

- **Unwilling or unable to accept sustained sub-market returns.**
  In exchange for the guarantees that they offer, fixed annuities typically reward contract owners with lower rates of return than they would likely be able to earn through direct participation in equity and fixed income markets.

- **Require liquidity.**
  Fixed annuities are poor sources of liquidity, so they should only be considered by individuals who do not have a significant need for liquidity.

- **Unconcerned about longevity risk.**
  Investors with sufficient assets to support life longevity or younger, healthy investors are unsuitable candidates for fixed annuities.

- **Have concerns about counterparty risk.**
  Fixed annuity guarantees, like other insurance guarantees, are subject to the claims-paying ability of the issuing insurance company. This means that a fixed annuity contract is only as good as the company that backs it. If an insurance company that has issued fixed annuity contracts gets into financial trouble, the potential exists that the company could default on its payment obligations to contract holders. Thus, if an investor has concerns about the financial standing of the insurance company, then he/she should not consider these products to be appropriate.

Types of Annuities

There are two primary types of fixed annuities: ***immediate annuities*** and ***deferred annuities***. The primary difference between these annuities is based on when the first payments are made by the insurance company to the contract holder.

1 The single best example for owning a fixed annuity is for advanced senior citizens with limited assets, given their projected longevity. Fixed annuities can be attractive investments in this set of circumstances and may allow such investors not to run out of savings prior to their demise.

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As the name implies, the owner of an ***immediate annuity*** contract begins to receive annuity payments immediately upon purchasing the annuity contract. Such a contract, also often referred to as an "income annuity," is purchased with a single lump sum payment made in exchange for a guaranteed series of payments to the contract owner for the remainder of his or her life.[2] The amount of income that is generated by an immediate annuity is determined at the time of purchase and is dependent on several factors, including the purchase price, the contract owner's age, the payment term, and the level of prevailing market interest rates.

Immediate annuities can be simple and effective tools for offsetting longevity and/or market risk, although they come with certain drawbacks. Let's begin with the positive characteristics. For certain older investors (age 80+) with limited resources who are unconcerned about bequeathing assets to their heirs, fixed annuities can be quite useful. In some cases, these investors can get paid a far higher rate of return than is available through the bond markets. This phenomenon transpires because the insurance company has made a calculated gamble on the life longevity of that investor. Should the investor die early in the annuity contract time period, the insurance company will have made huge profits on that contract. For those investors who live a long time, the income generated from the fixed annuity should be considerable and well above bond market rates of return.[3]

As for the drawbacks on immediate annuities, once a contract has been purchased, the contract owner relinquishes any and all control over the annuity assets. The only liquidity provided by most immediate annuities is the guaranteed series of cash flows that issuing insurance companies are contractually obligated to pay to contract owners. Certain annuity contracts may allow owners to borrow against future cash flows, but these provisions are typically very limited and may have adverse tax consequences.

A ***deferred annuity*** is a contract that obligates the issuing insurance company to pay the contract owner a stream of cash flows starting at a predetermined date in the future. Between the time of purchase and the time when payments commence, a deferred fixed annuity increases in value based on the cumulative payments made into the annuity and a guaranteed, fixed rate of return. A deferred annuity can be purchased with a lump sum payment or with a series of payments over time.

2 In some cases, contracts may contain provisions that guarantee income for a beneficiary even after the contract owner has passed. Less commonly, some immediate annuity contracts may only guarantee income for a set number of years.

3 If the investor is using a fixed annuity to offset longevity risk, a cost of living adjustment rider should be evaluated as part of the purchasing decision.

Similar to immediate annuities, deferred annuities can be used to offset longevity risk and may be useful tools for senior citizens to increase their retirement income. These products can give investors peace of mind by reducing the stress of generating investment returns. They remove uncertainty, which can be rather valuable to retirees.

However, it is also worth noting that guaranteed rates on deferred annuities are typically low relative to market interest rates unless the insurance company believes your life expectancy to be short. Guaranteed rates incorporate all fees and expenses, such that the difference between the market interest rate and the rate paid on a fixed annuity contract is the insurance company's compensation for assuming market and longevity risk. In the investment industry, because the word, "guaranteed," is used in situations where the guaranteed rate of return is well below market rates, the cynical investor should question the value of the guarantee itself.

Costs & Liquidity

The costs involved with fixed annuities are both complicated and difficult to calculate. While the costs are not specifically spelled out in the fixed annuity contract language, these costs typically lower the rate of return on fixed annuities to well below market rates of return. Furthermore, in the case of deferred annuities, insurance companies levy severe penalties upon contract holders, should they need to access the capital prior to the end of the surrender period.

While variable annuity contracts must explicitly state all associated mortality & expense and administrative fees, fixed annuity contracts simply incorporate these fees into the rates of return paid on the contracts. Issuing insurance companies offer guaranteed interest rates that are below what the companies expect to earn on the investments that they subsequently buy with annuity contributions. The difference between what an insurance company earns on investments and what it pays in interest on contract values is effectively the fee paid by a contract owner. This fee can be estimated, but it cannot be known with certainty. However, what is nearly certain is that fixed annuities are priced in such a way that the contracts are almost always highly profitable for the companies that issue them.

In addition to the fees that insurance companies extract through the interest rates that they pay, deferred fixed annuities can potentially have other costs, specifically in the form of surrender charges. As mentioned previously, fixed annuities are generally poor sources of liquidity. For deferred annuity contracts, this illiquidity is primarily due to the fact that, for the first several years of a contract, typically ranging

from five to fifteen years, any need to take money from the contract will likely result in the forfeiture of a material portion of the contract's value.[4] The percentage of the contract that must be forfeited depends upon the surrender schedule specifically stated in the fixed annuity contract. In many cases, surrender schedules start at a percentage that matches the number of years in the surrender period and then declines by one percentage point per year until the surrender period ends.[5]

Surrender charges are designed to discourage contract owners from prematurely ending their contracts. Insurance companies pay significant upfront commissions to their salespeople who sell such annuity products, with the expectation that these commissions will ultimately be recouped through fees charged to contract owners over time. However, when contracts are surrendered, insurance companies must recoup the lost fees through surrender charges. These charges also help to protect insurance companies against short-term losses on long-term investments that must then be liquidated to meet surrender requests. Surrender charges can severely impact a contract's value when it is needed most, during times of significant liquidity needs. Thus, deferred fixed annuities should only be purchased with the expectation that the capital will be completely off-limits until the contract is annuitized.

Taxation

All deferred annuities, whether variable or fixed, enjoy tax-deferred growth, allowing contract values to increase without being encumbered by the drag of taxes. However, income payments received from an annuitized contract (deferred or immediate) are taxed as ordinary income in the year in which they are received.

While the tax-deferred nature of annuity growth can be an attractive feature, annuities also have some drawbacks with respect to taxation. Just as with other tax-deferred vehicles, payments made from deferred fixed annuities prior to age 59½ are typically subject to a 10% tax penalty, in addition to any other applicable taxes.

4 Some deferred fixed annuity contracts contain language that allows for small withdrawals to be made at various intervals during the surrender period without penalty, though these allowances typically come at a cost, in the form of lower guaranteed interest rates.

5 For example, a contract with a 10 year surrender period would charge a 10% surrender charge if the contract was surrendered in the first year, a 9% surrender charge in the second year, and so on until the surrender charge reaches 0% in the contract's 11th year.

While certain annuities can be passed to a beneficiary upon the death of the contract owner, these annuities do not receive a step-up in cost basis.[6] Beneficiaries of annuities are responsible for paying ordinary income tax on all growth in excess of the original contract owner's basis.

Additional Information

For readers who are interested in learning more about the structure of fixed annuity contracts and some of the various types of contracts available in the market, please see the Appendix.

Conclusion

Like other insurance products, fixed annuities are designed to serve a specific purpose for individuals with certain circumstances. Unfortunately they are often sold to people who may be financially better off owning different investment products. If you are considering purchasing a fixed annuity or currently own a fixed annuity contract and have questions about whether it is the most suitable product for your needs, please contact your portfolio manager. We are happy to discuss how a fixed annuity may or may not fit into your personal financial plan.

6 When the owner of traditional securities such as stocks, bonds, and commodities passes away and his or her heirs take ownership of the securities, the cost bases of those securities are stepped up to their value as of the date of the owner's death, thereby significantly reducing the tax burden on the heirs.

Appendix

While all deferred fixed annuities share certain basic characteristics, these contracts can be configured in a number of different ways with respect to both value growth and payout structure. Set forth below are the four primary growth options for deferred fixed annuities.

- **Multi-Year Guarantee**
  A multi-year guarantee annuity is a deferred annuity contract that is guaranteed to grow at a specified rate for as long as the contract's surrender period is in effect. This type of contract is popular because the interest rate is known and fixed for the entire surrender period, and the contract can be surrendered without penalty at the expiration of the higher guaranteed rate.

- **Banded Rate**
  Banded rate annuities are structured in much the same way as multi-year guarantee annuities, except that, instead of having a single guaranteed rate for the entire surrender period, these contracts guarantee a materially higher interest rate for the first year of the contract (e.g., 8%) and then adjust to a much lower guaranteed rate (e.g., 2%) for the remainder of the surrender period.

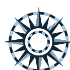
- **Equity-Indexed**
  An equity-indexed deferred fixed annuity grows relative with the performance of a broad equity index (e.g., the S&P 500 Index). The issuing insurance company guarantees a minimum interest rate on the contract and then pays incremental interest when equity markets perform favorably. Therefore, the investor does not bear downside risk with such contracts, but market upside is capped such that significant upside may be lost.

- **Market Value Adjusted**
  Market value-adjusted fixed annuities offer relatively high guaranteed interest rates during their surrender periods but carry additional risk to which other fixed annuities are not subject. If an annuity owner needs to liquidate his or her annuity during the surrender period, the value that he or she receives will not only be reduced by the applicable surrender charge but may also be subject to an additional adjustment based on the movement of interest rates.

Contract Riders

Fixed annuity contracts can be customized in a multitude of other ways to meet a number of different needs through the use of riders. Set forth below are a few of the most common riders that can add to the utility of a fixed annuity contract. It is important to bear in mind that riders, while often very useful, typically come at a material cost. Adding riders to a fixed annuity contract typically results in a lower guaranteed interest rate, a lower payout rate, or both. Fixed annuity buyers should fully understand the costs of any riders before entering into a contract.

- **Guaranteed Death Benefit**
  If a deferred fixed annuity contract owner dies before he or she begins to receive income payments from the contract, a guaranteed death benefit rider ensures that the contract owner's beneficiaries will receive the contract value.



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- **Return of Premium/Refund**
  This type of rider protects against untimely death in the early years of the income phase. If, at the time of a contract owner's death, he or she has received less in income payments than was paid into the contract, the contract owner's beneficiaries will receive the difference so that the total of all payments made by the insurance company equals the total contributions made by the contract owner.

- **Long-Term Care**
  Long-term care riders are designed to increase income payments should a contract's owner develop a need for long-term healthcare during the income phase.

- **Cost of Living Adjustment**
  A cost of living adjustment rider provides for steadily increasing income payments over time in order to try to keep pace with increases in living expenses due to inflation.

Payout Options

Fixed annuities offer two primary options with respect to how income payments are structured: lifetime payments and fixed period payments.

- **Lifetime**
  When a fixed annuity contract owner decides to annuitize his or her contract, he or she may choose to receive income payments for the remainder of his or her life. This type of payment structure completely eliminates longevity risk for the contract owner, as the insurance company is obligated to make payments to the contract owner at regular intervals for the rest of the contract owner's life, no matter how long that may be. Some contracts may even contain provisions that allow income payments to be transferred to a spouse upon the death of the original contract owner, though such provisions result in lower income payments throughout the payment period.

- **Fixed Period**
  In contrast to the above payment option, a deferred fixed annuity contract owner may choose to receive a specified number of income payments over a certain period of time that is agreed upon in advance. This type of payment structure typically results in higher periodic payments to the contract owner because of the reduced risk faced by the insurance company. However, it also nullifies one of the most powerful features of annuities, which is the potential elimination of longevity risk for the contract owner.

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