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Annuity Myths vs. Realities

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This is the 5th in a series of articles on annuities. The previous 4 articles can be accessed on my AZ blog site at: http://www.azcentral.com/members/user/DrWongInvestorGuide. Use this site to find the details on my winter education campaign, as I have scheduled over 30 seminars from December, 2009 through April, 2010. Also, feel free to email me with your questions at: haroldwong1@yahoo.com. Here are some of the major myths in the annuity field:

Myth #1: All annuity fees are high.

Reality: Fixed annuities and fixed indexed annuities have very low or no annual fees, far less than the typical mutual fund. Variable annuity fees can average 3% of your account's annual balance, which is not too different from many mutual funds or managed money funds, where the fees typically are around 2-3% per year.

Myth #2: There are big commissions in annuities.

Reality: The commissions paid on fixed or fixed indexed annuities do NOT come from the investor's funds. Often, a bonus of 5-10% is added to the investors' original balance. This is very different from "load" mutual funds, where the commission is subtracted from the investor's funds.

Example: If an investor purchased a fixed indexed annuity and deposited $100,000 of premium, he could have $105,000-110,000 working for him on day 1. In contrast, $100,000 deposited into a mutual fund with a 5% "load", would leave only $95,000 of funds on day 1. In addition, the mutual fund investor might have 2-3% of annual fees. Over the last 10 years, owners of mutual funds or managed money funds have paid up to 35% in total fees, even though they have lost 20-40% of their principal. In contrast, the purchaser of the fixed indexed annuity would have NO commissions subtracted from his original deposit.

Myth #3: I can't buy an annuity because surrender penalties prevent me getting my money out for 10-15 years.

Reality: Annuities come in all sorts of durations, from 1 to 20 years. If one pulls money out early, there may be a surrender penalty. Over time, the surrender penalties decrease and eventually cease. This is very different from bank CD's, where it's all or nothing. If you have purchased a 5-year bank CD, and pull your money out at month 59, you suffer the same "early withdrawal penalty" on ALL your money. Most fixed indexed annuities allow you to withdraw 10% of your money each year without a penalty. Some policies have a cumulative feature, where if one did not need to withdraw any money for the first 4 years, and in year 5 one needed to withdraw 50% of one's money, there would NOT be any penalty.

Dr. Wong analysis: Surrender penalties can actually be good for the long-term annuity purchaser. It allows the insurance company to use the investor funds for a longer time period. Thus, the company can afford to give a 5-10% upfront bonus or a higher interest rate to the investor. Also, the surrender penalty is a good deterrent to prevent people prematurely robbing their retirement account. A similar deterrent is the 10% IRS penalty on people who withdraw funds from their traditional IRA or 401(k) prior to age 59.5.

Myth #4: Annuities are only for old people.

Reality: The average age at which owners purchased their first annuity was 52. However, millions of teachers have contributed to annuities, starting as early as in their 20's. The real issue is whether one wants to risk losing 20-50% of one's life savings in the stock and bond markets, OR one prefers the safety of a fixed or fixed indexed annuity.

Myth #5: Because one's earnings are tax-deferred inside an annuity, it makes no sense to purchase an annuity inside one's traditional IRA or 401(k) or other qualified retirement account.

Reality: This is a common perception held by CPA's. However, fixed or fixed annuities can often yield a higher interest rate than bank CD's and are guaranteed to have no principal lost. Why should the CPA's clients not want to protect part of their life savings?

Author: Dr. Harold Wong has a Ph.D. in economics and passed the CPA exam in 1979. You can contact him at (480) 706-0177 or haroldwong1@yahoo.com. For a list of his seminars, visit his AZ Republic blob site at: http://www.azcentral.com/members/user/DrWongInvestorGuide.