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Annuity: When Is It A Good Solution

There has never been a financial product that was more misunderstood, misrepresented, or over-sold than an annuity. I am the first to admit that annuities have drawbacks (e.g. fees, surrender charges, and limited growth potential). That being said, I firmly believe that annuities can be a good fit in the right situation. Let me share an example that demonstrates my position.

Can I get a second opinion, please?

In April of 2017, a prospective client asked me to give his wife and him a second opinion on their fixed indexed annuity policy. This couple was in their late 60s and recently retired. They had pulled about half of their retirement savings out of the stock market in December 2008, when the sky was falling. Their instinct was to put that money in the bank for safety and peace of mind. Their financial advisor suggested an annuity instead, which they subsequently purchased.

The amount invested in this annuity was $750,000. The main attraction was the lifetime income rider, which guaranteed that their future income would increase at a minimum of 7% per year. Fast forward 8 years and 3 months to the time I was reviewing the annuity. The account value had grown to $1,056,000, which represented an average annual return of 4.25% after all fees. This couple can cash out of the annuity and walk away with their account value at any time. However, their plan is to take the guaranteed lifetime income beginning later that year, December 2017. The insurance company will pay this couple $65,287 per year for the remainder of both spouses' lives.

Each distribution from the annuity will reduce the account value and the corresponding death benefit. Their beneficiaries will inherit the remaining account value (if any) at the passing of the second spouse. A likely scenario is one or both spouses will live long enough to deplete the account, at which time the insurance company will go right on distributing $65,287 every year as long as at least one spouse is still alive. I forecasted that the annuity's account value will be depleted when they are between ages 87 and 92. The couple is not worried about the annuity running out of money because it will not impact their income.

Let's compare this to the other option they were considering:

The $750,000 would have grown to $848,000, if they had earned 1.5% per year in the bank over the past 8 years and 3 months. Suppose that they began the same $65,287 annual withdrawal from the bank account beginning this December and the account continued to earn 1.5%. This couple, who will be 68 in December, would run out of money by age 82. Naturally, the bank will not continue to distribute funds once the account is depleted. Instead, it will say, "Thank you for banking with us and have a nice day."

I think it is important to think about **how likely it is that this couple will outlive their account value** in either the bank or annuity scenario. In other words, was it worth paying for these guarantees? The Social Security Life Expectancy tables show a 50% chance that one member of a 68-year-old couple will live to age 90 and about a 20% chance that one of them will live to age 95. **The Social Security Administration's life expectancy tables**are one of several resources commonly used to estimate longevity. Some of the others, such as U.S. Life Tables from the **U.S. Census** and the Annuity 2000 tables from the **Society of Actuaries**, tend to assume slightly greater longevity. Naturally, medical advances over the coming years could increase longevity even further.

The bottom line:

This annuity was a good solution for a couple who was nervous about the stock market, and needed/wanted guaranteed lifetime income. The best part is this couple left the other half of their money in the stock market so they still have liquidity and growth potential. Also, since they do not need to worry about depleting the annuity, they are able to take a **higher withdrawal rate than otherwise would have been prudent**. This means they can let their other account(s) grow without the need for distributions. I told this couple they did well and wished them a long, healthy, and happy retirement.

Disclosure: Examples used are for discussion purposes only and not meant as a recommendation of any specific product. Annuities are not suitable for all investors. Fixed indexed annuities are not stock market investments and do not directly participate in any stock or equity investments. Additional requirements and restrictions may apply and some annuities and/or riders are not available in all states. Withdrawals and surrenders may be subject to federal and state income taxes and, except under certain circumstances, will be subject to IRS penalty if taken prior to age 59 ½. Guarantees are based on the claims paying ability of the insurance company. Speak with a financial advisor regarding your specific situation.

-Jeremy Kisner, Senior Wealth Advisor