BUYER BEWARE

WHY DO THEY KEEP TRYING TO SELL YOU THAT ANNUITY?

ANNUITY PITFALLS

You may have heard the saying "take some of the risk off of the table with a percentage of your assets," or "you can participate in the ups of the market without participating in the losses." An increasing number of clients we speak with have been told annuities are the be-all and end-all solution to managing investment risks and achieving financial security. Why would you be locked into something for 10+ years when it has supposedly no risk? Does that sound like it is in your best interest?

> ***Unfortunately, most annuities are great for the salesman but not so great for the consumer.***

WHY DO CONSUMERS FALL FOR THE ANNUITY BAIT AND SWITCH?

This goes back to the adage "annuities are sold, not bought." It comes down to the persuasion of the salesperson that plays into a consumer's fear of investing and market volatility. Many consumers would prefer never to invest in the market, deeming it too risky. So to risk-averse people, the annuity appears to have the safeguards that the consumer wants: protection from the market's downside and an income that you cannot outlive. Just remember that there is no such thing as a free lunch. If it sounds too good to be true, it probably is.

WHAT IS AN ANNUITY, ANYWAY?

TYPES OF ANNUITIES

Annuities can vary based on different factors such as how the account will be invested and when you would like to start withdrawing your money. First is the **variable annuity**, which is invested into stock and bonds and can grow tax-free. However, withdrawals are taxed as ordinary income, unlike other taxable brokerage accounts. There are also lots of fees to consider including surrender charges (for cashing it out early), fees from the funds you are invested in, and certain administrative fees.

On the more conservative side is the **fixed annuity**, for the person who does not want any risk. It as their bond portfolio, with returns similar to a 3% fixed rate. However, this overall rate is locked in and can be so low that with the fees, it becomes a wash and clients actually lose money in the long term. Fixed annuities pay interest on the principal. The minimum rate of interest is stated in the contract but depending on market conditions, the interest rate can be higher than the minimum in order for the annuity to be more competitive in the marketplace.

THE INDEXED ANNUITY

Another type of annuity that we see most often at Wiser Wealth Management is the indexed annuity. **An indexed annuity is a variation of the fixed annuity**, but it can be sold as a type of safer "investment" vehicle from the variable annuity because it is not directly invested in the market. It is more complicated and generally implies you have the opportunity to "participate in the stock market" without the volatility of the stock market. Indexed annuities also pay interest, but the rate is extremely complicated and tied to the performance of an index, such as the S&P 500. However, there is no direct investing.

RISKS WITH INDEXED ANNUITIES

The sales pitch for an indexed annuity says that you can participate in the market upswings with no downswing risk. Sounds great, doesn't it? Who wouldn't want that? However, if you take a closer look, things aren't so simple.

Say you purchase the annuity and tie it to the S&P 500 and that year, the S&P 500 index goes up by 20%. You would expect to see a 20% return on your annuity, right? Wrong! It is not that simple with annuities. Honestly, nothing about annuities is simple. This is just another reason why annuities are not as great as they seem. The interest credited to your account is actually determined by multiple factors including participation rates, caps, and calculated values. We will explain each of these in the next section.

PARTICIPATION RATE

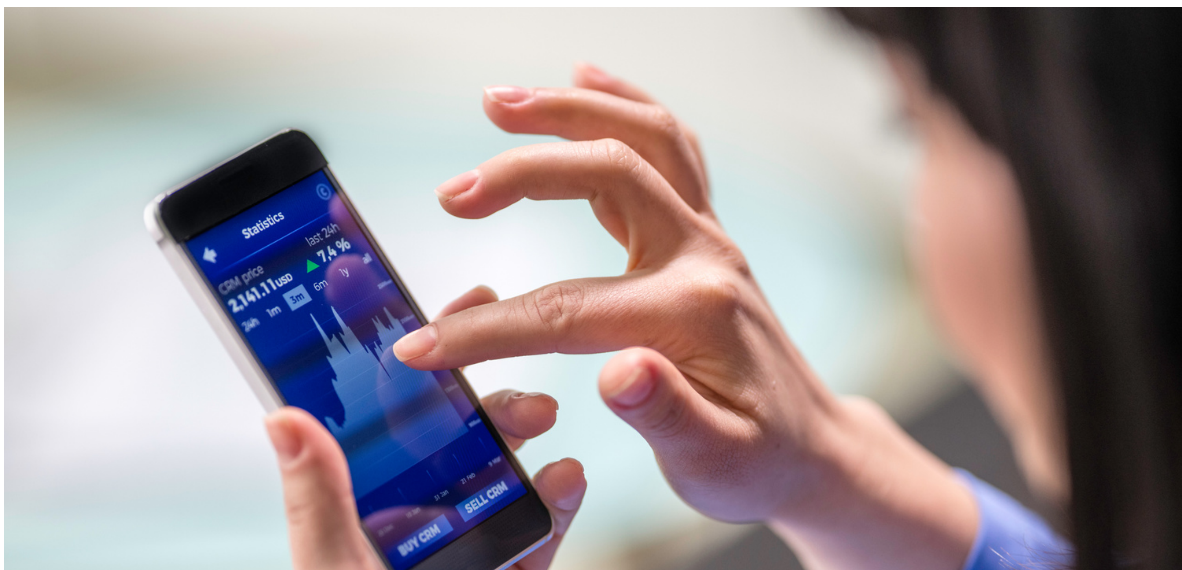
The participation rate is the percentage of growth that is actually used in the calculation. A 75% participation rate means that with a 20% return on the S&P 500, only 15% would be used in the calculation of interest for your account. If the S&P returned 4%, only 3% would be used in the calculation.

SUBJECT TO A CAP

The cap is the maximum amount of interest that can be credited to your account. Say you have a 7% cap. When the return on the index is below the cap rate, the entire index return will be applied to your account. However, when the index return is higher than the cap, the maximum amount credited to your account will be 7%. When combined with your participation rate the total amount of interest credit your account is eligible to receive is the return of the index times your participation rate not to exceed your cap. So, once again if the S&P returned 20%, with a 75% participation rate, you'd think that you would receive a 15% interest credit, but then you would actually be maxed out at the 7% cap.

ZERO FLOOR

So, what if the S&P returned 20%, like in our other example? Again, with the 75% participation rate, the applicable interest rate drops to 15%. Then the cap kicks in, dropping the rate to the 7% cap. So even though the S&P 500 did 20%, you only see a 7% return in your annuity account. That's 13% you lost out on. What happens if the return of the S&P 500 was negative? Then you receive nothing. This is because indexed annuities have a zero floor – zero interest is paid when the return of the index is negative. In comparison, even in a down market year in normal investing, you still receive dividends. The market also has historically had more up years than down, so there is no clear reason to buy an indexed annuity.



CALCULATED VALUES

CHOOSING HOW THE RETURN IS CALCULATED

CNBC may say that the S&P 500 index rose by 20% in the last year. However, **the indexed annuity calculates the return based on one of three methods – point-to-point, averaging, or a monthly sum.**

POINT-TO-POINT METHOD

In the point-to-point method, the indexed annuity looks at the value of the index chosen on a given day, usually the contract date, and then compares it to the value on a future date, usually one year later.

AVERAGING METHOD

In the averaging method, the annuity looks at the value every day and takes the average value for that year, and then compares it to the average value from the previous year.

MONTHLY SUM METHOD

In the monthly sum method, monthly values are added then divided by 12, then compared year over year. Values also are usually subject to caps.

You have to choose one of these methods when you sign up, just like you choose the index. Confused yet?

WHY WE DON'T LIKE ANNUITIES

COMPLICATED, FALSE ADVERTISING, & CONSUMER LOSSES

We would rather shut down our company and sell toothpicks than sell an annuity to our clients. Why? Fear sells, and annuity salespeople know this.

Take financial news headlines and market volatility over the last ten years and you have a great sales pitch as to why an annuity might sound good, but the math does not add up. They are usually marketed as safe investments, with guaranteed income, whenever you are ready. Most buyers never see the truth. It's buried in huge, complex, jargon-filled contracts that normal folks can't understand without a dictionary, gallons of coffee and a claimant's lawyer. Few read them. Sales reps (many well-intended) believe in annuities but are paid handsomely to blind-eye reality. Why? A single, big sale can fund a year at Yale for his or her child. Some say, "Yes there are bad ones, but I find the good ones for you." It's almost always untrue.

The reality is there are ways to replicate the positive benefits the annuity claims through other means of investing that don't involve actually purchasing one.

INVESTING DURING RETIREMENT

INVESTMENTS DURING RETIREMENT

Unfortunately, too many retirees think that because they are no longer working, their investments do not need to work for them and they should be conservative. While they should not be 100% invested in stocks, it is essential to invest in the stock market in some form or fashion in order to achieve long-term financial success.

SUCCESS FOR RETIREES

If your desire is to not lose money and even earn a little, you'd be better off with a liquid 5-year certificate of deposit (CD) that pays a guaranteed rate of interest for a smaller lock-in period. Although, a retiree's success is most enhanced through a properly managed portfolio, consisting of healthy long-term asset classes, low-cost ETFs allocated based on risk tolerance, and periodic rebalancing.

Another aspect to look at is the investment objective based on the individual's risk tolerance. Are you younger and looking to grow your assets or nearing retirement and looking for a more conservative account with principal protection and some income?

And finally, look at the costs. While costs have gone down in the past, there are still some expensive financial products and funds out there. Some annuities have internal expenses that are well above most management fees. This is why it is important to talk to a fiduciary advisor, who looks out for your best interest.

OUR FIRM

At Wiser Wealth Management, we are a fee-only fiduciary firm. Fee-only means we only charge clients for the management of their assets and we do not receive any commissions from the sale of financial products like annuities or insurance and we do not receive any trailing incentives from pushing proprietary funds. We focus on what is in the best interest of our clients through financial planning to help guide them toward financial freedom. **Our goal at Wiser is to get our clients to age 95 with the highest probability of success within their financial plan.**

If you have questions about how our financial planning process works, feel free to reach out. If you're ready to schedule a consultation to speak with one of our financial advisors, you can schedule it on your own by clicking here or you can call our office (678-905-4450).

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