7 Reasons I'm Not Fond Of Annuities

DECEMBER 1, 2015 • RIC EDELMAN

I once told our firm's clients that the advice we don't give them is sometimes just as important as the advice we do give.

That was in response to someone who asked my opinion of a hybrid investment product that Wall Street was touting at the time. In our firm's newsletter, I explained that if we don't talk about certain investments, it doesn't mean that we aren't aware of them; it means we don't recommend them. And then I provided a list of 13 products and strategies that clients will not hear me recommend.

One of the items on that list might annoy some advisors: It's annuities.

At Edelman Financial, my colleagues and I are simply not big fans of these products, which have morphed dramatically over the past couple of decades.

Helping clients establish retirement income that they won't outlive is a service that's much in demand at our firm—as I'm sure it is at yours. However, we cringe at these brand new wrappers called QLACs or longevity insurance.

The jargon is nifty, but you and I know that longevity insurance is just a new name for an old product—similar to life insurance salesmen calling themselves financial planners.

Yes, I realize that many financial advisors love to sell annuities to their clients. So many, in fact, that whenever I mention the topic or field a call from a listener during my radio show, I usually get a nasty phone call or e-mail from some advisor or wholesaler demanding that I explain my contrarian view.

So, OK. Here are seven problems I have with annuities:

1. Cost

Annuity products today tend to be far more expensive than alternative choices. Sure, there are low-cost variable annuity products available, but I don't think those are the products being touted at free-lunch seminars, nor are they attracting the majority of the assets that are flowing into the category.

An additional cost is taxation: Profits from these products don't enjoy capital gains rates or pass tax-free at death.

2. Income Is Not Inflation-Adjusted

A client might be content with the income he or she initially receives from an annuity, but let's see how happy that client is in 10 or 20 years—after inflation has taken its toll. I wonder how many advisors selling these products simply figure that they'll have quit the business by the time the client starts to express dissatisfaction. The absence of accountability sure makes it easier to sell the product!

3. Deceptively Pointless Guarantees

Some annuities offer guarantees of one sort or another. Don't worry about market declines, dying too soon or living too long, they proclaim. We'll protect you or your heirs no matter what! In exchange for these promises, the products charge even more.

The extra fee charged for many of these guarantees is a big problem—but not the way you might think. On one hand, the fee is exorbitant. On the other, it's far too small. Let me explain. First, some guarantees are worthless, as they promise to protect you if a certain something happens that's extremely unlikely to happen. I'm reminded of the client who wore an ugly necklace that cost him $50. When I asked him why he wears it, knowing that he thinks it's ugly, he said it's because it protects him from being eaten by a tiger. He boasted that ever since he's worn the necklace he's never been the victim of a tiger attack—proving to him that the 50 bucks was money well spent. Ditto for many absurd annuity guarantees: Clients pay money to protect themselves from market losses that they either won't experience at all or for long.

The second problem is the opposite: Insurance companies are charging so little for the guarantees they're making that they won't be able to pay up if required. See item 5 below for more on this.

4. Lack of Liquidity
Once clients place money in an annuity, they often face limitations in getting it back—at the least, they may experience surrender charges. In other cases, they face taxes and IRS penalties. Even worse, some contracts limit the amount they can withdraw per year, even of their own principal. And this lack of liquidity applies in virtually every case once annuitization starts. I wonder how many clients fully understand these restrictions or their implications. And by the time they become apparent, the advisor who sold the product may be long gone.

5. Low Returns
The low interest rates offered by fixed annuities don't even require elaboration. And the returns of variable annuity subaccounts are reduced by the fees mentioned earlier.

6. Early Death Risk
Any annuitant who wants money to go to a spouse, children, charity or other heirs might be called insane to annuitize an annuity contract: Get your first monthly payment today, get hit by a bus tomorrow, and watch the rest of your account evaporate. Clients who want to protect a spouse have to accept lower monthly incomes, and kids and charities can't be protected. Oh, wait, yes they can: You can sell the client a life insurance policy in addition to the annuity policy. Why settle for one commission when you can earn two?

7. Longer Life Expectancy
According to the Society of Actuaries, women now live to about age 88 on average, men to about 86. Imagine how long people will be living when today's 65-year-old annuity buyer reaches age 85! My research into exponential technologies has led me to worry that the actuarial assumptions that insurance and annuity companies use are flawed, and that the companies simply will not be able to honor the promises they are making to today's annuity holders.

The industry seems to know it has a problem. Why else would so many insurance and annuity companies be quitting the business, altering their products, initiating buyout offers to current policyholders and selling their books of business to private equity firms that are too dumb to realize what's happening?

Shortly after the Society of Actuaries added two years to everyone's life expectancies, General Motors had to add $2 billion to its pension plan. The workers' rising life expectancy, from age 84 to age 86, cost GM $2 billion! What will happen to the carmaker when mortality tables increase by 20 years? Will GM be willing and able to pay? I shudder to think about what happens to all those retirees if GM doesn't honor its promises, or if the thousands of other companies that have made similar promises don't.

When clients invest in a globally diversified portfolio consisting of low-cost ETFs and index funds, they maintain control over their money. They
can make investment changes anytime, and they can withdraw their money whenever they want. But when they put money into an annuity, they face higher costs and often severe restrictions, sometimes permanent ones.

No wonder the SEC, Finra and NASAA have issued so many investor alerts regarding the sales practices of annuity products.

Now you know seven of the concerns we have with many of the annuity products on the market these days. If you routinely recommend them, you might want to reconsider which products you use, why you use them and how much your clients truly understand the risks associated with them.

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