Editorial

"Why I Don't Like Annuities"

Before detailing why I do not recommend annuities, let me make several general points.

(1) The agent will "recommend", no, "strongly recommend", annuities because the fees are stiff, bordering on rapacious. According to Suze Orman,[1] except for annuities offered by no-load mutual fund companies, the agent receives a commission of 5% to 6%. Ouch! Right off the top you have lost essentially a full year's return. The same applies to any mutual funds with a load. This is not how you accumulate wealth.

(2) The more complex the annuity, the greater the risk, and the higher the fees. Peter Lynch of Fidelity Magellan notes that if you cannot illustrate something within 5 minutes using only a crayon, you should not invest.[2]

(3) The only time I might consider an annuity is as a charitable gift. Ex: you donate $3.5 million to a university to endow a professorial chair. Depending on your age, sex, marital status, and other details, you receive $xxx per month for the rest of your life. But note: Only after you pass is the chair created. The school cannot pay you and support the chair at the same time. You are probably better off to just hang on to the money and endow the chair in your will.

I will discuss only the simplest annuity, referred to as SPIA (Single Premium Immediate Annuity). It is a single payment upfront, you receive distributions immediately, and for the rest of your life. In an example from *Barron's*,[3] a 70-year-old man invests $200,000 with New York Life. The annual distribution is 6.75% of $200,000 = $13,506, and starts immediately. By age 90, total distributions are $270,120.

Consider these alternatives. Rather than send the money to NY Life, you purchase $200,000 of risk-free 30-year U.S. Treasuries paying 1.45%. As in the above example, you take off $13,506 per year. You will run out of money in the 17th year.

Now say you buy a portfolio of blue-chip stocks, such as Johnson and Johnson (JNJ), Chevron (CVX), Proctor and Gamble (PG), Pfizer (PFE) and Verizon (VZ), or a mutual fund or ETF (Exchange Trade Fund) of similar stocks, with an average dividend yield of 3%. You run out of money in the 20th year. But, these are the companies that try to increase their dividend every year. Plus there will almost certainly be some capital appreciation, so unless things get really bad, your annuitized payments should be funded, with money to spare. If things get that bad, it will also affect the ability of the insurance company to fund your payments.

Or you take the $200,000 and buy a piece of rental property that produces a rent of $1,125 per month = $13,506 per year, the same amount you receive from the insurance company. Not only should the value of the property and the rental payments track inflation, but you still own the property.

Before proceeding on, note that the U.S. Federal Reserve has a stated goal of, at least, 2% inflation per year. At the end of 2 decades, unless your annuity payments are indexed to inflation, they have lost half of their purchasing power.

Here is the big question: If a 30-year Treasury pays only 1.45%, how will the insurance company fund your annuity payments?

(1) Considering we are at a multi-decade low in the cycle, interest rates might increase in the future. Well, maybe, and maybe not. They were saying that 5 years ago, and interest rates have continued to fall.

(2) Even if the interest rate on the 30-year Treasury double to 2.9%, or go even a little higher, the insurance company will still have to invest in other products besides fixed-income to generate a 6.75% return, such as the same stocks available to you (see above), real estate (see above), and possibly other more exotic products.

(3) Here is my realization, and the most important point of this Editorial. It is why annuities make no sense to me. A very significant majority of the money the insurance company pays back to you is just a return of the money you initially invested—minus a very stiff fee.

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(4) In this example, if you die within 10 years, your heirs receive the payouts through year 10, but that's all. A terrible investment for you and your heirs. If you live to 102, you got lucky. No one knows how long they will live.

(5) With SPIAs, the lumpsum you invested upfront belongs to the insurance company. It's theirs, not yours, gone forever. If you avoid an annuity and live off your investments, the entire amount you would have sent to the insurance company remains in your estate.

To summarize, with an SPIA annuity, you give the insurance company your money, they invest it in the same products available to you, such as Treasury bills, corporate bonds, income-producing stocks, and real estate, then give you your money back—minus their fee. In general, I think you are best off avoiding SPIAs, and annuities in general. Annuities make no sense to me.

Disclosure

Dr. Doroghazi is not a registered financial advisor under federal law or any state law. The advice provided is of a general nature, and should not be interpreted as personalized or individualized to your specific portfolio

Author Agreement

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Acknowledgments

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