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CRAIG PULLIAM CFP®, AIF®, CLU®, REBC | MICHAEL R. COMSTOCK CFP®, AIF®
WWW.PREMIERCARES.NET

"Hey Little Lady . . . Wanna Buy an Annuity?"

This Commentary is the first of two parts regarding annuities. The next will be published in October.

For years, shady, unsavory sales practices associated with annuity products have been under the scrutiny of agencies such as the Financial Industry Regulatory Authority (FINRA). While relatively few agents selling these products are dishonest, FINRA still has seen fit to put "Investor Alerts" about annuities on its website. Let's have a look at why this is.

- **Most are Exceedingly Complex:** FINRA states that Fixed Index Annuities, FIAs (the most popular sold), "are anything but easy to understand." FIAs are hybrids of fixed and variable products. They are linked to an index and the buyer is limited to how much of the gain she is credited (cap rate). There are various ways the insurer can calculate this . . . each producing a different result for the consumer.
- **Confusion, Continued:** You can buy an income guarantee with some annuities, but try asking the guy selling it to you to explain the difference between a GMWB, a GMIB, and a GMAB . . . which all describe a different type of income guarantee. How about that index calculation for the FIA above? Do they use an "annual reset," a "high water mark," an "annual point to point," or a "monthly point to point?" Is your head spinning yet? This is *your* hard earned money you're giving to these folks, and we can almost "guarantee" you won't understand what you're buying.
- **Our Main Beef with Annuities:** The idea of an investment where you give a company your money and they guarantee a monthly payment for the rest of your life (the *basic* concept of annuities) is simple and forthright. But these products have become so extremely complex that few of the people selling them can accurately explain how they work (we're not exaggerating this). Plus, the sales tactics are often rooted in scaring the client about the prospect of losing money in other investments versus the "guarantees" offered in the annuity. Charts are often produced, "cherrypicking" periods which favor the annuity being sold.
- **They can be Expensive:** Take a "variable annuity" as an example. The average expenses, before any income guarantees, are 2.42% (Morningstar). Add one of the income riders and you're up to about 3.6% in expenses. That can be almost double what you'd pay an advisor to actively manage your portfolio (assumes low cost mutual funds, exchange traded funds, and/or stocks). And many annuity companies pay the agent selling them a healthy commission of 5% or 6% right up-front. And so, the annuity company assesses *you* a surrender charge of up to 8% for the next 9 or 10 years (the percentage declines over time), because they paid that sales agent a $12,000 commission on your $200,000 annuity purchase.

- **Taxation, and Other Stuff you need to Know:** Annuities grow tax deferred, but when you take the money out, the growth is taxed not at potentially lower capital gains rates, but rather at higher income tax rates. In a stock portfolio, you'd pay capital gains rates. In a non-retirement investment portfolio, when you die your heirs get a "stepup" in tax basis (this is good); in an annuity you get no step up in basis (this is bad, by comparison). On the FIAs above, the insurance company reserves the right to lower the crediting rate (cap rate). In other words, they can change the deal.
- **Annuitizing:** When you annuitize, you're telling the company that you want to start getting a steady stream of income for the rest of your life (there are other options on the payout too). They calculate your life expectancy and then pay you a certain amount, "X" per month. You have now given all that annuity money to the company, it's not yours any more . . . you cannot access it (maybe for a disability). If you die, the company keeps what they didn't pay out (again, there are some other options). A rough estimate is that its takes 15 years of payouts for you to get your money back (Kass, onwallstreet). And here's something more to think about: *the payments are not indexed for inflation normally, so that $10,000/year you're getting now will spend like $5,000 in 15 years (assuming 3% inflation).*
- **That's your Agent Walking Away:** Some years ago we were faxed an annuity ad touting an annuity we should sell clients. It referred to a "10% walk-away," and went on to tell us we could make a 10% commission and then just walk away . . . from you, our clients. Wow. We sold a ton of those! Just kidding. But that highlights an issue with front-end commission products in general: what's the incentive for the guy who just made $12,000 up-front to continue to provide you ongoing service and advice?

Annuities are some of the most complex investment products we see. They are often misunderstood by the salespeople selling them and most generally by the customers buying them. They are often pitched at seminars and dinners as a way to beat the markets and guarantee against losses.

Don't let yourself be hoodwinked into buying something unsuitable for you. At least, let us give you a second opinion. But here's a surprise . . . in our next issue we'll tell you why and when annuities just might make sense for some people.

*Fixed insurance products and services offered though CES Insurance Agency.
**Annuities are long-term, tax-deferred investment vehicles designed for retirement purposes. Variable annuities are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained from a financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Craig Pulliam and Michael Comstock are CERTIFIED FINANCIAL PLANNER™ professionals practicing at 112 Westwood Place, Suite 310, Brentwood, TN. They own Premier Wealth Management, LLC. Advisory services offered through Commonwealth Financial Network, a Registered Investment Adviser.
We can be reached at 615-777-2125.
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