

Investment Insight

GHP Investment Advisors, Inc.

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Annuities – Do They Have A Place In Your Investment Portfolio?

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In the 1950's and 60's most working Americans were not concerned about saving for their retirement. They usually worked for the same company for most of their career and then received a pension to support them in their golden years. Fast forward to 2011, and circumstances have changed. Most companies are not offering pension plans as an employee benefit and for those companies that do have a pension plan, there is always the risk that the company backing the plan fails to meet its obligations. In addition, the solvency of Social Security is being questioned (a topic for another newsletter), and the financial markets experienced significant volatility over the last 10 years. Considering these factors, many investors are searching for alternative investment strategies intent on augmenting their retirement income while still providing for the preservation of their retirement nest egg.

To address these concerns, the financial services industry created products to provide the feeling of security in retirement. Among these products are annuities, which are sold with promises of principal protection, tax deferral and lifetime income. There are four main types of annuity products: Indexed, Fixed, Variable and Lifetime Income. Although annuities may provide a sense of financial security, in many cases, as the following examples illustrate, investments in an annuity wrapper may result in higher costs, illiquidity and reduced long-term performance.

Indexed Annuities – Downside Protection at High Cost

Of all annuity products sold by insurance companies, indexed annuities are among the most complex and, therefore, require detailed analysis of their benefits and features prior to purchase. With the promise of a guaranteed minimum return even during negative years in the stock market, coupled with the ability to partially participate in the positive years in the stock market, they appear on the surface as competitive products for long-term investors. The catch is that this "downside protection" is maintained by the insurance company by capping or limiting the buyer's participation in positive performing markets. In other words, the buyer pays for safety in a down market with the additional market earnings above the cap retained by the annuity company when investment returns are robust.

For example, a large insurance company currently offers an equity indexed annuity which presently provides a fixed rate of 2.5% along with an S&P 500 Index participation strategy capped at 6%. It also comes with a 7-year surrender schedule, which heavily penalizes the buyer if they attempt to surrender the annuity within the first 7 years. The fixed rate of 2.5% is only the current annual rate offered and the annuity company maintains the unilateral ability to adjust that guaranteed rate down to as low as 1%. Likewise, buyers are currently allowed to participate in up to 6% of the annual returns from the S&P 500 Index, but the company also reserves the right to adjust that cap rate down to as low as 2%. Furthermore, this indexed annuity, like



most indexed annuities, does not index to the S&P 500 Total Return Index, but instead uses the S&P 500 Index, which excludes dividends. This means that the particularly important impact of reinvested dividend income is not included in this strategy. To put it simply, this product allows the buyer to receive 1–2.5% during negative years for the S&P 500 and only 2–6% during positive years (even though market returns may be significantly higher).

To better understand how this product works, it is helpful to create a 20-year comparison of the performance of \$100,000 invested into the S&P 500 Total Return Index along with the hypothetical performance of this equity indexed annuity, assuming current and best case parameters for the annuity (**Chart 1**).

Although during the last 20 years the stock market has experienced extreme volatility, **Chart 2** illustrates how the buyer of this equity indexed annuity, with a final investment value of \$253,608, falls well short of the overall performance in the S&P 500 Total Return Index, with a final value of \$575,112. **Ultimately, the cost of the equity indexed annuity's downside protection exceeds \$320,000** for this hypothetical 20-year investment of \$100,000.

Undoubtedly many buyers of indexed annuities are looking past the total return opportunities in the equity markets in favor of a more conservative and guaranteed rate of return with the annuity. In the example above, the indexed annuity provided a 20-year annualized return of 4.76%, which is fairly competitive with a 20-year U.S. Treasury Bond. The big difference is that while the bond market provides liquidity for the investor, this indexed annuity is sold with a 7-year surrender schedule that charges a 10% penalty in the first four years and is only lowered to 7% in the final year in which surrender charges apply. Although the Treasury bond market has experienced periods of price declines over the last 20 years, it is unlikely that future price declines would exceed 7–10%. And remember, most indexed annuity companies maintain the ability to annually reduce either the guaranteed fixed rate or the index cap rate depending on market conditions, so the buyer is always at the mercy of the annuity company in terms of their annual rate of return. Likewise, as soon as the buyer's premium is signed over to the annuity company, the prospects of receiving those guaranteed returns depend on the overall solvency of the annuity company and its ability to pay out on all policies.

Fixed and Variable Annuities – Look Before You Leap

Traditional fixed annuities are products that guarantee principal and an interest rate for a fixed period. The primary pitfall buyers encounter with fixed annuities is that **many policies are sold with a competitive first year interest rate which is then lowered significantly during the remaining years of the contract.** The problem is that most policies include a 5 to 7-year surrender schedule that usually enforces a 1% to 7% penalty should the annuity holder choose to terminate the policy within that surrender period. Therefore, it is important that the buyer consider the minimum guaranteed rate stipulated within the fine print of the policy prior to locking up their cash with an annuity company. During periods of low interest rates, it is very likely that an annuity company will drop their rates on existing policies to that minimum rate.

While fixed annuities offer guarantees, variable annuities, which allow the owner to invest in stock and bond mutual funds within the annuity wrapper, perform only as well as the investments within the annuity (after netting out the extra layers of annual fees and expenses). Therefore, any variable annuity analysis should address the mortality and expense (M&E) fees charged by the annuity company as well as the annual expenses charged by the managing mutual fund companies.



As annuities are essentially insurance products, they maintain the death benefit features offered with most life insurance contracts. The annuity company typically covers their life insurance risk by charging the owner an annual M&E fee in the range of 1–2%. The M&E fee is in addition to the variable annuity’s underlying mutual fund fees that average 0.5–1.5%. Moreover, these combined annual fees of 1.5–3.5% are only the beginning with regard to variable annuity expenses. The buyer will often be presented with an array of additional features, such as lifetime income riders (which will be discussed later)—each for an added annual expense. **Although these riders are offered with the intent of enhancing safety and returns, each additional expense can severely undermine long-term investment performance within the policy.**

Beyond these items, every fixed and variable annuity buyer should be familiar with a few tax considerations. First, as annuities are provided tax deferred status by the IRS, it is important to understand that any earnings within an annuity that are withdrawn prior to the owner reaching age 59.5 will trigger a 10% penalty in addition to ordinary income tax rates. Further, all future withdrawals of earnings from an annuity are taxed as ordinary income rather than at long-term capital gains rates. For many retired investors, the current long-term Federal capital gains tax rate of 15% is less than their ordinary income tax rate. Likewise, beneficiaries of annuity proceeds do not receive the favorable step-up in cost basis¹ at the date of death of the annuity owner, whereas beneficiaries of stock or mutual fund proceeds often avoid significant tax burdens when employing a step-up in cost basis. **Finally, annuities offer the same tax-deferred treatment obtained from a traditional IRA or 401k. Therefore, a prospective buyer should never be sold solely on the merits of tax deferral when considering annuities for their IRA or retirement plan savings.**

Lifetime Income Annuities and the Longevity Gamble

Many annuities are sold with the feature of providing a fixed annual or monthly stream of income that is guaranteed by the insurance company for the lifetime of the policy holder. While the guarantee of a lifetime income payment often appears attractive to a buyer, it is important to thoroughly analyze these products to determine their true investment potential prior to relinquishing full control of your cash to an annuity company in exchange for a monthly allowance.

Consider the following example of a \$100,000 lifetime income annuity purchased in June 2011 by a 65-year-old male.

Age at Issue	Annual Income	Annual Payout Rate
65	\$6,850.92	6.9%

With this quote, the insurance company agrees to pay the policy holder \$6,851 per year for his lifetime upon receiving the \$100,000 premium. This income stream is terminated with the death of the policy holder and no further payments are distributed to beneficiaries. The company points out that this generates a 6.9% “payout” rate for the policy holder. **It is extremely important to distinguish this “payout” rate from the annual interest rate on the original \$100,000 investment.** In order to calculate the interest rate for a lifetime income annuity you must assume a future date of death. If this policy is paid out over 20 years, the nominal interest rate is only 3.32%². Currently, a 20-year U.S. Treasury bond pays approximately 4.09%³ while a 20-year AA U.S. corporate bond pays approximately 5.25%⁴. Therefore, the buyer of



this lifetime income annuity is essentially betting that his longevity will far exceed age 82 (see **Table 1**) in order to obtain a better yield than a 20-year U.S. Treasury bond. To simply receive his \$100,000 initial investment back from the annuity company this 65-year-old would need to live past age 79, which is within three years of a male's average life expectancy.

The annuity buyer must also consider the worst case scenarios of either an early death (a scenario in which this annuity policy does not reimburse beneficiaries for remaining principal) or likewise, the failure of the insurance company to pay out its lifetime income policies if it succumbs to financial hardship.

If the buyer in this example is healthy and optimistic of his prospects for longevity, this lifetime income stream provides a 5.55%² interest rate when living to age 95 and, of course, that rate improves with each subsequent year. **Perhaps the French philosopher Voltaire completed this sort of analysis when he said, "I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left."**


Investors perusing annuity brochures will often find idyllic images of blissful retirement-age couples walking along the beach or hiking in the Rockies. Although these images are pleasant, the true potential for a secure retirement with an annuity is better ascertained in the fine print of each brochure where fees, minimum rates and penalties are disclosed. Quite often the initial promises of downside protection, a guaranteed rate of return, and lifetime income may appear to the prospective buyer as a bowl full of cherries, but as the foregoing analysis illuminates, one must use caution to avoid being left with nothing but the pits. 

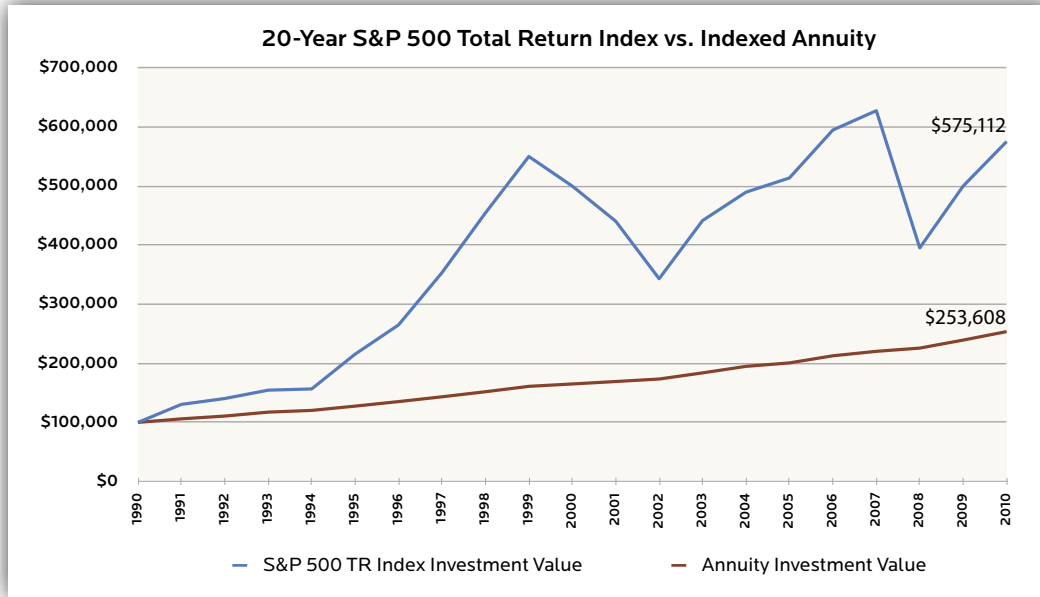
Chart 1

Year	S&P 500 Total Return*	Index Investment Value	S&P 500 (Ex. Dividends)*	Indexed Annuity Return	Annuity Investment Return
01/01/1991		\$100,000			\$100,000
12/31/1991	30.5%	\$130,466	26.3%	6.0%	\$106,000
12/31/1992	7.6%	\$140,406	4.5%	4.5%	\$110,732
12/31/1993	10.1%	\$154,558	7.1%	6.0%	\$117,376
12/30/1994	1.3%	\$156,598	-1.5%	2.5%	\$120,310
12/29/1995	37.6%	\$215,445	34.1%	6.0%	\$127,529
12/31/1996	23.0%	\$264,911	20.3%	6.0%	\$135,181
12/31/1997	33.4%	\$353,295	31.0%	6.0%	\$143,292
12/31/1998	28.6%	\$454,261	26.7%	6.0%	\$151,889
12/31/1999	21.0%	\$549,845	19.5%	6.0%	\$161,003
12/29/2000	-9.1%	\$499,785	-10.1%	2.5%	\$165,028
12/31/2001	-11.9%	\$440,381	-13.0%	2.5%	\$169,153
12/31/2002	-22.1%	\$343,055	-23.4%	2.5%	\$173,382
12/31/2003	28.7%	\$441,458	26.4%	6.0%	\$183,785
12/31/2004	10.9%	\$489,498	9.0%	6.0%	\$194,812
12/31/2005	4.9%	\$513,542	3.0%	3.0%	\$200,659
12/29/2006	15.8%	\$594,652	13.6%	6.0%	\$212,699
12/31/2007	5.5%	\$627,322	3.5%	3.5%	\$220,205
12/31/2008	-37.0%	\$395,227	-38.5%	2.5%	\$225,710
12/31/2009	26.5%	\$499,822	23.5%	6.0%	\$239,253
12/31/2010	15.1%	\$575,112	12.8%	6.0%	\$253,608

*Source: Bloomberg.
Index returns do not take into consideration the nominal fees associated with buying index ETFs.



Chart 2



**Source: Bloomberg.
Index returns do not take into consideration the nominal fees associated with buying index ETFs.*

Table 1

Period Life Table, 2007		
Life Expectancy		
Age	Male	Female
65	17.19	19.89
70	13.73	16.05
75	10.62	12.55
80	7.9	9.43

*Source:
<http://www.ssa.gov/OACT/STATS/table4c6.html>*



Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2011:Q2	P/E Benchmark	Over/Under Valuation	Price/Book Value 2011:Q2	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	16.8	27.0	-37.8%	3.5	5.7	-38.6%
Large-Cap Value Stocks	13.6	20.2	-32.7%	1.6	2.5	-36.0%
Mid-Cap Growth Stocks	23.0	24.8	-7.3%	3.2	4.5	-28.9%
Mid-Cap Value Stocks	20.0	19.1	4.7%	1.7	2.2	-22.7%
Small-Cap Growth Stocks	21.6	23.2	-6.9%	2.7	3.5	-22.9%
Small-Cap Value Stocks	27.6	18.2	51.6%	1.5	2.1	-28.6%

*Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 6/30/11.

Returns by Index

Index	2011:Q2*	YTD*
DJIA Total Return	1.41%	8.57%
NASDAQ	-0.04%	5.01%
S&P 500	0.10%	6.02%
S&P 500/Value	-1.47%	5.23%
S&P 500/Growth	1.64%	6.79%
S&P MidCap 400/Value	-2.20%	6.51%
S&P MidCap 400/Growth	0.77%	10.69%
S&P SmallCap 600/Value	-2.19%	4.01%
S&P SmallCap 600/Growth	1.96%	11.28%

DJIA & NASDAQ: Bloomberg L.P. as of 6/30/11.

S&P Returns: Standard & Poor's (July 1, 2011) Standard & Poor's Reports June Index Returns. Press Release.

*Dividends Reinvested.





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