ANNUITIES & MUTUAL FUNDS

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6/1/2008

I. **Annuities--**insurance companies issue all annuities, though sold by brokerage firms and banks as well as insurance agents. Legislation may change this rule. An annuity is a **contractual relationship wherein one party agrees to pay a sum of money/fee in exchange for the other to receive payments for life**. Annuities are not subject to Security and Exchange rules (exempt security) and follow U.S. contract law.

All Annuity Contracts have a thirty day right to rescind by the consumer, only one other industry contract has this feature--Time Share contracts, which have three days.

Earnings inside an Annuity are tax free (all payouts are taxed at the ordinary income tax rates no matter how earned, very similar to how all pension plans work).

Different issues must be considered when buying an annuity within a tax deferred plan (Annuity Savings Program) versus buying an annuity outside a tax deferred plan.

A. **Types of Annuities**

1. **Deferred Annuity**: Allows money to compound tax free until you withdraw the money to an immediate annuity.

2. **Immediate Annuity**: company guarantees to pay you a certain amount of money periodically as long as you live (annuitization). Cost and payments are based on your life expectancy and a certain interest rate. Part of your payments will be a return of your own money. That part is not taxed.

    a. "Guarantee of principal" & "guaranteed death benefits" Death benefits amount to a return of principal (your money) plus interest usually at 3%.

3. **Annuity Language**:

    a. **"Fixed**" in insurance lingo means that the rate is fixed for six months up to two years, after which a new "fixed" rate is set.
        1. The typical fixed-rate annuity is pay is equivalent to the one year CD rate or one year treasury rate.

    b. Guarantee is only as good as the company’s finances. Guaranteed payout rate is different than the “fixed” or the “regular” payout rate. Usuallly 3% on old contracts and on new contracts it is tied to the one year treasury rate.

    c. Single-premium annuities are one time payment by the consumer.

    d. Flexible annuities are accounts you can add to at any time. Almost all annuities sold to 403 (b) participants are flexible annuities.

e. Annuities are insured. Usually by state-run guarantee associations that generally promise to compensate you for **all or part of your loss** in the event the insurance company fails. Guarantees vary greatly depending on the product. In the event of failure it could take a while before you are paid. In California, Executive Life insurance failed in 1991 and some customers received their money after 3 years without any income.

e. **Types of Payouts**
   1. Introductory or fixed
   2. Regular rate
   3. Guaranteed rate
   4. Withdrawal rate
   5. Annuitization rate

4. **Variable annuity**: An annuity wherein you become your own advisor and pick among stock funds, bond funds, etc. Your earnings in the annuity are deferred and your retirement amount will depend on your investment decisions, it will vary.

   a. Variable annuity: Offers similar tax benefits as an IRA, TSA, etc. and you are not limited as to the amount you can contribute annually (valuable only for individuals outside of a 403 (b) type plan.)

   b. The variable annuity is a purchase of a shelter within a shelter, you are buying an umbrella and you already have a roof over your head.

      1. Few variable annuities offer top ranked stock funds and you pay not only for the annuity contract (1.5%) but also the mutual fund expenses (Wall Street Journal 2/2/94).

      2. The annuity component protects your heirs from your poor investment decisions. This benefits your heirs not you during retirement, because you will have less to live on through your retirement.

B. **Annuity Advantages**

1. For an older conservative individual who wants to assure an income for as long as he or she lives without having to make investment decisions. The rates are generally higher than Money Market Rates or Certificate of Deposits.

2. For conservative investors who are able to leave their money in place for years.

3. For the wealthy individual who has maximized his/her 401 (k) or 403 (b) plan or other retirement deferral plans.

4. For the procrastinator who doesn't or would not have been a participant in a retirement program.

5. Annuities offer loan provisions for emergencies. Although it seems inexpensive, is it really?

a. You're borrowing your own money.
b. You're paying 3% to 6% interest which may be more than the insurance company was paying you, usually with a fee.
c. Your repayments must come from funds in the annuity
d. If you default on your loan, you pay the income tax, surrender charges from the insurance company, withdrawal penalties.
e. You are locked in until you repay the loan.

C. **Annuity Disadvantages**

1. Low rate of return without inflation protection.

2. **Commissions and fees are high**. Commissions are most likely in the range of 5% to 18%. The commissions are taken from surrender charges and from the spread between what the insurance company earns when it invests your money and what it pays you. There are a few no commission annuity contracts.

   a. Surrender penalties: if you withdraw your money within the first 5 to 10 years, the charges are typically at 7% of your account balance in the first year and remain as high as 5% by the fifth year. These rates vary with insurance companies; two companies have none--Vanguard & USSA. An additional penalty called MVA-"market-value adjustment" is increasing among insurance companies for extra-early withdrawal.

3. Insurance is not considered an investment product; therefore full disclosure is not required on the part of the insurance agent. Insurance agents almost never call themselves "insurance agents" or call the products they sell insurance products or disclose their commissions.

   a. Wall Street Journal (2-4-94)In answering the question **what do insurance agents sell?** "They peddle such euphemisms as "private retirement accounts," "college saving plans"...Insurers nowadays rely on "estate planning specialists," retirement planning specialists" and "benefit specialists" to sell their policies."

4. There is limited flexibility.

D. **How to buy a fixed annuity**

1. Ask to see the **insurer's renewal rate history** (remember the fixed rate is only good for one or two years).

2. Look for a company that has a history of paying new buyers a similar rate as older buyers.

3. Look for a company that has a history of fairly mirroring the shifts in interest rates.

4. **Check the rating services** on the financial soundness of the insurance company: A.M. Best, Duff & Phelps, Moody Investors Service, Standard & Poor's and Weiss Research.

II. MUTUAL FUNDS--Mostly owned by investment companies (though American Airlines. GE & IBM have their own funds) wherein moneys are pooled and invested by the fund manager. Investments range from gold to fertilizer and everything in between. There are over 8,000 mutual funds from which to choose.

A. The kinds of mutual funds,(Developed by Lipper Analytical Services) for the purposes of comparisons.

1. **Stock Funds** (based on objectives)

2. Two major styles of stock investing

    a. Growth
    b. Value
    c. Blended(third style, blending growth & value)

3. **Taxable Bond Funds**

4. **Stock & Bond Funds**
    a. Blended funds

5. Municipal Bond Funds (tax free) **you don't want to invest in tax free investments in a tax free retirement plan.**

B. **Types of Mutual funds: load & no load.**

1. **Load funds**--funds which are sold through broker/dealers and carry a commission. Cost to the buyer ranges from 2% to 5.5%. More than 3% is considered high.

2. **No load funds**--funds that sell directly to the public and do not carry a commission charge.

3. **Back load funds**--low load or no load funds carry a commission that is not payable until you withdraw your money.

4. Other expenses, as listed in the prospectus:

    a. **12b-1 fees**--additional fees beyond managing the investments such as marketing, etc.
    b. **C shares**--the commission is an annual expense, sometimes included as part of the investment management fees.
    c. **Investment management fees**--range from 35 basis points to 3%. More than 1% is considered high.
    d. **Other Expenses**--additional marketing or administrative expense. Usually an indication that this is not the mutual fund for you.

5. **BOTTOM LINE**--You can always count on paying a commission if you buy a financial or insurance product from a broker or insurance agent. They don't do it free of charge!

C. **Mutual fund advantages**

1. Diversification
2. Professional stock selection.
3. Low cost entry.
4. Stock market over the long term has had the best return.

D. **Mutual fund disadvantages**

1. The average mutual fund tends to under perform the market.
2. You still have to decide on where to put your money.
3. The market does go down

E. Deciding on a mutual fund family & company.

1. Two main measurements:

    a. **Performance**--review 3, 5 & 10 year periods. Be sure to check down periods.

    b. Expenses--all of them! **REVIEW THE PROSPECTUS**

2. What business is the fund family a part of? insurance, bank, etc.
3. Does the fund meet my personal goals and my risk tolerance?

4. How has the fund performed compared to other funds with similar objectives?

5. Resources:

    a. The Investor's Guide to Low-Cost Mutual Fund ($5.00), write to: The Mutual Fund Education Alliance 1900 Erie Street Suite 120, Kansas City, MO 64116.

    b. Morningstar Mutual Funds (library)check date

    c. Lipper Mutual Fund Profiles

    d. The Value Line Mutual Fund Survey

6. **READ THE PROSPECTUS** The legal duty of an investment advisor or mutual fund is full disclosure. This requirement is met through the prospectus.

7. From Barron's 2/28/94 regarding picking a mutual fund based on past performance,

"Academics and other researchers have scoured their data banks repeatedly, searching for even a hint of evidence to support the notion that choosing funds based on historic results makes sense. And almost every time, they reach the same conclusion: Past performance helps not a whit in predicting future returns."

*..."Switching strategies to time the market is a major reason for under performance."...**"So what is an investor to do?** Look for funds with a well-articulated,*

*clearly defined investment style."..."Performance is the result of a **manager's investment style**, investment process, decision-making environment, and quality of people, organization and other factors."*

III. USING A PROFESSIONAL

A. **My number 1 reason for using a professional is to prevent procrastination**. The financial incentives are high for an insurance agent to stay on you to make the decision to participate. A financial planner will help you determine how much to save – run the numbers.

1. Remember it is difficult to identify an insurance agent and that you are buying an insurance product.

2. **National Scandal**--Wall Street Journal 12/21/93, front page headline story: **"...over the practice of marketing life insurance as a retirement vehicle and failing to make clear to customers they are buying insurance."**

    a. Met Life has promised to pay up to $40 million nationwide.

    b. New York Life, Sears, Roebuck & Co.'s Allstate Corp. and Prudential Insurance Co. of America--have admitted that one or more of their agents have used a virtually identical marketing scheme.

    c. BUYER BEWARE

2. A financial advisor selling you a financial product (mutual fund, partnership, bonds, etc.) must disclose method of compensation. Most disclose through the prospectus. **DISCLOSURE IS THE ONLY MAJOR LEGAL REQUIREMENT**

    a. **The obvious**, that no one ever checks: education, experience, compensation and references (*not was he a nice guy*).

3. Assurance that what the planner is recommending is based on your needs and not on what is being pushed by his/her company or the need for a larger commission.

4. Know how your professional is being paid in **percentage terms and in actual $$ amounts**, including any continuing fees or commissions.

5. **Three basic methods of compensation**:
    a. fee only
    b. fee and commission
    c. Commission only.
    d. **Quality of investment advice has no correlation to how one is compensated. You must be informed!**