ANNUITIES

Annuities Pitched With a Free Dinner? Be Wary

When a financial adviser invites you to a free meal, complicated, high-cost flavors of annuities are often on the menu.

Illustration by Jacob Myrick

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After years of declining sales, annuities are hot again. Annuity sales in 2018 were projected to top $230 billion—a 13% increase over 2017—reports the Limra Secure Retirement Institute, an industry research group.

Part of the reason for the resurgence is that rising interest rates are increasing payouts, making these insurance products more attractive to investors. But much of the credit for the rebound goes to the demise last year of the fiduciary rule—the U.S. Department of Labor rule that would have required brokers and others to put clients' financial interests ahead of their own when giving retirement-account advice.

Insurers offer several kinds of annuities, from straightforward to downright confusing. Kiplinger's often recommends the plain-vanilla type to retirees: an immediate income annuity that can generate enough income along with Social Security and, perhaps, a pension to cover basic living expenses. But other types—namely, variable and indexed annuities—are complicated, often carry high fees or commissions, and are periodically the subject of investor alerts from regulators.

"Free" Dinners

The more complex flavors of annuities are often on the menu at free dinners staged by financial professionals to attract new clients. David Fuith of Shoreview, Minn., a suburb of St. Paul, attended a few such free dinners, hoping to find an adviser. After a meal of steak and chicken at a restaurant last year, Fuith, an editor at a legal publishing firm, agreed to follow-up meetings with the firm hosting the dinner.

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During the third meeting, an adviser recommended an annuity. Fuith says he isn't sure what kind it was, and thinks some details were glossed over, but from his description it appears to have been an indexed annuity. The adviser wanted Fuith to put 90% of his assets held outside IRAs and a 401(k) into the annuity. He also suggested that Fuith sell a mutual fund he had owned for 25 years so he could invest the proceeds in the annuity—although Fuith says that would have triggered a big capital-gains tax bill. But Fuith balked at tying up so much of his money in the annuity.

The adviser said he was willing to negotiate. "My idea would be to put 10% or 20% in an annuity. Their idea was 90%. That's a lot of real estate to negotiate," says Fuith, who didn't buy the annuity. "Maybe I ought to have some modest percentage of my money in annuities," he says, "but I can't invest in something I don't understand."

Gerri Walsh, senior vice president of investor education at the **Financial Industry Regulatory Authority** (Finra), says a free-dinner seminar can be a legitimate way for companies to prospect for clients and for consumers to learn about a new product or strategy. "But ultimately, whether the hard sell happens at the seminar or happens later, the person putting on the seminar and providing you with the meal is hoping to do business with you," she says. "If you go to one of these pitches, go with an open mind. But don't go with your checkbook open."

Pros and Cons

Annuities can provide a valuable income stream in retirement, especially for those without a traditional pension. Recognizing this, the government now allows people to use a portion of their pretax **401(k)** and **IRA** money to buy a deferred-income annuity—sometimes called longevity insurance—that would start payouts at, say, age 80. And Congress has been weighing legislation to encourage more employers to offer annuities within their 401(k)s.

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Some planners recommend variable annuities to high-income savers who have maxed out their 401(k)s and IRAs and want another tax-deferred investment. Indexed annuities are often pitched as a way for older investors to potentially enjoy some of the upside of the market without losing principal.

Sounds simple enough, but variable and indexed annuities are far from simple, and terms and riders may differ from insurer to insurer. Even some financial experts admit that they have difficulty describing how they work.

"Variable and fixed indexed annuities are the most complex, opaque and conflict-ridden, because they pay the people recommending the annuities the highest commissions and give them other types of perks," says Micah Hauptman, counsel with the **Consumer Federation of America**.

The Labor Department’s fiduciary rule was supposed to curb conflicts of interest when brokers and others give advice on retirement accounts. The rule required advisers to put a client’s interests first, instead of recommending the investment that paid the highest fees and commissions.

The prospect of the rule’s implementation depressed sales to holders of retirement accounts. In 2016, the year after the fiduciary rule was announced, variable-annuity sales fell $28 billion. But a federal court last year struck down the rule, saying that the Labor Department had exceeded its authority, and the Trump administration didn’t appeal. Todd Giesing, annuity research director at **Limra**, says uncertainty over the rule’s status affected sales. But even if the court hadn’t struck down the rule, he adds, annuity sales would have rebounded as companies and brokers adapted.

Meanwhile, the Securities and Exchange Commission has proposed an alternative rule that would require brokers to act in the best interest of clients. “Regulation Best Interest” aims to enhance disclosures to clients, but consumer advocates say the rule doesn’t even define what “best interest” means and is much weaker than the fiduciary standard.

The SEC proposal, expected to be finalized this year, would apply only to brokers selling securities, which includes variable annuities, says Hauptman. It would not apply to indexed annuities, sales of which are regulated by state insurance commissioners. Insurance regulation is typically more lax than securities regulation, Hauptman says, so “that’s where you get a lot of the bad incentives and bad practices.”

Look Before You Leap

Anyone offering you an annuity should review your finances and goals first, and only then determine if an annuity would work for you. Kashif Ahmed, a CFP in Bedford, Mass., says you should be asking, “What hole in my plan is this going to solve?”

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One criticism of annuities is that they can be a more expensive way to accumulate retirement savings than using low-cost mutual funds, says Jamie Hopkins, director of retirement research at the **Carson Group**. Plus, you’ll pay capital-gains taxes on the earnings from a fund, which tend to be lower than the regular-income taxes that apply to annuity withdrawals.

But if you're highly risk-averse or likely to sell in a panic when stock prices fall, investing in an indexed annuity or a variable annuity with a rider providing protection in a market downturn can be worthwhile if it keeps you in stocks, Hopkins adds.

Before pulling the trigger, ask about fees and the penalties for pulling out of the contract early. Ask how the adviser is being compensated by the insurer, including any sales incentives, because that could be a big driver behind the annuity recommendation. A salesperson might receive 5% or 6% of the sale—or opt for a slightly smaller percentage up front and get a trailing commission of, say, 0.25% annually for the life of the annuity, says Ashley Foster, a CFP in Houston.

Also, check out the background of the adviser selling the annuity. At **brokercheck.finra.org**, you can review the record of brokers selling variable annuities. Go to **naic.org** for links to state insurance departments, where you can check on agents selling other types of annuities.

The Annuity Menu

With a simple fixed-annuity contract, you pay money to an insurance company in exchange for a stream of income for life or for a certain number of years. You can choose to pay a lump sum and start payouts shortly thereafter—called an immediate-income annuity. Or you can buy a deferred-income annuity, say, in your fifties or sixties and delay payouts until years later. Variable and indexed annuities, however, are more complex.

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Variable annuities. You're able to invest your money among a variety of mutual-fund-like accounts, and your earnings grow tax-deferred. The investment risk is on you, so your account value can go down if your investments tank.

Almost all variable annuities are sold with riders that increase the cost, says Jamie Hopkins, director of retirement research at the Carson Group. The most common is a guaranteed lifetime withdrawal benefit, or GLWB, which promises a certain level of income even if your investments lose value. But the fees on riders can add up. A GLWB, for instance, can cost 1% to 1.5% of your account value each year.

Variable annuities have other annual fees, too, such as a fee that averages 1.25% to cover a basic death benefit and other guarantees in the contract. Annual investment fees also run much higher than if you purchased similar funds outside the annuity.

Variable and indexed annuities also charge a penalty if you dump the annuity before the insurer recoups the cost of setting it up—including the up-front sales commission. This surrender charge often starts at 7% to 10% of your account value and drops a percentage point each year until it disappears.

Not all variable annuities are pricey. Vanguard sells them directly to investors with no commissions, no surrender charges if you're older than 59½ and an average yearly investment fee of 0.50%—compared with the industry average of 2.24%, the company says.

Variable annuities are securities, and their sale is regulated by the Securities and Exchange Commission and Financial Industry Regulatory Authority. Finra has taken action against firms whose brokers persuade investors to exchange one annuity for another while misstating the costs and benefits of doing so. An exchange generates a new commission for the broker and starts the clock again on surrender charges for the investor. "That's one of the troublesome issues," says Finra's Gerri Walsh.

Indexed annuities. Sometimes called fixed-indexed annuities or equity-indexed annuities, these promise a minimum amount of interest each year, which protects your principal, plus the potential to earn more interest based on the price change in the annuity's benchmark, such as Standard & Poor's 500-stock index. (Your money isn't invested in the securities making up the index.)

The calculations to figure your return can make your head spin. You are guaranteed an interest-rate floor each year, usually 0%. This means you won't lose principal if the index plunges, unless you pull out more than 10% of your account value that year and get hit by a surrender charge, says Michael Foguth, a CFP in Brighton, Mich.

But your upside return is limited. The annuity might have a cap, so if the index jumps, say, 15% for the year, your return may be limited to 6%. Or it may have a "participation rate" in which you receive a percentage, usually 80%, of the index's gain. Insurers differ on when and how they measure changes in the index, and they can revise the terms periodically. If you add riders, indexed annuities can get even more complex and expensive.

Be aware that your return will be tied to the price change in the index, not its total return, which includes dividends. Dividends account for a sizable portion of investors' stock market returns. For example, if you invested $10,000 in the S&P 500 from the start of the bull market in 2009 until the end of last year, your balance would have grown to $45,520 with reinvested dividends—but only to $37,050 without.

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