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Life Insurance Perspectives

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Katt & Company is a national fee-only life insurance advising firm. The June 2002 Forbes magazine, and a July 16, 2003 Wall Street Journal article, name Peter Katt as one of only four nationally recognized advisors. The Forbes article states that, "...advisers are well worth the money... These savants are working for no one but you..." For references please contact us.

Annuities: Whattup

An analysis of the deferred annuity scorecard pretty much eliminates all but deferred fixed annuities... VAs [variable annuities] are not attractive because they convert capital gains into ordinary income... EIAs [equity index annuities] are slightly less attractive than fixed annuities... EIA-like combination of fixed income and equity fund should produce a larger up-side, with the principal guaranteed, than the insurance company packaged EIA.

Investors with large estates should probably avoid deferred annuities and, if they already exist, should consider replacing them with a combination of immediate fixed annuity and trust owned life insurance.

Annuities seem to be **more popular than ever** if insurance industry and general financial media focus on them, and annuity promotion spam I receive, are any indication. **Likely this isn't due to investors** awakening to the advantages of these packaged tax-deferred investment gems. **More likely this is driven from the supply side.**

Types of Annuities - Quick Refresher

Deferred and Immediate Annuities - A deferred annuity accumulates value on a tax-deferred basis, whereas an immediate annuity distributes income until the death of the annuitant with perhaps a guaranteed period for payments that could extend beyond the annuitants death. Ten years is a typical guaranteed period. A deferred

annuity can be exchanged, on a tax-free basis, for an immediate annuity.

Fixed, Variable and Equity Index Annuities - Fixed and variable can be either deferred or immediate. Equity index annuities are only the deferred type. Fixed annuities earn value at prevailing interest rates. They cannot suffer losses. Typically, the interest rate will be guaranteed for a period of time, such as five years, after which a new rate will be established for the next guarantee period, generally ranging from one to five years. Variable annuities (VAs) allow the investor to choose from a family of sub-accounts that include geographic, sector and broad index stock funds. They also have a fixed account. Some companies only have variable annuities with investors wanting only the fixed variety simply using the fixed account. Equity index annuities (EIA) promise a capped participation in equity returns with the guarantee no losses will be incurred. As such, although the promotion focuses on the equity participation, EIAs are a hybrid fixed, not variable annuity, and should be compared with fixed annuities.

Annuity Tax Characteristics

All deferred annuities postpone ordinary income taxation on earnings and gains until a future event. Withdrawals from deferred annuities are taxed on an interest first basis and subject to 10% early withdrawal penalty when done prior to 59 ½. This makes them **quite unsuitable if access to the funds will be needed prior to retirement**. Immediate annuities define a portion of each payment as ordinary income or tax-free return of principal depending on the cost basis involved.

Upon a deferred annuitant's death the annuity's gain is subject to income taxes, or often the spouse is the beneficiary with the deferral continuing until the spouse's death when the gain is subject to income taxes and the entire value is subject to estate taxes, depending on the size of the estate. There are problems with transferring deferred annuities to trusts. Because of this their **value is greatly eroded in estates large enough to be subject to estate taxes**. In such circumstances **it is almost always better to exchange the deferred annuity for an immediate annuity and purchase life insurance that is owned and payable to an irrevocable trust, using the annuity income to pay the premiums**. Depending on annuitant ages, whether single-life or joint immediate annuity and life insurance are used and when the second death occurs, **the immediate annuity / life insurance combination can double the net value of the deferred annuity, taking all applicable taxes into account**.

Variable Annuities

VAs are flawed because they convert capital gains into ordinary income and have considerably higher expenses compared with comparable mutual funds. For this reason they are **quite unsuitable for most investors**. However, for aggressive traders, especially in combination with market timing, the ability to move often among various sub-accounts without any current taxation may make VAs ideal. But this should be tested using various simulations extending over a long period of time before moving ahead with such VA investing.

As lots of positive VA articles attest, VA marketers' use of *bells and whistles* have successfully created enough of a distraction to avoid dealing with the capital-gain-to-ordinary-income *elephant*. These creative features include: various death benefit riders; certain guaranteed account balance and withdrawal options; and guaranteed annuitization rates. Our examination of each of these features and their costs suggest they don't offset the tax disadvantage.

Bottom line, except for aggressive trading and timing strategies that would substantially benefit from doing so without incurring taxes, VAs are not a worthwhile asset because of their adverse tax characteristic.

(The same conversion of capital gains into ordinary income criticism can be noted for qualified pension plans as well. As a macro investing planning issue it is probably wise to concentrate fixed-income investments in qualified plans and equities outside. Because of tax deductions associated with qualified plans, maximum contributions should be taken and this can cause a large percentage of invested assets inside pension plans. Under such circumstances an investors' preferred allocation between fixed-income and equity investments should take precedence over this capital gains to ordinary income issue, making equity investing within a pension plan an appropriate choice).

Equity Index Annuities

EIAs offer reduced equity participation with protection against losses. A typical EIA has a current 6.5% cap on equity participation and a 3% guarantee if it is held for a minimum number of years, usually around seven. As noted, **EIAs should not be compared with VAs regardless of the term "equity" in their title. Instead they should be compared with fixed annuities. The level of EIA caps will be related to interest rates, not stock prices. Our testing shows EIAs have no investment return advantage compared with a fixed annuity.** EIAs tend to have larger commissions associated with them. Larger commissions do depress the overall yields, but more important, larger commissions are usually associated with higher surrender charges for longer periods making them less liquid and flexible. There isn't any outstanding reason to avoid EIAs, but I don't see any advantage over using fixed annuities.

EIA Alternative

In examining the EIA concept it occurred to me that an **interesting alternative** is available to **investors looking for equity participation but wanting to eliminate losses.** Selecting a specific time period, an investor can **apportion a percentage of the funds to a fixed income instrument and the rest to equities such that the earnings on the fixed income portion will grow during the specified period of time to equal the total investment, making the equity account determine how much gain is achieved.** If this is being done via a qualified plan, corporate or government bonds can be used and perhaps an index mutual fund. If the investment funds are non-qualified it might make sense to use a fixed annuity for the fixed income portion to enhance the deferred yield. Let's say the total investment is \$100,000 and the time period is 10 years. Assuming a 5.5% fixed-income yield, if \$58,540 is invested in the fixed income component it will guarantee the original investment of \$100,000 in 10 years with the balance of \$41,460 invested in equities. Using a Monte Carlo test for the equity portion, assuming a 9% arithmetic mean and 20% standard deviation (volatility) there is a **39% probability** that the equity portion will earn less than a 5.5% actual yield, bringing **the overall pre-tax yield below 5.5%.** This means there is a **61% probability it will be greater than 5.5%.** More precisely, there is a **30% probability the overall pre-tax yield will be 8%, a 21% probability it will be 9%, and a 13% probability it will be 10%.**

Annuity Payment Purchases

Certain financial firms have stepped up their marketing efforts to **purchase immediate annuity payments for lump-sum amounts.** Several times during the past few months national publications have asked me to review and opine on marketing materials and case studies of such transactions. **None** of the case examples **provided a financial advantage to annuitants.** Since I would expect the marketing materials to show as much consumer advantage as possible - with actual transactions being of lesser value to consumers - I conclude that these firms are counting on their greater financial math acumen and consumers relative ignorance to make these deals at considerable profit. **Except for investors in desperate need of cash I doubt the sale of annuity payments is a good**

idea. For those who do need to raise cash, shop the sale of annuity payments around to enhance the value.

Immediate Annuities

Investors that wish to exchange a lump-sum, whether from a deferred annuity or otherwise, **for guaranteed lifetime income are immediate annuity candidates.** The obvious **disadvantage is giving up the principal, including the ability of leaving it to heirs.**

Immediate annuity purchasers in poor health should use companies that are willing to underwrite annuitant applicants. Poor health shortens life expectancy and this increases immediate annuity income payments. Poor health purchasers should not purchase immediate annuities without this underwriting.

Immediate variable annuities can also be acquired whose income fluctuates with the performance of the sub-accounts selected. Fluctuating income undercuts the main attraction of immediate fixed annuities. The conundrum is that while immediate variable annuities may be attractive to sophisticated investors, they probably don't want immediate annuities in the first place. **The variable approach to immediate annuities may be *too clever by half.***

Conclusion

An analysis of the deferred annuity scorecard pretty much eliminates all but deferred fixed annuities, which insurance companies aren't really promoting. Except for one type of investor, **VAs are not attractive because they convert capital gains into ordinary income. EIAs** don't have any particular drawbacks, but **are slightly less attractive than fixed annuities.** And an investor built **EIA-like combination of fixed income and equity fund should produce a larger up-side, with the principal guaranteed, than the insurance company packaged EIA.**

Investors with large estates should probably avoid deferred annuities and, if they already exist, should consider replacing them with a combination of immediate fixed annuity and trust owned life insurance.

Immediate fixed annuities do the job they are intended for, which is to provide guaranteed lifetime income in exchange for an investor giving up principal. Immediate variable annuities should probably be avoided.

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