Fixed Immediate Annuities by Mary Dean 7/26/2010

Owning *fixed immediate annuities is* emotionally satisfying in down markets. They are insurance products that pay a *fixed amount* over a period of time and *never* show the underlying changes in investment performance. Note: *Do not confuse them with variable annuities* that rise and fall with your investment selections.

The highest payments are over your life expectancy but nothing is left for the heirs. Someone buying a fixed immediate annuity at age 80 will receive substantially higher payments than someone starting at age 65. Payment amounts are based on your life expectancy. **If someone 80 or older expects to live beyond their life expectancy, a fixed immediate single life annuity is ideal for them if they have no heirs and fear outliving their assets**. Remember that with a *single life annuity* the heirs receive nothing.

Another time to strongly consider a fixed immediate annuity is when interest rates are high. Fixed annuities purchased when interest rates are high pay more than when interest rates are low. An added benefit is that the high interest rate returns could equal that of the stock market over a long period of time. **Buying in today's low interest rate environment is poor timing**. The probability of interest rates rising is almost a given.

Another candidate for a fixed immediate annuity is someone who needs or wants a forced budget. Fixed immediate annuities only pay fixed payments. You do not have access to the principal. This can provide long-term financial security for those who cannot or do not want to budget.

Would a fixed immediate single life annuity outperform a bond fund? Given that interest rates are low and cannot go much lower, an intermediate term bond probably would outperform. As the intermediate bond fund's bonds mature they would be replaced by higher yielding bonds while the annuity payment would remain fixed.

Would a fixed immediate single life annuity outperform a balanced fund (bonds and stocks? In a down stock market, the answer is yes. With the current low interest rates, a balanced fund would only have to generate a 4.4% annualized return over 20 years to match the annuity return. Although there have been 20 years where bonds have (barely) outperformed stocks, the average annualized return on the stock market is 10%.

What happens if the stock market is flat for ten years then resumes a ten percent rate of return? The fixed immediate single life annuity would work well for ten years then underperform. Not only would it underperform, the higher stock market would probably be combined with higher inflation. Those living off fixed payments would fare poorly in an inflationary environment. Still emotions as well as investment performance need to be considered. The average investor recently sold low (October 2008 through March 2009) and bought high in March 2010. Factoring in emotional reactions to stock market swings, the immediate single life annuity could provide higher returns. Our clients to date have avoided or mitigated emotional reactions to the stock market. Only one client would not reenter the stock market in 2009. Most invested cash in March 2009 which was the bottom.

The downside of fixed annuity payments are as follows:

1) They are fixed and will not rise with inflation. Inflation adjustments can be included in some fixed annuities but the additional cost may offset the benefits.
2) The principal cannot be withdrawn. You receive only payments and the payments cannot be stopped.
3) The annuity cannot be transferred to another insurance company once the payments (called annuitization) begin.
4) The payments are only as safe as the insurance company's general fund. There are rating agencies that rate the solvency of insurance companies but the ratings could change over the years. Most states will guarantee the principal up to the lesser of 80% of value or $100,000 for ALL annuities combined that you own. To research the coverage limits applicable in your state, visit the Web site of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) at www.nolhga.com. The site's Guaranty Association Laws section offers contact information for your state's insurance guaranty association.
5) Single life annuities will disinherit your heirs. Payments can be extended beyond your lifetime. They will be lower than single life payments. Still it pays to check amounts particularly if you are over 80. Over 80 the amounts can be close to single life payments.
6) The returns quoted usually include principal as well as income. This means that the returns are overstated. See below.
7) The income portion is taxable as ordinary income. If the annuity is held in an IRA or qualified plan, the entire payment (principal and income) will be taxable as ordinary income.

Returns include principal: A Sunday, July 4th *newspaper* article quoted returns of 6% to 8% and gave two examples both for a male age 65 with what appeared to be a single life annuity for the 8% and a single life with twenty year period certain for the 6%. The first was for a $100,000 annuity paying $628 per month. The second was for a $100,000 annuity paying $552 per month. That is a 7.5% and 6.6% return respectively including PRINCIPAL. The payments consist of income and principal. Assuming a 20 year life expectancy, the INCOME returns would drop to 4.4% and 3% respectively. Even if the man lives to age 105 the income returns would be only 6.8% and 5.8% respectively.

Summary: In short those over 80 should strongly consider a fixed immediate annuity if they expect to live beyond their life expectancy and face the danger of outliving their money. If someone also has difficulty budgeting, they also might consider fixed immediate annuities. For those with 10 or more year life expectancies, the risk of inflation and rising interest rates may offset the emotional security of fixed payments.

The best annuity is social security since it is inflation adjusted. Of course, some fear that could be taken away given the rising deficit and large influx of baby boomers into the social security system.