BOB CARLSON'S
Retirement Watch

THE TRUTH ABOUT ANNUITIES:

AND HOW TO MAKE THEM A LIFETIME STREAM OF INCOME

Bob Carlson

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Income Investing When Rates Rise

Cash is trash, but many investors are afraid of bonds because interest rates are likely to rise. You have alternatives. Other vehicles offer higher yields than cash (and many bonds) and provide diversification and safety of principal. Even better, they won't lose value when interest rates rise. Cash is trash these days because yields are too low. You lose purchasing power after inflation and taxes. Even if you shop around, you'll find that on a five-year CD you're going to earn only a little over 3%.

You earn a higher yield with longer maturity bonds, but investors fear rising interest rates. Once rates start to rise the value of bonds and bond funds will fall. Even a modest rate increase will reduce the value of the bonds by more than one year's interest income. When you want higher yields than cash and fear what rising rates will do to bonds, consider putting the safe or fixed-income portion of your portfolio in certain types of annuities.

Note that I'm recommending you consider only particular types of annuities. I'm not recommending the high-fee variable annuities that are roundly criticized. Unfortunately, many critics of variable annuities shorten their advice to, "Don't buy annuities." The annuity world consists of much more than variable annuities. Some of the other types of annuities can increase financial security and should be considered.

Let's focus on three types of annuities.

Deferred fixed annuities. These are a classic, plain vanilla annuity. You make a deposit with an insurer. It's usually a lump sum, but periodic deposits also are possible. Each year the insurer credits a return or yield to your account. Usually, the yield is determined by the insurer based on its expected investment returns, expenses, and other factors. Yields on deferred fixed annuities usually are about equal to the yield on intermediate investment-grade or mortgage bonds. There usually is a modest guaranteed minimum yield.

The interest credited to your account compounds tax-deferred until you withdraw it.

You’re likely to have limited access to the money in the annuity. Most insurers limit withdrawals to 10% of the principal per year without penalty for at least a period of time. You probably won’t be able to take your money back or switch it to another insurer’s annuity without penalty for at least seven years.

For example, the yield for recent top-yielding deferred fixed annuity is 3.65% for a ten-year commitment, 3.25% for seven years and 2.95% for five years. Remember your income was compounding tax deferred.

Insurers offer optional features on deferred fixed annuities, including having more access to your money. But those features generate higher fees and reduce your returns. They generally aren’t worth the cost.

The advantages of a deferred fixed annuity are a healthy yield that rises over time if market rates rise, tax-deferred compounding, and safety of principal. Of course, the major advantage is your account’s principal value won’t decline as interest rates rise. The main disadvantage is restricted access to your money.

Deferred indexed annuities. In principle, these are similar to deferred fixed annuities. The main difference is that with an indexed annuity the return on your account is determined by reference to an external index, such as a stock market index. With a fixed annuity, the insurance company sets your yield each year.

We discuss indexed annuities in some detail in a few pages, but let’s have an overview. You don’t earn the full return of the index. Instead, a formula determines the amount credited to your account based on the performance of one or more indices. There are four main formulas and variations for each formula, but we don’t need to go into details here. On top of that there might be a limit to the percentage of the index return you receive, known as the participation rate. For example, your account might be credited 70% of the return calculated by the formula. Plus, there’s usually an absolute limit on your annual return, known as a cap, which usually is 8% to 10%.

There are a lot of differences between different fixed indexed annuities on all these details. The result is that when the index rises 12%, some FIAs are credited with a 5% return while others receive 10% and a bunch receive something in between.

An FIA has a guaranteed minimum return, which is 0% for most of them these days. So, you’re guaranteed not to lose money even if the index does.

Then, you have the potential of earning more than a deferred fixed annuity if the index does well, though you could earn less than a fixed annuity if the index doesn’t do well.

For example, one FIA recently on the market credited your account based on the return of a model portfolio 70% invested in the S&P 500 index and 30% in a fixed account paying 1%. While your interest was calculated daily, gains earned to date weren’t locked in until two years after the contract anniversary, and a new two-year period began. If the model portfolio’s performance was negative over the two years, your account was credited with 0%. If the return was positive, you locked in the return and potentially built on that going forward. You had a worst-case result of a 0% return with the best case depending on the two-year return of the model portfolio.

There are literally hundreds of different formulas for crediting interest to FIAs. For some perspective, the 10-year returns on FIA’s typically range from 2%-10%. A key point to know is that if a stock index gains 20% for the year, your account isn’t going to be credited with 20% interest.

As with a deferred fixed annuity, there are restrictions on access to your money. If you want to withdraw all your money or transfer it to another insurer’s annuity within seven years, you’ll pay a penalty. You might have access to up to 10% of your account each year without penalty.

The FIAs also can have a number of optional provisions that offer more access to your money and other features such as lifetime income payments and death benefits. These riders in my view usually aren’t worth the extra fees, but you can decide if they meet your needs.

Immediate annuities. The deferred fixed annuity and deferred index annuity generally are for money you aren’t planning to spend in the next seven years or longer. When you already are retired and drawing income from your bond investments, these might not be the best replacements for bonds. Instead, you should consider an immediate annuity.

These are the classic annuities. You deposit money with an insurer, and it begins making guaranteed regular payments to you. The payments last for the rest of your life, the joint life of you and your spouse, or a guaranteed term of years, whichever you select. The payments aren’t purely income. They are both income and a return of your principal. Once you pass life expectancy, payments are all income.

You have limited or no access to money beyond the guaranteed annual payments, depending on the annuity you select, so you should have other assets or income to tap in case of unexpected spending needs.

The payments vary considerably from insurer to insurer. My research over the years consistently shows that even among insurers with the highest safety ratings the payments to the same person vary by as much as 20%. That’s a 20% difference in your income every year for the rest of your life, so shop carefully.

For example, if a 70-year-old male today recently deposited $1,000,000 with the top-paying insurer and chooses payments to last for his lifetime, he would be paid about $79,320 per year for life. (The amount is subject to change as interest rates change.) If he chooses the 10th highest-paying insurer instead, he would receive only $64,743 annually. That’s more than an 18% difference.

Over the years immediate annuity payout options have become more flexible. Now, for example, you can choose to have your principal returned to your beneficiaries in the event of your premature death.

All annuities are a trade-off. You transfer to the insurer the risks of low (or negative) investment returns, unexpected expenses, and, in the case of an immediate annuity, a long life. In return, you have limited access to the money on deposit with the insurer and give up the potential of earning a higher return with that money. In today’s investment world, you also transfer to the insurer the risk that rising interest rates will reduce the value of bonds.

Because of the trade-offs, there are few people who should put all or most of their money in annuities. But the right annuities can be a valuable addition to the nest eggs of most people.

If you want to learn which type of annuity and which of today’s offerings are best for you, contact my annuity expert Todd Phillips of Phillips Financial Services. He provided the annuity examples in this discussion. You also can buy Todd’s book, *The Future of Retirement Savings:* “How to take advantage of stock market linked growth without the stock market risk,” while supplies last. It normally costs $9.95, but my readers can purchase it for $4.95, which is his cost for shipping. For details about annuities or to purchase the book, call 888-892-1102.

How to Increase your Annuity Payouts by 20% a Year

Fixed annuities or immediate annuities can make a portfolio last longer. They can provide steady income for life and reduce the portfolio’s volatility; it won't be as subject to market fluctuations.

Annuities are not all the same. Yields and rates of return vary considerably. Insurers have different investment experiences, life expectancy assumptions, and expenses. As a result, annuity shoppers should compare a number of annuities before making a choice.

Every few years for more than 20 years I’ve conducted a simple survey that has the same results. Even among insurers that are top-rated for safety, immediate annuity payouts can differ between the highest and lowest payout by about 20% per month. That is 20% each month for life. Over time, that is a significant amount of money. If you want to venture outside the safest insurers, the difference is greater.

In this survey I compare only immediate annuities. These are annuities that begin paying you a fixed amount for the rest of your life. They are simple, old-fashioned, plain vanilla annuities without all the bells and whistles and high fees. They provide income for life, so you can’t outlive your income.

These days it is very easy to compare the payouts from many different annuities. A number of brokers have web sites that provide either instant quotes or delayed quotes by e-mail or mail.

You can find quotes on websites such as these:

- www.annuities.direct
- www.immediateannuities.com
- www.AnnuityFYI.com
- www.annuity.com

There are other sites as well, plus you can contact in person insurance agents and brokers.

None of the sites has relationships with all insurers or lists all annuities. So, do not use only one site if you want to maximize income or survey the whole market.

In addition, there are annuities sold directly by insurers or financial services firms that are not listed on other sites. I've been told that as many as half of insurers won't participate in these aggregation websites. Check the sites of Vanguard, Fidelity, T. Rowe Price, Charles Schwab & Co., Ameriprise and any other financial firm you use. You also might want to visit the sites of a few major insurers for their latest quotes. You also can contact my annuities expert, Todd Phillips of Phillips Financial Services at 888-892-1102. He's in contact with most annuity providers.

The National Association of Insurance Commissioners has a Consumer Alert on annuities that provides a great deal of information, including warnings about deceptive sales practices, at www.naic.org.

Remember we are talking about immediate and fixed annuities, not variable annuities. Those are a completely different vehicle. Warnings and details about variable annuities can be found on the SEC's web site at www.sec.gov.

Annuity Guarantees up to 8 TIMES your money at age 85!

Longevity insurance is the latest tool designed to relieve Baby Boomers' anxiety about outliving their income. This innovation spread rapidly and now is offered by a wide range of insurers.

You know the problem. A 65-year-old today has about a 50% probability of living past 85, and a 34% chance of living to 90. The odds are higher for women. Yet, most financial plans do not plan for long enough lives. For a married couple, to be safe they should plan for at least one spouse living to age 100. Even when people believe they'll have enough money, that belief depends on assumptions, such as inflation and investment returns. If reality is worse than the assumptions, the retiree could run out of money.

To deal with this hazard, longevity insurance was developed. More technical terms for the contracts are advanced life deferred annuity or deferred income annuity. The product is simply an annuity with a twist or two. So, despite the name it is not really insurance with a guaranteed payout; it is an annuity.

With longevity insurance, the policy owner deposits a lump sum with an insurer. The marketing is targeted at people ages 60 to 65, but the deposit can be made at any age. The insurer agrees to begin making payments after a waiting period of two to 45 years.

The policy purchaser decides when payments will begin. Unlike other deferred annuities, when the contract is purchased, the insurer tells the owner exactly the amount of the future payments, and the payments are guaranteed for life, no matter how long the owner lives.

This makes the policy a reversal of the traditional deferred annuity in which the insurer tells the owner the interest rate that will be credited to the account each year. Only at the end of the accumulation period does the insured learn the amount of the payments the contract will generate. It also differs from a traditional immediate annuity, in which the owner is told the amount of the payments, but the payments begin within a year. With longevity insurance, the amount of the payments is guaranteed, but the payments won't begin for at least couple of years.

Longevity annuities also can cover the joint lives of a married couple instead of an individual.

For example, in 2020 if a 65-year-old couple deposited $100,000 with an insurer, the insurer would guarantee to pay $10,845 annually to them at age 75. The payments are guaranteed to continue as long as one of them is alive, no matter how long that is. If at least one of them lives to at least age 100, the total payouts would equal $267,125.

The payout is even higher when the income payout is delayed even longer, to age 80 or 85. It also is higher when the payout continues for one life instead of the joint life of a married couple. A single person who waits until age 85 to begin payouts can receive about eight times the initial deposit over his lifetime.

One idea behind using longevity insurance is that an individual divides the retirement portfolio into two portions. One portion is managed to pay for expenses through age 85 or so. A relatively small portion of the portfolio is used early in retirement to purchase longevity insurance that will fund the post-85 period of retirement if the owner lives beyond life expectancy. In addition, longevity insurance allows the rest of the portfolio to be invested for higher returns since the owner knows there will be guaranteed payments after age 85 if the investments do poorly.

Another use some people make of the annuities is as a substitute for a long-term care insurance policy. They figure the annuity will begin payouts when they are likely to need LTC. But you can’t know when you’ll need LTC, and the longevity annuity isn’t likely to be enough to pay for LTC.

As with all other insurance products, there are trade-offs to consider.

One trade-off is that there are no payments to beneficiaries. If the insured does not live to the payout age, the insurer keeps the money. Likewise, the insurer comes out ahead if the annuity owner dies after receiving payments for only a few years.

The insurer takes the risk that the owner lives to a very old age, while the owner and his heirs take the risk he won't. In this respect it is like auto or home insurance. If you never have a claim, the only benefit from the policy is the security of knowing that it is there if you need it.

To counter this drawback, insurers offer "return of premium" options that pay the premium to a beneficiary if payouts are never made or last for only a short time. The cost of this feature is that the guaranteed lifetime income is reduced.

The standard policies also have no inflation protection. The monthly payout at age 85 might seem like a lot of money today, but after 20 years of 2% inflation its purchasing power will be close to half today's purchasing power. Some longevity annuities do offer inflation indexing. Again, that comes at the cost of a reduced initial payout, which can be considerable. Also, some policies state that the inflation indexing kicks in only after the payments begin. The erosion of purchasing power during the 20-years of deferral is not covered.

Another disadvantage is the opportunity foregone. By purchasing a longevity annuity, you lock in today's expected investment returns. If another long bull market begins or interest rates rise substantially, you might have been better off investing the money than buying the annuity. Of course, an extended bear market means you come out ahead and the insurer has to worry about how to make up the difference.

That’s what insurance is all about. You transfer risk to the insurer and give up some potential benefits. In this case, you’re transferring the risk of living a long time and earning low investment returns. You’re giving up the potential to earn higher returns on that money yourself and taking the risk you won’t live long enough to benefit from the policy.

Longevity insurance generally requires a lump sum premium instead of payments over time, though some offer a multi-year premium option. That also reduces the payout, because the insurer does not have your money to invest the entire period.

Compare longevity insurance with the alternatives.

One option is to purchase a traditional deferred annuity or an indexed annuity. These generally have a guaranteed interest rate of 0% (you won’t incur investment losses). Deferred annuities usually earn about the same rate as the yield on intermediate bonds, and there is the potential for the return on the account to rise if market interest rates rise. Indexed annuities earn interest based on market indexes. They both allow you to designate beneficiaries during both the accumulation and payout phases. The investment is not lost if you do not live to cash it in. But you aren’t guaranteed a payout under most of these annuities.

Another option is to designate part of your portfolio as money you won't touch until age 85 or some other age. You can invest this money more aggressively than the rest of your portfolio, knowing that you won't need it for 20 years or so. You still do not want to take high risks with the portfolio, but you can take a more growth-oriented approach than with the rest of your portfolio.

In 2014, the IRS announced a new rule that allows IRAs to own qualified longevity annuity contracts and not have those count in required minimum distributions, when the annuities were no more than 25% of the IRAs value at the time of purchase and no more than $125,000 was invested in them. This makes longevity annuities available to more people.

Finding Safe, Guaranteed Income

Money is pouring into index annuities at a rapid rate. They’re the annuities with the highest sales in most recent years. It’s not surprising. An index annuity is a good place for safe investment dollars. You have the potential to earn a higher return than traditional safe investments but are guaranteed both a minimum return and return of your principal. The better the stock market does, the higher your return is, but you don’t share in stock market losses.

But too many people are buying the wrong annuities. They’re earning lower returns than they should, paying too much in fees, or adding bells and whistles they don’t need or that aren’t worth the extra fees. They aren’t buying the annuities, they’re being sold them.

Index annuities are a simple concept that quickly can become complicated. An investor deposits money, usually a lump sum, with an insurer. The insurer invests the money in its own account and promises to credit income to the investor’s account each year. Most index annuities now guarantee the income for a year won’t be less than 0%, but guaranteed annualized returns over the life of a contract can go as high as 3%. It depends on the insurer and your state’s rules.

That’s only the minimum return. They’re called index annuities because your annuity has the potential to earn more, and the higher return is pegged to the performance of a public index, usually a stock market index. This is one of the places where an index annuity can become complicated.

You don’t earn the full return of the stock index. The annuity has a formula that determines how much of the index’s return is credited to your account. There are four basic formulas, but a lot of variations are allowed within the formulas. For starters, the annuities will have different formulas for computing the index return. Then, most limit the amount of the index’s return you receive, known as the participation rate. An annuity, for example, might be credit only with 50% of the index’s calculated return. Most index annuities also have a cap, or a maximum annual return, regardless of how well the stock index does.

The result is that when the index rises 12%, some index annuities will be credited 5% while others receive 10%.

You need a basic understanding of the annuity’s formula, but more importantly you need to know the crediting rate. Ask what the annuity’s current crediting rate is and for examples of how much the annuity will earn (after fees and expenses) when the index returns certain amounts. Also, ask what the recent history is for the annuity or similar annuities from the insurer.

There are other factors to consider, such as the financial strength of the insurer, surrender penalties, bonus interest, and more. You also have to consider withdrawal options, including income guarantees.

It’s easy to see the appeal of index annuities. They’re a good alternative for conservative investors or the conservative part of a portfolio that otherwise might be put in intermediate bonds or similar investments.

With an index annuity, your principal is safe and a minimum income is guaranteed. But you also have the potential to earn more than bonds, because your account’s income increases when the stock market does well. It’s a way to participate (but not fully) in a bullish stock market without the risk of losing money when the market heads south.

The complications scare people away or leave them uncertain that they bought a good annuity.

That's why I arranged a special deal for my readers to receive the report, *The Future of Retirement Savings*, by Todd Phillips.

It's a comprehensive, easy-to-read review of index annuities. You'll learn the basics of the annuities, the top 10 features to look for, how to choose the index for your annuity, the tradeoffs between the different crediting formulas, how to make a tax-free exchange, and much more. Todd is an annuity expert and works with his dad and my insurance expert, David Phillips, at Phillips Financial Services.

The 40-page report normally sells for $9.95, but they will make it available to my readers free. You pay only $4.95 for shipping and handling. To order the report, call 888-892-1102.

How to Avoid Getting Pressured into Buying the Wrong Annuity

Better late than never seems to be a principle of regulators. In that spirit after decades of criticism and complaints, regulations finally were issued covering the sale of variable annuities.

Variable annuities are one of the most-discussed investment vehicles of the last couple of decades. They have had strong sales, as investors are attracted by mutual fund investments coupled with the tax deferral of annuities and, in recent years, income guarantees.

Yet critics, this newsletter among them, point out that the higher costs and other features make the annuities unattractive for many investors who are buying them. In the 2000s, Raymond James Financial Services was fined almost $3 million for failing to supervise variable annuity sales. Waddell & Reed in 2004 paid a $5 million fine to NASD and agreed to refund up to $11 million to over 5,000 customers as a result of annuity exchanges. Those are only a couple of examples.

Regulators at the NASD finally issued comprehensive rules governing the sale of variable annuities, and these regulations incorporated many of the points raised over the years. While the rules apply to broker-dealers who sell the products, investors can use them as a good checklist for determining when a variable annuity is appropriate for them.

The big temptation with variable annuities is that they pay high commissions to brokers. Investors need to be careful that the lure of a commission is not causing a broker to oversell the annuity. The rules also recognize this temptation by requiring multiple reviews of the suitability of a variable annuity before the sale is finalized.

Here are some factors we have emphasized in the past that are reflected in the rules.

Long-term investments. Variable annuities have higher expenses than straight mutual fund investments, and they tend to convert tax-advantaged long-term capital gains into ordinary income. To overcome these effects the investor must hold the variable annuity for a long time. The minimum holding period depends on the annuity's costs, but the minimum break-even investment period generally is 10 years. Higher cost annuities require longer minimum holding periods.

This means that if the investor is older a variable annuity is inappropriate. Also, if the investor is only a few years short of retirement but will need to begin withdrawals from the annuity as soon as retirement begins, a variable annuity likely is inappropriate.

Tax position. The investor is not likely to need the deferral of an annuity unless he or she is in at least the 28% tax bracket. Also, the annuity is more valuable if the investor expects to be in a lower tax bracket in retirement than during the accumulation years. Distributions from an annuity before age 59½ are subject to a 10% early distribution penalty in addition to income taxes; anyone who might need the money early probably should not purchase a variable annuity.

Annuity lock-ins. Most variable annuities impose surrender penalties or redemption fees if the investor withdraws money without waiting a minimum period. Some surrender penalties expire after seven years; others last much longer. Investors need to fully understand these penalties and their effects.

Other saving options. A variable annuity should not be considered unless the investor already has exhausted other tax-saving investment opportunities such as 401(k)s and IRAs. These also have tax deferral and usually charge lower costs than annuities.

Retirement distribution methods. Annuities generally allow several different distribution methods: lump sum, systematic withdrawals, periodic withdrawals, and annuitization. The investor must understand which are allowed under the contract, the details of how they work, and which methods are not allowed.

Lifetime and survivor guarantees. Many investors believe that these guarantees merit the higher costs of annuities, even if they are included in vehicles that already are tax-advantaged such as IRAs. A lifetime payout might allow the investor to withdraw 4% of the original investment annually for life, regardless of how the investments performed.

But if the investor wants to cash out the annuity in a lump sum, the guarantee does not apply. The investor could receive less than the original principal if the investments did not perform well. Also, the guarantees are only as secure as the insurer making them.

Effects on heirs. When a variable annuity is inherited, it is included in the estate of the owner. In addition, heirs pay income taxes on the accumulated income and gains as they are withdrawn. Therefore, a variable annuity is not ideal for money that is surplus funds likely to be left to heirs.

Investment risk. To offset their higher costs, annuities need to be invested in higher-returning investments. If the investor is risk averse and does not want such investments, a variable annuity probably should not be purchased.

Retirement income needs. An annuity should be part of a full investment package that ensures enough income to pay for basic living expenses in retirement.

Exchanging annuities. Critics believe some of the biggest annuity abuses occur when an annuity is exchanged tax-free for another annuity. Often, the broker earns a sizeable commission on the exchange without changing the investor's position in a meaningful way. Insurers have to closely monitor annuity exchanges, especially if they extend or restart redemption penalty periods.

Investors who are considering variable annuities can expect to spend more time on the process than some have spent in the past, and that is a good thing. The broker or agent has to document why the annuity is suitable for the investor and also that the investor understands the policy’s features and costs. The purchase will be reviewed by supervisors before it becomes final. In some cases, investors might be told that the sale will not be finalized because it is inappropriate.

The rules provide needed protection for investors, though they come too late for many. They require checklists and reviews by sellers and also supply a good outline of factors for the investor to consider.

How Long to Hold a Variable Annuity Before You Break Even

Low tax rates significantly tarnish the appeal of variable annuities.

A variable annuity allows the owner to select how the account is invested among mutual fund choices offered by the insurer. All income and gains compound tax-deferred within the annuity. When income and gains are distributed, they are taxed as ordinary income. One can view a variable annuity as a nondeductible IRA with no contribution limit.

The tax deferral of variable annuities is attractive, but you pay two steep costs to get that advantage.

One cost is that long-term capital gains and qualified dividends are converted into ordinary income. Gains from mutual funds that are held for more than one year in a taxable account face a maximum tax rate of 20%. Any gains distributed from a variable annuity are taxed as ordinary income.

The tax cuts in place since 2003 and solidified in 2013 increased this cost by reducing the top rate on long-term capital gains by more than the tax rates on ordinary income are reduced. A taxpayer in the top bracket now will pay more than a 35% rate on ordinary income but only 20% on long-term capital gains. In addition, any dividends that would be taxed at the ordinary income rate when distributed from the annuity would be taxed at 20% now if earned in a taxable account.

The other cost is the additional expenses imposed by the annuity. In addition to normal mutual fund management and trading expenses, the annuity imposes a mortality or insurance charge plus its own administrative expenses. These additional expenses range from less than 1% of the account on the few low-cost annuities available to over 2% on high-cost annuities. The average additional cost among variable annuities is about 1.4%. A variable annuity also might impose a front-end load or commission or a surrender fee or both.

Before 2003, I found that it took about 10 years of compounded returns for a low-cost variable annuity's benefits to overcome the disadvantages. A high-cost annuity took at least 15 years to overcome the disadvantages. After the rates were cut in 2003, I plugged the new numbers into my variable annuity analyzer program to see how the new rules affect the appeal of variable annuities. Here is what I found:

A tax-wise investor in the top tax bracket never would benefit from investing through a variable annuity.

The tax-wise investor earns only long-term capital gains in the portfolio, paying the 20% tax rate on accumulated gains. The after-tax value of such a portfolio in a taxable account always would exceed the after-tax value of a variable annuity if the two achieved the same investment returns before expenses and taxes. This conclusion holds true whether the annuity is high cost, average cost, or low cost.

Even a low-cost annuity with annual expenses of only 0.70% does not make sense for the tax-wise, top-bracket investor. The higher taxes on distributions and higher expenses are too big a burden for the tax deferral to overcome.

I tried scenarios for less tax-wise investors. Even when 50% of the annual returns in a taxable account were taxed at a combination of long-term capital gains and ordinary income tax rates, the taxable account still is a better deal for the top tax bracket investor.

Suppose an investor has 75% of the annual returns from a taxable account taxed at the 35% rate. Even then, according to my program, it takes 22 years for the tax deferred compounding of the variable annuity to overcome its higher expenses and having the ordinary tax rate imposed on all its distributions. Remember, this result is for a low-cost annuity with 0.70% annual expenses.

Suppose the investor is in the 28% tax rate, so there is a smaller gap between the long-term capital gains rate and ordinary income rate. Suppose also that this is not a tax-wise investor, so 75% of annual returns in the taxable account are taxed at the 28% rate. Even then, it takes 24 years for the variable annuity to have a higher after-tax value than the taxable account.

The break-even point is much shorter for an ultra-low-cost annuity with annual expenses of only 0.20%. Then, the annuity comes out ahead after only 13 years of compounding if the investor is not tax wise and has 75% of annual returns taxed at the 28% rate. But if the investor is moderately tax-wise and only 35% of annual returns are taxed at the 28% rate, it takes the ultra-low-cost variable annuity 34 years to have a higher after-tax value than the taxable account.

The above conclusions were reached assuming that each portfolio was fully invested in stocks and that the stocks returned 9% annually. Are the results different if the variable annuity is in high-yielding investments that would be fully taxable outside the annuity, such as high yield bonds?

I assumed an investor in the 28% bracket earned 7% annually in ordinary income, such as might be earned from high yield bonds, preferred stock, corporate bonds, real estate investment trusts, and a few other investments. The after-tax income in the taxable account is reinvested and compounded each year.

Here, the variable annuity makes some sense. The ultra-low-cost variable annuity with 0.20% annual expenses has a higher after-tax value than the taxable account after only four years. With a $100,000 investment, after 10 years the variable annuity's increased after-tax value is about $5,000, after 15 years the advantage is $15,000, and after 20 years the variable annuity is about $34,000 more valuable than the taxable account’s.

When the annuity's expenses are raised to 1% annually, the variable annuity's advantage disappears. In that case, it takes the variable annuity 27 years to have a higher after-tax value than the taxable account.

If the investor is in the top 35% bracket, the 1% expense annuity has a faster pay off — only 22 years.

Keep in mind that even under the pre-2003 tax law, a variable annuity needed to own investments with a high return to overcome its additional expenses. A low to moderate return investment, such as a general bond fund, is not a good investment for a variable annuity.

While variable annuities were advantageous only to select investors in the past, they make sense for even fewer investors today.

Before considering a variable annuity, be sure you have taken full advantage of other tax-deferred accounts that have lower costs, such as IRAs and 401(k)s. Even nondeductible IRAs should be maximized before considering an annuity. Also, put the maximum amount in a Roth IRA if you are eligible.

Before taking the plunge with a variable annuity, consider investing in a tax-wise way through a taxable account. Hold investments for the long-term so you incur only long-term capital gains taxes. Invest in individual stocks or fund you will own for longer than one year. Select mutual funds that make few annual distributions.

If you buy a variable annuity, be sure it is one with no load and rock bottom expenses, such as those offered by Vanguard and TIAA-CREF. Other mutual fund firms and brokers such as Charles Schwab & Co. also offer variable annuities with low, but not rock bottom, costs.

In addition, try to use the variable annuity for investments that are not tax-advantaged on their own and that have relatively high returns. Plain vanilla bonds don't belong in a variable annuity.

Many of the variable annuities sold before the financial crisis included a rider that allows a lifetime withdrawal equal to about 3%-5% of the annuity's original value. (The guarantees on these riders were reduced from an initial 6% in the mid-2000s and other restrictions have been put in place.) The riders promised that after a certain age owners would be able to withdraw a fixed percentage of their initial investment each year for life. If the annuity runs out of money, the insurer makes up the difference. A variation is to guarantee a minimum return on the annuity for the years before distributions begin.

The guarantees make the analysis a little different. You're really comparing them with deferred annuities or indexed annuities. Or you're comparing them with the results of investing in a taxable account for a period of time and then buying an immediate annuity. This is a more difficult analysis.

But it doesn't really matter. After the financial crisis and the Federal Reserve's introduction of zero interest rates, insurers couldn't afford these terms. Many policies had their terms changed, and new policies have much less attractive terms. New guaranteed income riders, when you can find them, guarantee payouts of 3% to 4% or less. The same is true for minimum returns. Insurers also are limiting the dollar value of policies with these riders they'll sell each year. In addition, on existing and new VAs insurers are restricting investment options, eliminating the riskiest investments and those that are hard for the insurer to hedge. Insurers also are mandating or limiting the asset allocation of the accounts, generally limiting the percentage that can be invested in stocks and other risky assets.

How you should respond to these changes depends on your situation.

The changes don't make VAs unattractive to someone who wants their advantages. The lower guarantees and reduced investment options are consistent with what's available elsewhere in the financial world. The era of 6% guaranteed safe returns is gone and not likely to return for several years. If you want the potential to earn solid returns in a tax-advantaged vehicle with principal protection or a guaranteed minimum return, consider a VA, knowing you won't find a policy as attractive as what was available a few years ago.

The longtime buying advice still is valid. Find out what the surrender fee is and how long it is in effect.

Ask what happens to your guarantees if you want to leave the annuity. Also ask if you're required to take distributions in a certain amount or pattern to qualify for the guarantees. You'll pay for the guarantees. Be sure you know the cost to determine if they're worthwhile. Know all the other costs of the annuity.

Three Types of Annuities that protect you from Inflation

As the Baby Boomers age, financial services firms are interested in meeting their needs. One need is for guaranteed lifetime income that replaces old-style defined benefit plans. Another need is for that income to retain its purchasing power over the years. Some investment advisors used to say that owning stocks for the long term met these needs, but the bear markets since 2000 refuted that argument.

There are several investments available to accomplish these goals, and more are being developed by insurers.

1. Buy an immediate annuity and keep saving. A traditional immediate annuity achieves the goal of lifetime income. The income payments, however, are fixed. Over time inflation erodes the purchasing power of the income.

There are two major advantages of the standard immediate annuity. One advantage is that they have a long history; investors know how they work, and insurers know how to manage and price them. The other advantage is that the initial payout is higher than for the alternatives. The added features of newer annuities come with costs.

An investor searching for reliable income should consider buying an immediate annuity but not spending all the payouts. To support purchasing power over time, save and invest some of the distributions.

2. Buy an inflation-indexed annuity. These annuities make regular payments for either life or a term of years, just like immediate annuities. The payments, however, are adjusted to reflect increases in the CPI. There usually is a maximum one-year increase of 10% or so.

The annuity owner, however, pays for inflation indexing. The initial payment generally is 20% to 30% less than that of a standard immediate annuity. The initial reduction is less when there is a lower ceiling on the maximum one-year increase. (Inflation-adjusted annuity payments generally can rise or fall with the CPI.

Payments will not decline below the initial payment amount, but negative CPI changes that are not reflected in the payments will offset future CPI increases.)

Inflation-adjusted annuities still are not widespread. Vanguard offers an inflation-adjusted option as part of its Vanguard Lifetime Income Annuity. Here's an example, but keep in mind the numbers change over time. Don't expect to receive the same terms. A 70-year-old purchasing a non-indexed annuity with $500,000 would receive an initial $3,962.93 monthly payment. If he selected a 2% annual increase, the initial payment would be $3,375.54. After 10 years the payment would be $4,736.07. If he selected full CPI indexing, the initial payment would be $3,039.18; the payment after 10 years would depend on the inflation rate. (The Vanguard annuity actually is issued by an insurance company that also offers the annuity through other channels.) At the Vanguard web site, you can check the payouts you would receive under different scenarios.

3. Buy a variable immediate annuity. In variable deferred annuities, the amount accumulated in the annuity account depends on the investment returns earned by the account's investments. There also are variable immediate annuities for which the distribution each year depends on the performance of the investments.

The VIA is fairly complicated. The owner selects an assumed investment return (AIR) from among several choices offered by the insurer. The higher the AIR, the higher the initial payment will be. Future income payments will vary based on how the investments selected for the account perform relative to the AIR. If the returns are above the AIR, payments will rise, but if actual returns do not at least equal the AIR, the payments will decline. You should realize that if the account's return is positive but less than the AIR, the next year's payments will decline.

To avoid an income reduction, select a relatively low AIR of no more than 5%. That reduces your initial payment but makes future reductions less likely. Most VIAs also offer an option that eliminates income reductions, but that costs about 1% in extra annual expenses.

VIAs didn't really take off. Versions often are available through the major mutual fund companies and major insurers.

No matter which annuity you lean toward, be sure before buying that you understand the version other than the standard immediate annuity. Review what the results would be under different circumstances. Also, realize that the additional features cost money.

Review the fees and how much your income is reduced. Most important is to compare redemption or cancellation fees. Often, it is difficult to exit one of these investments without a steep cost.

How to Choose the Best Annuity Distribution Option for You

Almost every retiree has a choice of how to receive benefits: as either a lump sum or a stream of annuity payments. The choice is critical, yet it doesn’t receive the critical analysis it should.

About half of employers give these options on 401(k) and other retirement plans. You face a similar choice with an IRA.   You can manage the account or you can purchase an annuity with all or part of it.

Once an annuity is selected, the decision cannot be reversed without a penalty. Select a lump sum and an annuity can be purchased later with the account balance.

Here are the factors to consider when making this choice.

A lump sum has the potential to earn a higher return and increase net worth or make the money last longer. Many people who take lump sums do so for this reason.

Before choosing a lump sum, consider how you would invest it and what the likely rate of return will be. Then, estimate how long the account will last after spending and taxes.

A problem in the 1990s was that many people over-estimated the long-term returns they could earn. Many invested very aggressively to earn the estimated returns. The bear market of 2000 caused a sharp reduction in their accounts. In fact, studies show that when making long-term decisions most people look at investment returns for the last six months or so and project them indefinitely into the future.

To avoid big problems, you should make conservative estimates. Choose a reasonable estimated rate of return. Carefully estimate your spending and adjust it for inflation each year. Then, take a look at what would happen if you earned only 1% or 2% less each year.

Don't underestimate life expectancy. The fastest-growing age group is ages 90 and older. Most of us will have to make our money last longer than our parents did.

After making estimates for the lump sum, compare it with an annuity.

First you have to select the type of annuity payment you would want. An annuity could pay for your life or for the joint life of you and a beneficiary (such as your spouse). Or an annuity could make payments for a fixed term of years. Some annuities will pay for either life or a period of years, whichever is longer. Once you select an option, the employer will tell you what the annual or monthly payments would be.

The big advantage of an annuity is that it is guaranteed to last for the selected payment period. You cannot outlive a life annuity.

There are disadvantages. Most annuity payments are fixed, meaning that they will lose purchasing power to inflation each year. An annuity also leaves nothing for your estate, though you can have payments continue to a beneficiary if you take lower lifetime payments.

The payments from an annuity are based on a yield close to that of intermediate bonds. With a lump sum you might earn a higher return.

The security of an employer annuity depends on the financial health of the employer and its pension fund. The annuity might be guaranteed by the Pension Benefit Guaranty Corporation, though there is an annual limit of about $44,000 (indexed for inflation) on the guarantee. An insured annuity depends on the insurer’s stability.

Many prospective retirees miss one important step. After getting your employer's annuity quote, compare it with commercial annuities. Each employer and insurance company uses its own interest rate and expenses to calculate annuity payments. When an employer offers an early retirement incentive, the annuity might be subsidized. Otherwise, insurers might make higher annuity payments. As discussed earlier in this report, I’ve found that payouts among top-rated insurers vary by up to 20%. That is a 20% difference in your annual income for life. Don’t settle for the first annuity you are quoted.

An insurer also might allow partial withdrawals of up to 10% of the balance in the case of emergency spending needs. An employer annuity might not offer this feature.

Now, you have all the information needed to make a decision. With an annuity, you probably have to live on less than the annual payout and invest the rest for the future. With a lump sum, you have to manage the investments and spending to make the money last.

Health, family history, and heirs are other considerations. If a less-than-average life span is a probability, you might take a lump sum to ensure the benefit goes to heirs or charity instead of an insurer or retirement plan. Some people will select a lump sum just to increase the odds that their heirs get something.

Of course, you might take both options. You could take a lump sum and buy an annuity with part of it.

Perhaps the best strategy is to take the lump sum now and buy an immediate annuity later. The advantage is that when you are older the annuity payments will be higher than they would be today. This strategy also gives you the opportunity to build up the fund a bit through investing and careful spending. You do take the risk that the fund will be diminished through low investment returns or high spending.

This article shows you how to gather and analyze the data to make this choice. The issue boils down to: Which risks do you want to take? A lump sum carries the risk that you will earn low investment returns, overspend, or live a long time. An annuity carries the risks that inflation will significantly reduce its purchasing power over time and that you could have earned better returns with a lump sum.

Extend your portfolio with annuities

The greatest fear of most retirees is outliving their portfolios. The right kind of annuity can reduce the probability of running out of money by making a portfolio last longer.

Retirees should consider shifting part of their portfolios to immediate annuities at some point in retirement.

An immediate annuity is one that shortly after purchase begins making fixed payments for the life of the owner (or the joint lives of the owner and spouse). The retiree (and spouse) will not outlive that portion of the portfolio, as long as the insurance company is solvent.

Despite this, sales of immediate annuities are low. Most retirees do not like the idea that if they die early, the annuity payments will stop, and there will be nothing for the estate. In addition, the annuity payments are fixed and will lose purchasing power over the years because of inflation.

Yet, shifting a portion of the retirement portfolio to immediate annuities can increase financial security. Studies done by Retirement Watch and by others demonstrate this. The immediate annuity replaces the old-style defined benefit plans that are available to fewer and fewer retirees. It provides an income floor to cover a portion of retirement expenses.

A study in the *Journal of Financial Planning*'s December 2001 issue found that putting 25% or 50% of a retirement fund into an annuity increased the odds that the portfolio will last through at least 30 years of retirement. The study looked at four different portfolios, ranging from a conservative portfolio that was 20% in stocks and an aggressive portfolio that was 85% in stocks. Using Monte Carlo simulations, the study found that the initial conservative portfolio had a 32.6% probability of success with no annuity, but the odds improved to 53.3% when an annuity was purchased with 25% of the portfolio and to 81.3% when an annuity was 50% of the portfolio. The improvement was less dramatic for the aggressive portfolio, which already had a 90% probability of lasting at least 30 years, but still increased security after adding an annuity.

Beyond the decision of whether or not to use immediate annuities, the next issue is when to buy the annuities. A study in the April 2005 issue of *Financial Planning* found that retirement security is enhanced when annuities are purchased over a period of years using dollar-cost averaging instead of in one purchase late in retirement.

The study compared two strategies. In one strategy, a couple purchases annuities gradually until age 80. The other strategy involved a gradual shift of the portfolio from stocks to bonds until late in retirement, then annuities were purchased. The couple purchased variable payout annuities in each case, so the annuity payout rose with inflation. The study found that dollar-cost averaging into the annuities increased the amount of wealth the couple owned at age 92.

One assumption that contributed to this result was that owning the annuities allowed the couple to invest more aggressively with the rest of their portfolio. The couple kept a constant percentage of its non-annuity investments in equities. Another assumption was that the annuities were purchased through tax-favored accounts. This allowed the couple to sell equities to purchase the annuities without incurring taxes, and also allowed taxable accounts to be used for investments that will qualify for what was then the 15% maximum tax rate on capital gains. Purchasing the annuities through a tax-deferred account also allowed the income from the annuities to compound tax-free until needed for spending.

A third strategy that also produced good results was to shift a third of the portfolio into annuities at the beginning of retirement. But dollar-cost averaging did better.

An immediate annuity provides several advantages to the retiree. Unlike the rest of the portfolio, the value of the annuity and its distributions will not fluctuate with changes in the stock market and interest rates. Also, the payout will not decline if there is a long-term decline in interest rates, as happens with bonds and CDs.

Retirees often are not advised to purchase immediate annuities. These annuities pay agents lower commissions than other annuities. Also, most financial services firms that provide investment advice, such as mutual fund firms, receive no benefit from advising investors to include annuities in their portfolios. But retirees who seek independent advice and research will learn that immediate annuities in a portion of their portfolios can increase their retirement security.

When purchased in a taxable account, the full annuity payment is not taxed. Part of each payout is a tax-free return of the original investment or principal. The rest of the payout is fully taxed ordinary income. To determine the taxable and nontaxable portion of each payment, the taxpayer uses IRS life expectancy tables to estimate life expectancy and the expected return from the annuity. This is used to determine the percentage of each payout that is excluded from income. Details are in IRS Publication 575, Pension and Annuity Income.

National Annuity Sources - Websites

annuities.direct, immediateannuities.com, tiaa-cref.org, fidelity.com, troweprice.com, quotesmith.com, vanguard.com,

National Brokers

Annuity & Life Insurance Shopper: 800-872-6684

Quotesmith: 800-556-9393

NOTE: Each broker does not offer the products of every insurer. Consumers should compare quotes from three or more brokers to view the full range of offerings on the market.

A broker who deals with a national client base and almost all insurers is Todd Phillips of Phillips Financial Services. He can be reached at 888-892-1102.

Thank you for taking the time to read this special report. As you may have guessed, there's a lot going on behind the scenes in Washington, D.C. that could have a major impact on your retirement nest egg. In fact, there's one development – a new law – that I'm warning my readers about at every turn. Click here for my updated research.

Biography

Bob Carlson is editor of the monthly newsletter and website, *Retirement Watch.* He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $4 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is the revised edition of "The New Rules of Retirement" (Wiley, 2016; first edition 2004). He also co-authored "Personal Finance after 50 for Dummies" (with Eric Tyson; Wiley, 2015) and wrote "Invest Like a Fox…Not Like a Hedgehog" (Wiley, 2007).

He has written numerous other books and reports, including "The New Rules of Estate Planning," "Securing Your Lifetime Stream of Income," "Tax Wise Money Strategies, Retirement Tax Guide," "How to Slash Your Mutual Fund Taxes," "Bob Carlson's Estate Planning Files" and "199 Loopholes That Survived Tax Reform." He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post* and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.

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