

Top 8 Misconceptions About Annuities

What you don't know about these investment tools may surprise you.

Every investment comes with its own rewards and, of course, risks. Annuities are no exception. However, these insurance instruments seem to have become the target for a significant amount of negative attention – some of it warranted, some of it not – over the past couple of decades.

Here, we clear the air around annuities, providing a fair look at the good, the bad and the hyperbole.

TOP MISCONCEPTIONS

1. Every annuity is a variable annuity.
2. Annuities are illiquid.
3. Annuities should be avoided because they are complex.
4. Annuities entail larger commissions than other investment options.
5. Never invest your IRA money in an annuity.
6. Never buy an immediate annuity when interest rates are low.
7. Variable annuities are expensive.
8. Variable and index annuities are “ticking tax bombs.”



1. EVERY ANNUITY IS A VARIABLE ANNUITY.

It is not uncommon for so-called experts to lump all annuities together. Since variable annuities are by far the biggest slice of the annuity pie, their perceived pitfalls have become the poster children for the category as a whole. However, there's more to annuities than variables.

There are two basic types of annuities: deferred (accumulates funds to be paid out later) and immediate (begins paying out right away). Within each of these groups, you'll find fixed and variable options, with risk increasing as you move toward the variable end of the spectrum.

For example, if you're already in or are quickly approaching retirement, an immediate fixed annuity could be a suitable option, providing payments based on the principal at a guaranteed interest rate. Whereas, a variable deferred annuity could offer the potential for tax-deferred growth – based on the performance of the vehicles the annuity is invested in – to someone still in savings mode. While you won't pay taxes on the principal paid out by an annuity, any gains will be taxed as ordinary income. In addition, gains withdrawn from a deferred annuity before you reach the age of 59½ are subject to a 10% federal tax penalty.

The two types of annuities discussed in this material are fixed index annuities and variable annuities. The following paragraphs briefly explain these annuities.

Fixed index annuities are linked to broad-based stock indices and have the ability to potentially earn a higher interest rate than a fixed annuity. The issuer guarantees a return that is the greater of a contractual minimum rate or the return that would be generated by the underlying index, such as the S&P 500 (the S&P 500 is an unmanaged index of 500 widely held stocks). Since annuity holders do not invest directly in the index, they do not participate in any dividends accumulated on the securities represented by the index, nor do they participate in any losses in the index. The features of the fixed index annuity, such as a cap or participation rate, determine how much of the gain of the underlying index will be credited to the annuity each year. Since gains are locked in each year, you will not lose original value or any interest earned even if the index declines. The fixed index annuity buyer is willing to give up a known interest rate for a fluctuating interest rate with higher potential returns.

Variable annuities are the most investment-oriented of deferred annuities. They typically offer annuity holders a wide array of securities. The return they deliver is based on the performance of the underlying securities. Unlike deferred fixed annuities, variable annuities do not guarantee a specific rate of return or offer any guarantee of your principal. However, variable annuities allow you to move funds within the annuity without tax consequences and offer an option to receive a full return of your principal as a death penalty.

Each of these products comes with its own unique benefits and limitations. As with anything else, it's best to take sweeping statements about annuities with a grain of salt – or at least a critical eye.



2. ANNUITIES ARE ILLIQUID.

It's one of the most pervasive myths surrounding annuities, and it simply isn't true. You will be expected to pay a surrender charge should you choose to withdraw a substantial portion of an annuity in the early years of your contract (these charges diminish annually before disappearing, usually around year seven), but your funds are accessible. And with most annuities, you can take out up to 10% per year free of fees.

It's also worth noting that annuities are hardly the only product that charges investors for "getting out" early. Some investment products are well known for their early withdrawal penalties, and the sale of most other investments will be subject to market conditions and, perhaps, commissions.

Therefore, while an annuity is certainly not the first place to look when confronting an unexpected need for cash, calling them illiquid is just inaccurate.



3. ANNUITIES SHOULD BE AVOIDED BECAUSE THEY ARE COMPLEX.

While complexity can be a little intimidating, it doesn't equal "bad investment." In the case of annuities, things get complicated thanks to the variety and number of features and benefits offered. The industry could certainly design simpler annuities, but such contracts would be far less flexible and, consequently, less capable of helping to meet your retirement needs.

The key here is taking the time you need to really understand the product you're buying, and being sure to work with financial advisors and other professionals you trust.



4. ANNUITIES ENTAIL LARGER COMMISSIONS THAN OTHER INVESTMENT OPTIONS.

Since an annuity is typically meant to be held for your lifetime (depending on your contract), the commissions involved are structured to take that into consideration. While the commissions associated with other products might seem substantially lower, it's worth remembering that these instruments are bought and sold on a regular basis and those lower commissions can add up over time.



5. NEVER INVEST YOUR IRA MONEY IN AN ANNUITY.

One of the benefits of an IRA is that your money grows tax-deferred, but tax deferral is also one of the main advantages of an annuity. For this reason, some say that holding an annuity in an IRA is like wearing a raincoat indoors. However, there are many exceptions to this rule, particularly if the annuity is meeting your objectives as an investment tool.

Whether or not an investment should be placed into a retirement plan depends on what goals that investment meets, not the tax consequence of that particular investment. For example, stocks and mutual funds are common and very appropriate retirement plan investment options despite the fact that the retirement plan can turn long-term capital gains to ordinary income.

Ultimately, whether or not it's wise to invest IRA money in an annuity comes down to what works best for your individual situation.



6. NEVER BUY AN IMMEDIATE ANNUITY WHEN INTEREST RATES ARE LOW.

It is common to read positive articles on immediate annuities that conclude by advising readers to wait until interest rates rise before actually purchasing an immediate annuity. On the surface, this makes sense. After all, the amount of income provided by an immediate annuity depends to a great extent on interest rates – the higher the interest rates, the higher the income. However, much of the income generated by an immediate annuity actually depends on the expected life span of the purchaser. In fact, as you get older, that income hinges more and more on your expected longevity and less on interest rates. And let's not forget that people have been waiting for interest rates to go back up for more than 25 years now.



7. VARIABLE ANNUITIES ARE EXPENSIVE.

The fees associated with variable annuities can certainly add up, but they're not as pricey as their reputation would have you believe. While figures vary by issuer, variable annuities typically charge a small percentage in management and mortality & expense fees. It's when you add bells and whistles – the riders – that you'll see that percentage go up.

However, it's these bells and whistles that provide additional benefits and downside protection. Comparing the total cost of a variable annuity with living and/or death benefit riders to the cost of a mutual fund is comparing apples to oranges.



8. VARIABLE AND INDEX ANNUITIES ARE “TICKING TAX BOMBS.”

While it's true that the earnings, but not the principal, held in an annuity are taxed as income upon distribution, remember the biggest benefit of tax deferral is that you control if and when to pay taxes. For most people, there will come a time when it's advantageous to withdraw the money and pay the taxes. And with taxable investments, you don't have this control.

With an annuity, you have plenty of time to plan for taxes accordingly and appropriately for your needs. It also means that any remaining funds that pass to your heirs will be taxed at their, presumably lower, income bracket.

Deferred annuities are long-term investment alternatives designed for retirement purposes. Surrender charges may apply for early withdrawals and, if made prior to age 59½, may be subject to a 10% federal tax penalty in addition to any gains being taxed as ordinary income. Guarantees are based on the claims-paying ability of the issuing company.

Investors should carefully consider the investment objectives, risks, and charges and expenses of variable annuities before investing. The prospectus contains this and other important information about variable annuities and their underlying funds. Prospectuses are available from your financial advisor and should be read carefully before investing. An investment in annuities involves investment risk, including possible loss of principal. The contracts, when redeemed, may be worth more or less than the total amount invested. Past performance is no guarantee of future results.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // TOLL-FREE: 800.248.8863 // RAYMONDJAMES.COM/RJIG

Investment products are: not deposits, not FDIC/NCUA insured, not insured by any government agency, not bank guaranteed, subject to risk and may lose value.

© 2018 Raymond James Financial Services, Inc., member FINRA/SIPC.

Raymond James® is a registered trademark of Raymond James Financial, Inc.
Raymond James & Associates, Inc., Member New York Stock Exchange/SIPC PCA-01220318-SS