The Decision to Buy an Annuity

Given the current turmoil in the stock market, people are wondering where to invest for retirement. Many are searching for other investment opportunities (Levitz, 2008). They see advertisements proclaiming the safety of an annuity. They wonder, "Should I buy an annuity?" This presentation can be used for a workshop on buying an annuity. A worksheet can be used to guide the decision making process.

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Introduction

An annuity is an investment contract or policy between an individual known as the policy holder and an insurance company (Orman, 2008). When the policy holder purchases the annuity, he will receive certain guarantees from the insurance company. The guarantees could be for a minimum rate of return for the life of the contract or a guaranteed interest rate for a given year. Like investing in a 401(k), an annuity offers tax-deferred growth within the policy or account.

Review of Literature

The most basic type of an annuity is a fixed, immediate, lifetime annuity (Agnew, Anderson, Gerlach, & Szykman, 2008). The purchaser is guaranteed a steady stream of income for the rest of his life. This type of annuity might also be called a payout annuity or an income annuity. (Scism, 2008). Usually the purchase of a fixed annuity is made from an insurance company but it could be purchased from a brokerage firm, bank, or mutual fund company. There is a commission charge on the purchase. If the purchase is made through a mutual fund company, there is a load or commission percentage of about 5 or 6 percent (Orman, 2008).

If the purchase is made from an insurance company, the purchaser should investigate the financial strength of the insurance company (Orman, 2008). A prospective purchaser should look for a company with an A, AA or AAA rating. A purchaser can ask the insurance company to provide its ratings or contact the ratings companies (e.g., AM Best, Moody's, and Standard & Poor's).

A variable annuity is a product that competes with fixed annuities (Orman, 2008). Like other annuities, a variable annuity is a contract with an insurance company for a specific period of time. However, a variable annuity does *not* offer a guaranteed rate of interest or earnings. It is similar to a 401(k) or an Individual Retirement Account (IRA) because the purchaser is asked to select from several mutual funds within the insurance contract. In a variable annuity, the policy holder can buy, sell, or switch funds at any time without incurring taxes until he/she begins to withdraw.

Age 59 ½ is the earliest age at which the policy holder can withdraw from the annuity. At that time, gains on the investment are taxed as ordinary income (Orman 2008). During retirement, many variable annuity owners withdraw their money or annuitize it to provide a lifetime stream of income. Some insurance companies have added living benefit riders (at extra cost) that promise minimum investment returns (Scism, 2008). The immediate annuity eliminates the risk the purchaser will outlive his/her resources. Although a fixed, immediate, lifetime annuity sounds like a "good" investment for retirement, the market for annuities is small.

Research Design

To understand why the market for immediate annuities is so small, four professors (from economics, finance, and marketing) developed a study to investigate what is known as the annuity puzzle. The research was funded by FINRA Investor Education (Agnew et al. 2008). The research design was focused on negative framing (e.g. emphasizing the risks). Three five minute slide shows were developed (Agnew et al. 2008). The slide shows were factual but they were biased. The first slide show favored annuities by highlighting the negative features of an investment split between equities and risk-free assets. The second slide show favored investments by highlighting the negative features of annuities (e.g. dying early before recouping the benefits). The third slide show was neutral. The research also controlled for level of risk aversion and financial literacy.

Results of Research on the Annuity Puzzle

The sample was large and representative of consumers. There were 445 women with an average age of 54 and 400 men with an average age of 56 (Agnew et al. 2008). For both men and women, one or both of the biased slide shows had significant effects on the purchase of an annuity compared to those who saw the neutral slide show. That is, the negative framing (biased message) was effective. This is a strong indication that the sales presentation can persuade the buyer without his being aware of it. Also, men and women in the study with high financial literacy were *less* likely to purchase an annuity and men and women with high risk aversion were *more* likely to purchase an annuity.

Recommendations

An Investor Alert from FINRA recommends that prospective purchasers of variable annuities should ask themselves these questions before investing.

- ✓ How long will my money be tied up? Are there surrender charges or penalties if I withdraw funds early than I anticipated?
- ✓ Am I already contributing the maximum amount to my 401(k) plan and other tax-deferred retirement plans?
- ✓ Am I going to need the money before the surrender period ends (usually at least 7 to 10 years)? Will I need the money before I am 59 ½?
- ✓ Do I understand how the variable annuity works, the benefits it provides, and the charges I have to pay?
- ✓ Have I shopped around and compared the features of various variable annuities, such as sales loads and other fees and expenses?
- ✓ Do I understand the effect annuity payments could have on my tax status?
- ✓ If I am considering purchasing a variable annuity within an IRA, do I understand that IRAs already provide for tax-deferred savings?

References

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Endnotes

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