UNDERSTANDING ANNUITIES IN THE 21ST CENTURY

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An Excerpt From: *The Holistic Retirement Planning Revolution* by Lane Martinsen

The Right Combination of Financial Products

A good retirement plan should be customized to your individual situation. It will often include a mix of financial products, depending upon their unique strengths and attributes to achieve an optimal result.

It is helpful to think of financial products, financial institutions, and investments as financial tools. We use tools to build and fix things and we want to build a retirement income that we can depend on. The various types of financial products available today make up what I like to call the “financial toolbox.” Before we start the planning process, we want to make sure we have access to all available tools. We should not arbitrarily exclude certain types of financial tools or asset classes because we think we will not need them; we want to start with a complete toolbox.

The Pros and Cons of Red and Green Tools

To simplify the overwhelming variety of financial tools, I find it helpful to divide the large financial toolbox into two categories. Let’s call the first category “Red Financial Tools,” and the second category “Green Financial Tools.”

All the Red Tools have an element of market risk with no guarantees. All Green Tools do not have market risk and do come with certain guarantees.
Red = Market Risk.
Green = No Market Risk.

Both Red and Green tools have unique strengths and weaknesses, pros and cons. There are trade-offs that need to be weighed and considered.

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21st Century Innovation

"Everything that can be invented has been invented." This is the infamous quote of Charles H. Duell, the Commissioner of US patent office back in 1899. I'm sure most people living in the 19th century could hardly imagine the innovation and advances that took place during the 20th century. And now in just the first two decades of the 21st century alone, innovation has been nothing short of remarkable.

As a boy in the 70s, I remember imagining what it would be like to have a cordless telephone that you could take with you anywhere. It seemed too good to be true. Fast forward to present day, I can use my smart phone to do that and infinitely more. From anywhere in the world I can see who is at my doorstep and speak to them. I can unlock the front door, open and lower my garage door, adjust the thermostat, and have face-to-face video calls with my daughter attending an out-of-state University. I can order virtually any product and expect it to arrive on my doorstep in 24 hours. I can take a photo or record a video and publish it around the world within seconds. I can pay bills, make deposits, transfer money, and never have to wait in line at the bank.

We will soon have self-driving, all-electric, cars and be able to order an Uber drone that will fly me across town when we need to get somewhere quickly. Yes, flying taxis are just around the corner; the futuristic day of the Jetson's has arrived. Innovation has and will continue to change the quality of our lives.

Innovation is found in all industries, including the financial services industry. In chapter 7, we learned about the birth and growth of Exchange Traded Funds and new access to Separately Managed Accounts. These are 21st century improvements and are the direct result of innovation.

Guarantees and No Market Risk

"Green Tools" are financial products that come with guarantees and have no market risk. There has been little innovation with a basic savings account and certificates of deposit which would be considered Green Tools and are available at the local bank. The insurance-based products including annuities and life insurance, however, have evolved and transformed with remarkable 21st century innovation.

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The History of Annuities

Annuities have been around for centuries. Believe it or not, archeological evidence of annuities dates back to Babylon in 2500 B. C., Egypt in 1100 B. C., and within the Roman Empire in the second and third centuries A. D. The first annuity was offered in America in 1759 by a company in Pennsylvania for Presbyterian ministers and their families. Ministers could contribute to a fund in exchange for lifetime payments. After the 1929 market crash, the demand grew for financial products that offered guarantees.

The basic concept of an annuity is a sum of money paid to someone on a monthly or yearly basis, typically for the rest of their life. A company pension is basically an employer sponsored annuity. Social Security is a big public annuity funded through taxes, and personal asset-based annuities are provided and guaranteed by insurance companies.

The annuity world is vast. There are many different annuity products available with a host of features, configurations, and benefits. Annuities are an important tool in retirement income planning that can be used for various reasons and can solve many financial problems. The evolution and innovation have made annuities more and more effective and beneficial. As with any tool, annuities should be used appropriately and with skill.

Types of Annuities: Fixed, Variable, and Fixed Index

The oldest and most basic type of annuity is a Fixed Annuity. A Fixed Annuity generally comes with a guaranteed fixed interest rate while guaranteeing the principal investment. The problem with Fixed Annuities is that the interest rates are generally low and not as exciting as market-based investments. As the industry looked for ways to improve annuities and bring together the benefits of market-based investments as well as the benefits of an annuity, it led to the creation of the Variable Annuity in the mid-20th century.

The concept of the Variable Annuity is pretty good. It is based on investments subject to market risk that can lose value but with a minimum guarantee offered by the annuity company. The Variable Annuity structure, however, has multiple components, including mutual fund like investments called "sub accounts" with their own fees and inefficiencies, as well as increased administrative costs from the annuity company. They are burdened with layers of fees in the range of 2.75% to 3.5%. I have even seen some as high as 4%. This creates a tremendous drag on the investment account and explains, in part, their underperformance.

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When I referred to outdated and rusty old financial tools this would be one of them. When negative stories are told about annuities, they are most often referring to variable annuities. The problem is, many broker/dealers are still promoting them.

The idea behind a Variable Annuity is that the investments in them have a chance of growing above the minimum guarantees offered by the annuity company, but in my experience, it just doesn't happen. After years of evaluating Variable Annuities for new clients, I have never seen one exceed the minimum contract guarantees. If anyone reading this book has a Variable Annuity that has experienced growth above the minimum contract guarantees, I would love to hear about it!

I give Variable Annuities a rating of "Poor" but something amazing has happened in the 21st century: the development of Fixed Index Annuities (FIAs).

Fixed-Index Annuities (FIAs)

Imagine if there was a place you could put some of your retirement nest egg that had zero downside market risk, zero fees, tax advantages, and your money could grow based on the upside performance of a market index such as the S&P 500. It sounds almost too good to be true and you may be wondering if such a place really exists? Yes, it is called a Fixed-Index Annuity and it is a game-changer for soon-to-be retirees.

The FIAs available today did not exist during the 20th century. The birth of the first FIA was in 1995 but they were in their infancy and hardly anybody knew about them.

Within the first five years, at the turn of the century, the number of carriers offering FIAs had grown from 1 to 50. As the advantages of FIAs became better known and understood during the mid-2000s, the consumer demand continued to grow. After the 2008 financial crisis, FIA growth soared with billions of dollars moving into FIAs every year. Today, total FIA assets are in the hundreds of billions and growing rapidly.

A Financial Tool with Unique Attributes

The advantages of FIAs are truly revolutionary with their guaranteed principal, and the new potential for growth tied to a market index at either no cost or very low cost depending upon the specific annuity. Just as the first automobiles were nothing like the automobiles available today, the FIA innovation has continued each year. They have further improved with more flexibility and problem-solving abilities.

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Innovative Indexing Strategies

Much of the research and innovation has been focused on new and better indexing strategies within the FIAs. There are many different index crediting methods and combination of methods to choose from, but the basic concept is that if a market index like the S&P 500 goes up then you enjoy upside growth. If the market goes negative, you are guaranteed to never lose money due to market losses.

With a Fixed-Index Annuity, you will never get all the stock market gains, but you also never get any of the losses. This means you will never waste time trying to recover from a market loss. If you remember from chapter four, we demonstrated how volatility is enemy #1 and can damage your nest egg, especially in retirement when negative sequence becomes a threat. Again, not losing money is more important than chasing after the highest gains possible.

Having said that, there are some remarkable breakthroughs in recent years with uncapped index strategies that have amazing potential for growth. One such index was designed by Roger Ibbotson, PhD., a professor at Yale University, who has helped to change the way investors think about investment allocations, especially for those nearing retirement age.

Potential for Double Digit Gains with Zero Market Risk

Double digit gains can be achieved when the market is up, but you will not get all the market gains because the insurance company is using options (derivatives), which means a FIA typically will have index caps and/or participation rates. The historical returns average around 7% growth for income over 10 years. When you don't have to spend time recovering from market losses, your money can grow surprisingly well. Less volatility results in better growth performance.

Where else can you potentially average 7% returns with no market risk? Only with "Green financial tools," such as Fixed Index Annuities.

FIAs: an excellent Alternative to Bonds

Now, annuities are not in competition with mutual funds and other "Red financial tools." It is important to know that you would never want to put all your retirement assets into a FIA. We are only talking about a portion of your retirement nest egg. In chapter five, we pointed out that with traditional asset allocation you will need a combination of stocks and bonds. You can't afford to take on too

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much risk as you head into retirement and, therefore, if you follow the outdated "Traditional Asset Allocation" portfolio model, you are going to end up with between 40% to 60% of low interest bonds in your portfolio.

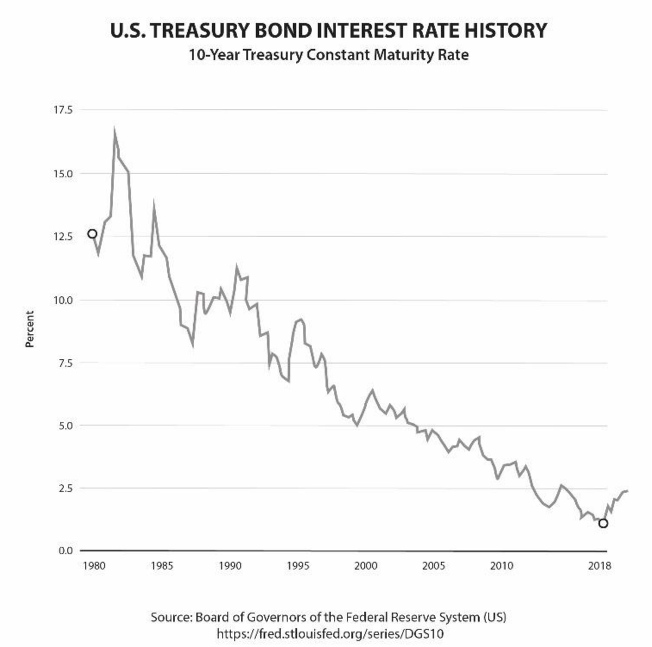
Hope Is Not a Strategy

The Traditional Asset Allocation model is an investment strategy, but it is not a retirement strategy! It has no safety net and it relies solely on market growth. It requires a lot of hope in more risky "red" markets. It is important to remember that hope is not a strategy.

Bonds are generally considered less risky than stocks, but they come with no guarantees. Bonds have many risks and they lose value in an increasing interest rate environment. Because interest rates are low, and we are in an increasing rate environment, there is a trend for "Red Investment Only" firms to move to higher yielding junk bonds to try to remain competitive, but increasing risk is not a great solution.

The Bond Bull Market has Ended

Since our more than 30-year bond bull market has reached the floor, our historically low interest rates have only one direction to go, and that is up to normal levels.



For many people heading into retirement, bonds do not even belong in their retirement portfolio! How is that for a revolutionary statement? A FIA is an excellent alternative to bonds and can provide better growth and stability than bonds.

Now, I have not even mentioned one of the greatest strengths and advantage of annuities, and that is the guaranteed income stream for life. One of the risks that could cause you to run short of money in retirement is Longevity Risk. As explained in chapter five, longevity is a risk multiplier because the longer you live the more money you will need, and you have more time for all other risks to become a problem. FIAs can solve the longevity problem with guaranteed income for life.

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Creating More Income with FIAs

What if you could get $100,000 to do the work of $200,000 or even $300,000, depending upon the length of retirement?

With "Traditional Asset Allocation" you spend principal and interest. With a guaranteed income stream from an annuity, you spend principal, interest, and "mortality credits." Mortality credits are additional income dollars that can be paid to you above and beyond the principal and interest. The additional dollars are based on the guarantees of the issuing insurance company.

When we use an income annuity as part of a retirement income plan, we are combining actuarial science and investments. Actuarial science is based on the law of large numbers. The insurance companies know how long people will live, on average, as a large group. Some live longer than others, but the average is known. Based on that information, insurance companies can provide guaranteed income for life, regardless of how long you live. Even if you deplete your assets, the income stream just keeps flowing for as long as you live – it's guaranteed. Mortality credits, also known as mortality yield, are the terms that refer to the income received after funds have been depleted.

With an income annuity we can create leverage. As discussed in chapter five, with Traditional Asset Allocation, the safe withdrawal rate is no longer 4% but only about 2%. That means for every $100,000 in your portfolio, you can safely withdrawal only $2,000 of income per year without the risk of running out of money prematurely. However, with a guaranteed lifetime income stream from a good annuity, the withdrawal benefit rate is around 5% based on a single life or $5000 of income for every $100,000 in your portfolio.

Annuities can offer income streams based on either a single life or a joint lifetime for spouses. When based on joint lives, the income and mortality credits will continue until the death of the second spouse. The withdrawal benefit rate is around 4.5% for a joint life ($4,500 of income for every $100,000). Depending upon how much time you have before retirement, you may be able to achieve a 5.5% or even 6% withdrawal benefit rate with certain types of deferred FIAs.

The beauty of annuities and actuarial science is that you can take a higher income without the fear of running out prematurely. This is one of the unique attributes that can only be achieved with a "Green Financial Tool" such as the Fixed-Index Annuity.

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Annuity Fees

So, what about fees? Don't annuities have high fees? Variable Annuities do, and I would not recommend them. However, most FIAs available have either NO fees or LOW fees depending upon optional features.

You may be wondering how an annuity/insurance company can possibly offer a financial product with zero fees. Well, they can, and they do. As discussed in chapter six, the various types of financial tools each have tradeoffs. They each have their own set of pros and cons. So, what is the tradeoff with FIAs? It is the commitment of time.

An annuity is a long-term contract. Does the insurance company have expenses associated with providing annuities? Yes, of course, but they benefit from managing the assets over an extended period of time, not from charging you fees. It's remarkable how well this works to benefit all parties involved.

You may be wondering how an annuity/insurance company benefits from managing assets. The money managers within an insurance company are some of the best you will find anywhere. They are conservative investors with deep pockets and typically hold large blocks of bonds to maturity. The yield and the numbers are known. A portion of the interest from the bonds is used to buy stock options. If the market goes up, they exercise the option and realize the gains. If the market does not perform, they simply let the option expire. This is how they can pay you interest based on the performance of a market index and also make some money for the insurance company along the way. They can only do it with no fees or low fees when there is a commitment of time.

Understanding Liquidity

What we are talking about here is the liquidity factor. With a FIA, the tradeoff for the benefits provided is a commitment of time and reduced liquidity. Unenlightened annuity critics that live in the "traditional asset allocation ONLY" world, preach with religious fervor to "not lock up your money" in an annuity. So, let's take a closer look at this issue.

First, the idea of maintaining 100% liquidity of your entire retirement portfolio nest egg is not necessary and not at all practical. Often, we are dealing with qualified (pre-tax dollars) and you really don't have full liquidity anyway, because if you pull all the money out in a single year you would create a very large tax obligation that would bump you up into the higher tax brackets.

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Are we not planning for retirement income that spans three decades? If we are using a FIA as part of an overall retirement income plan, and as a bond alternative, then short-term liquidity is not the goal or even a concern. A FIA is best suited for those approaching retirement age and not well suited for those who are still in the early stages of their career.

Built-in Liquidity and Penalty Free Withdrawals

FIA contracts come with early surrender penalties, typically in the first 9 to 12 years, depending upon the specific FIA product chosen. The penalty only applies if you withdraw more than a specified percentage in any given year. FIAs today come with a built-in liquidity amount. In other words, a "penalty free" withdrawal is available each year if you need to pull out additional money early. The percentage that can be withdrawn penalty free during the first 9 to 12 years is typically between 7% to 10% depending upon the specific annuity chosen.

Keep in mind, only a portion of your assets should go into a FIA, not all. You should still have lots of liquidity with your other Red investments. If you need to pull out more than 10% of the "guaranteed portion" of your retirement assets every year, then you did not have a good plan to begin with.

Liquidity needs should be considered and is always a component of a comprehensive retirement income plan. If you want the guarantees, growth, and leverage that can only be provided through actuarial science and FIAs, with either no fees or very low fees, then giving up some liquidity in exchange for the benefits is a very good tradeoff.

Understanding Commissions

What about annuity commissions? Again, the "Traditional Asset Allocation ONLY" advisors will give warnings about high commission products. There is one company in particular which comes to mind. I will not name them, but their marketing message and TV commercials flood the airways and are both incomplete and misleading. There are elements of truth in their advertising and commissions can be a factor, especially for a "Green Tools Only" sales representative, but not for an independent fiduciary retirement planner with a full toolbox of both red and green financial tools.

The insurance companies that offer FIAs compensate representatives out of their own marketing budget typically with a one-time commission. However, there are no fees charged to the client for

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commissions! This is very different from what most people think of when they hear the word "commissions." If a realtor helps you sell your house, he or she is paid a commission out of the proceeds of the sale. This is not what happens with annuities. There are NO FEES deducted and your funds are not reduced by even one penny.

Advertisements that suggest you will pay high commissions with annuities are misleading and inaccurate. They suggest that annuities are recommended only because of commission incentives and that the better choice is to put 100% of your assets into their stock and bond mutual funds. To be clear, there are many different FIAs available and some have optional features that may charge a low fee of about 0.95%, but that is optional and often not necessary depending upon your specific needs.

So, how can an insurance company afford to do this? As mentioned, it is due to the long-term nature of an annuity contract and the time the insurance company will have in managing the money. A Certificate of Deposit (CD) at a bank is a similar concept. The longer the term of the CD, the longer the bank has to lend out the money and earn a spread.

The only time you would experience an early surrender penalty is if you deviate from the plan and surrender the CD or the annuity early (within the first 9 to 12 years). With a properly designed plan appropriately aligned with your needs and goals, you should never have to experience the early surrender penalties.

Red Tools Cost More than Green Tools Over Time

Over your retirement lifetime you will pay much more in cumulative fees on Red market-based investments than you will with a onetime commission that doesn't even come out of your pocket! This is a fact that the "Red Tools ONLY" guy fails to point out. Their advertisements suggest they will save you money. The reality is just the opposite!

A fiduciary planner is bound to only do what is in the best interest of the client and is required to be transparent with fees and compensation. A true fiduciary advisor will recommend an appropriate annuity when it is clearly in your best interest to do so.

Annuities are not for everyone and they are not always a good fit. There are times, however, when the right annuity, can be an important component of a retirement income plan, in which case it can provide stability, more retirement income, and peace of mind.

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How Safe are Insurance Companies?

The "Guarantees" are based on the claims paying ability of the insurance company. The insurance industry is heavily regulated, and insurers are required to maintain 100% of the legal reserve. The cash reserve requirements to be an "A" rated insurance company is very high and much higher than what is required of banks.

Your money in a bank's savings account has potentially more risk than that of an insurance company. The FDIC insures your money at the bank up to $250,000. Anything beyond that amount would be at risk if the bank failed. Insurance companies have layers of protection. In addition to the high cash reserves and strict regulations, they are required to buy insurance on themselves (re-insurance) from other insurance companies should they have a problem. In addition, the states require insurance companies to pay into a State Guaranty Fund which serves as a third layer of protection in the event an insurer becomes insolvent. All 50 states, Puerto Rico and Washington D.C. all maintain a State Guaranty Fund. The guaranteed limits vary by state, but the most common limits are between **$250,000 – $300,000** and can be as much as **$500,000** for both annuities and life insurance, depending upon your state of residence.

Conflicting Opinions and Outdated Practices

Within the financial services industry we find a mixture of conflicting opinions and outdated practices. How is a person to know who is best qualified to assist them with something as important as your retirement nest egg and the future income you and your family will depend on over many years in the future?

I have rubbed shoulders with many financial advisors of all types over the years and I can say, most all that I know are hardworking men and woman of integrity. These are good people who want to do what is right and what is in the best interest of their clients. However, their employers or the system in which they work controls and limits what they can and cannot do and that is a problem.

So, what's the next step? How do you obtain quality holistic retirement planning? How do you find the right kind of advisor with the skills and experience necessary to help you optimize and map out the chess pieces that make up your retirement plan?

Finding the right kind of advisor can be a very difficult task. How do you know who

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to trust to help you create a truly holistic retirement plan?

Does the advisor have a complete financial toolbox?

If the advisor is a “Red Financial Tools Only” advisor, or a “Green Financial Tools Only” advisor, they will have a strong bias. The advice will be limited to one way of thinking, rather than utilizing the right combination of unique financial attributes and strengths of all tools available. The best holistic plans often use a combination.

About the Author

Lane G. Martinsen is a financial planning practitioner, a Certified Financial Fiduciary®, an Investment Advisor Representative (IAR) and a Retirement Income Certified Professional (RICP®).

Lane graduated from the University of Phoenix and completed post undergraduate studies at The American College of Financial Services and Boston University.

Lane is the Founder and President of Martinsen Wealth Management, LLC serving clients nationwide and with offices in Chandler, Arizona and Valencia, California. Lane is a member of the Ed Slott Elite IRA Advisor Group and a member of the MDRT Top of the Table.

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At Martinsen Wealth Management, LLC, we provide comprehensive and holistic retirement income planning for our clients. Our aim is to preserve and grow our client assets by reducing market risk, and tax exposure. To optimize and coordinate all sources of retirement income for a more confident and sustained retirement.

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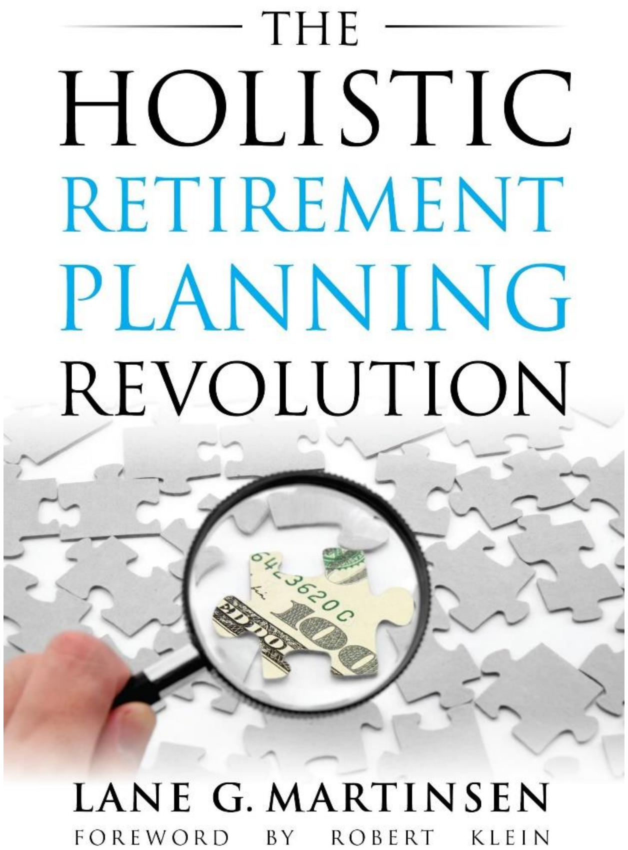

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Book Endorsement from Ed Slott:

Today, as we are living longer, retirement planning is all about income - because savings can run out! This is the number one fear I hear from retirees everywhere.

The plan in Lane's book is refreshingly different and more applicable to today's retirement realities. His book shows retirees how to generate lifelong income by making the most efficient use of your total financial picture, a/k/a Holistic Planning.

Your money can last as long as you do…and beyond. Consider this book a user's guide to a 21st century retirement plan.

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