The Patient and Disciplined Investor…

Ruminations on long-term wealth building

by Todd Kirsch July 2011

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"An unexamined life is not worth living" – Socrates

Annuities – Be Careful

When I arrived at law school, the professors initially talked a lot about teaching us to "think like a lawyer", sometimes referred to as the "Socratic Method". Essentially, it was an exercise in mind-training to see problems from every angle and expose contradictions. As law students, we were required to attend class and be prepared to discuss a particular case. After setting out the facts of the case, the professor would then call on a student and engage in a seemingly endless game of changing one fact and asking whether that would have changed the outcome of the case and why…then another fact, and so on. The whole process could go for nearly all of class in front of your classmates – one had better come prepared to class! I didn't appreciate it as much at the time, but it's been an invaluable skill in critically examining financial products. Let's look closer at annuities.

While annuities can be very appropriate solutions for many situations, they are oftentimes purchased for the wrong reasons.

Annuities can be sophisticated financial and insurance products. In my experience, the public has trouble understanding the various features and benefits of many annuity products. Lately, I've come across a few clients who have purchased annuities. While annuities can be very appropriate solutions for many situations, they are oftentimes purchased for the wrong reasons.

A feature in annuities that has gained widespread acceptance is a guaranteed income rider. Based on discussions with clients, people are confused how these riders work, and I wonder whether the insurance agents who sold the product actually understand them, either. The sales pitch goes something like this: "Mr. Customer, you can put a lump sum of money into an annuity and immediately earn a bonus of 10%." (they've got your attention). "Thereafter, your money will earn a guaranteed rate of return of 8.2% until you decide to begin taking income."[1] Well, as my Corporate Tax Law Professor used to say, "Not so fast, Red Rider." Unfortunately, the focus tends to be on the 8.2% and the 10% bonus, but you might actually be better off in a traditional annuity product or a different investment.

The problem with the figure earning "8.2%" is that, once the annuity payout begins, the customer is limited to a different set of payout tables that reduces his income. The customer does NOT participate in normal mortality tables. Rather, they participate in lower "lifetime withdrawal rates."

Let's use an example. Take a Colorado man, age 66, who deposits $100,000 into an annuity and then decides to take income nine years later at age 75. The $100,000 is credited with a 10% bonus, increasing his "Benefit Base" to $110,000. This figure increases to $223,582 at 8.2% interest. (Actually, $223,582 is a 9.35% return when you consider the 10% "bonus"). At age 75, the client can then begin taking income based on this amount. So far, so good. However, he's limited to a "lifetime withdrawal rate" used by the insurance company. In this case, it was 6.5%. Multiplying $223,582 by 6.5% = $14,533/year for the rest of his life.

[1] There are many annuity products available on the market that have various degrees of bonuses and returns on their benefit riders. I'm using a hypothetical from one company in particular that appears to be the most aggressive in crediting 8.2% versus lower rates for other companies.

In contrast, take an annuity that earns 4.5% over the 9 years. In this case, the $100,000 would grow to a decidedly less sexy figure of $148,609 -- remember, no "bonus" on a more traditional product. At age 75, this client would then annuitize the $148,609. If he were to retire today with that amount at age 75, he could expect to receive $14,516 per year based on an annuity factor of 9.768% (as of June 3, 2011).[2]

You might have noticed by now that $14,516/year at 4.5% is strangely similar to $14,533/year at 8.2% with a 10% bonus.

A few more things to consider: first, the "guarantee" is from the insurance company…financial strength matters. Second, once you annuitize (or turn on your income from the annuity), your payments are then fixed for life that will hurt your chances of keeping up with inflation (although deflation would help you). Third, the annuity factors used by insurance companies fluctuate with interest rates. All things being equal, higher interest rates mean higher payouts on your traditional annuity. The annuity factor used in my example (9.768%) on June 3, 2011 was on a day of extremely low interest rates. This number would have been higher if interest rates were higher.

<u>Annuity 1 -- with an income rider</u>
$100,000 deposit x 10% bonus = $110,000
$110,000 @ 8.2% for 9 years = $223,582
$223,582 @ 6.5% lifetime withdrawal rate = <u>$14,533/year</u>

<u>Annuity 2 – more traditional annuity</u>
$100,000 deposit @ 4.5% for 9 years = $148,609
$148,609 @ 9.768% annuity factor = <u>$14,516/year</u>

<u>Bottom Line</u>:
If you've bought one of these annuities, don't panic. They can be appropriate for many situations and are suitable for the conservative portion of your retirement assets. But do not be unduly influenced by the high interest rates being offered under these guaranteed income riders.

[2] The annuity factor was obtained on a phone call to Farmers Life Insurance Annuities Department on June 3, 2011. The annuity factors fluctuate daily based primarily on interest rates. The client could expect this level of income if he annuitized the $148,609 today.

<u>Everyone Seems a Bit Gloomy Again – But Not Us Contrarians</u>

In case you missed it, let me relay some terrific news on the MSN website June 8th:

> In a new study by Prudential Financial…58% of investors say they've lost faith altogether in the stock market. The risks aren't worth it, some say. And 44% swear they're done with stocks for good and are not likely to put any more money into the market.[3]

For us contrarians, this is music to our ears. First off, these people are not done with stocks – they're just done for now…until things "get better", which is the most ill-defined, ill-planned, and ill-advised way to approach investing. Second, if you were to move money into stocks, would you rather have done it on March 9, 2009 or October 9, 2007?[4] I hope you answered March 9, 2009 – the nadir of the markets and emotional depths of consumer sentiment. Had you had the courage to go against investor sentiment on March 9, 2009, you would have seen stocks nearly double over the next two years.[5]

Negative investor sentiment is generally considered a bullish indicator by many experts. But it's never easy to get your emotions out of the way and go against the crowd.

Negative investor sentiment is generally considered a bullish indicator by many experts. But it's never easy to get your emotions out of the way and go against the crowd. Of course, it also works in reverse – when people are feeling good about markets, they oftentimes take on too much investment risk. This all begs the question: are stocks riskier when markets are bottoming out or hitting new highs?

[3] http://money.msn.com/top-stocks/post.aspx?post=156554ae-4a78-41fe-8efd-d3ca6b27eed5, June 6, 2011.
[4] http://www.the-privateer.com/chart/dow-long.html. The Dow Jones Industrial Average closed at 14,164 on October 9, 2007 and closed at 6,547 on March 9, 2009.
[5] By the way, my only regret over the last two years is that stocks did, in fact, bounce back so quick. I wanted to continue acquiring shares at lower prices through new money being invested and dividend reinvestments.

The MSN article continues:

> About 40% of those surveyed aren't seeking the help of a financial adviser. And 53% don't think an adviser is helpful, even in extreme market conditions. And here's one that Prudential probably doesn't like -- 62% can't think of a single financial services company they would trust.[6]

Ouch! But that's because many financial professionals tout market performance and superior investments as the way in which they add value to client-advisor relationships. Although I don't rule it out, I never claim that I have superior or magic investments not available to other financial professionals that will somehow defy the odds of market downturns. One of my most important jobs is to help coach you through the market cycles and, as best I can, keep your emotions on the sidelines and your mind focused on your long-term goals through both the ups (euphoria) and downs (fear) of markets. Otherwise, you can make a tragic, expensive mistake. In addition, well-rounded financial professionals are not limited to recommending investments. We also can help you make better choices on insurance, estate issues, and taxes – oftentimes in conjunction with your other professionals. It's always best to look for financial professionals who have earned respected professional designations, such as the Certified Financial Planner® designation and those offered through the American College.

Bottom Line: Consumer sentiment can sometimes be a contrarian indicator. Your best investment opportunities can sometimes be when everyone seems glum about the future.

The People Around You, Dad

At the risk of being insensitive, I'd like to ask you a few questions. Why didn't you think about the people around you? Why didn't you get to the attorney's office and have a will drafted that included medical directives so that we didn't have to make the extraordinarily difficult, emotional decision when to end your life. Why didn't you keep that life insurance policy? It was never for you, anyway – it was for mom. Why didn't you buy that long-term care insurance your insurance agent suggested? Mom was physically unable to take care of you, and then everyone was at odds over your care, how to pay for it, and how it should be delivered. Mom ended up impoverishing herself and applying for Medicaid – a welfare program -- to pay for your care. Where's the dignity in that? And why did you always insist on saying, "I'm spending every dime…you're not getting anything from me when I die." Did you really mean that?...because that's pretty much how it ended up. We thought you were just being you and trying to be funny. But it's not funny anymore. It wasn't like you didn't have the money. You just didn't think about the people around you.

Bottom Line: If you love your family, don't make these mistakes.

[6] Ibid.

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