Kamp Consulting Solutions, LLC

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Fireside Chat

Your Monthly Update from KCS

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Rethinking the Retirement Playbook

If you are like me, you've probably heard the word "annuity" before, but you may not truly know what an annuity is or how this supposed financial tool actually works. Don't be embarrassed. Before embarking on this month's *Fireside Chat*, I really didn't have a clue either, and I've been fortunate to be in the investment industry for 33 years.

At KCS, we've been lamenting the demise of defined benefit plans (DB), and the loss of a monthly retirement payout (annuity) for their beneficiaries. With the death of DB plans comes the need for defined contribution (DC) participants to cobble together their own retirement plan. The DC marketplace has become aware of the plan participants' dilemma, and investment vendors, especially insurance companies, have started offering guaranteed income for life products within their fund lineups. While these products are fairly new, they are being embraced by both plan sponsors and participants.

Plan sponsors play a pivotal role in the retirement equation. DC plans may contain a feature called a Qualified Joint and Survivor Annuity (QJSA) which is the core of all defined benefit plans. Federal law requires QJSA plans to pay eligible participants a monthly retirement payment for the rest of their life. Instead of a QJSA, a distribution may be elected as a direct rollover, lump sum payment or in some cases, installment payments. Any married participant is required to receive spousal consent for any non-annuity distribution decision. Even though QJSA does not apply to unmarried DC plan participants, it is a good opportunity for plan sponsors to discuss the availability of annuities and their potential benefits with all plan participants.

Human nature also plays a huge role in the payout process. Some new retirees in DC plans may select a lump sum payout to get instant gratification for a lifetime of hard work – and spend it quickly! Also, since QJSA is optional for DC plans, sponsors not offering that feature force participants to determine their own retirement income path. While we support the idea that DB plans should be the backbone of our retirement industry, due to the shift to DC plans, this may not be a realistic goal. So let's take a look at how annuities can help impacted DC and DB participants (who may have also elected lump sum distributions) to achieve a lifetime income payout.

Inside This Issue

What is an Annuity?

Think of an annuity as investments with insurance features or insurance with investment features, and the order depends on the type of annuity or contract. Quite simply, annuities are investments with money-back guarantees.

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Interestingly, annuities have existed for at least 1800 years, dating back to ancient Rome when contracts, called annua, promised a stream of payments for a fixed period of time or life. They were first introduced in the U.S. in 1759, when the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers was chartered in Pennsylvania. That name's a mouth full!

The modern era of annuities began in 1952, when TIAA-CREF offered the first group variable deferred annuity. Individual annuities really took off after the tax reforms of 1986, when deferred annuities were the only remaining financial product that allowed people to save and invest unlimited amounts on a tax-deferred basis. Today, Americans have saved more than $1 trillion in annuities.

Variations on a Theme

As you would expect, annuities come in many variations, and each addresses a specific issue. The most popular examples are:

Variable deferred annuities: These may provide you or your spouse/beneficiary living benefits that include guaranteed income for you or both of you for life.

Fixed and variable immediate annuities: Immediate annuities provide for guaranteed income for life – either for a specific period or for as long as you and your spouse/beneficiary live. Immediate annuities provide more income than deferred variable annuities because you receive income from three sources: 1) the amount you invested, 2) the earnings on your investment, and 3) survivorship credits you receive when outliving other annuitants.

Initially, there were two types of specialized annuities – Deferred annuities and immediate annuities. In the deferred annuity, these contracts stay in the accumulation phase indefinitely, with one's assets growing tax-deferred. In the immediate annuity, the contract skips the accumulation phase and begins to pay out income shortly after the owner makes a large contribution (lump-sum investment).

Deferred annuities have continued to evolve, with fixed, variable and indexed rate annuities now being offered, with the difference related to an investment in either the insurance companies bonds, mutual funds or a market-based index product. The evolution in annuities also covers immediate annuities that come in different forms, including fixed or variable, which impacts the monthly income stream.

Other annuity considerations involve qualified versus nonqualified annuities and individual versus group annuities. These are concepts that we won't be covering at this time, but may in a future piece.

Why Consider Annuities?

As people move into the later work years, which seems to be getting later and later, the idea of safety and lifetime earnings can be comforting. Annuities or a combination of annuities can help one generate more income in retirement out of savings than any other financial tool.

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Various types of annuities can help you save for retirement, invest for retirement, distribute your savings, insure against longevity risk, and lastly, manage your taxes. With regard to the distribution of your savings, many retirees aren't sure how fast or slow to spend their savings. An immediate annuity or variable deferred annuity with guaranteed lifetime benefits can provide structure to this process.

The idea of guaranteed income for life sounds appealing, but the strength of annuity's guarantee depends on the insurer's ability to pay you back. Not all insurers are equal in this regard, and one should be careful to only do business with carriers who have an all-A rating. Likewise, for plan participants electing income for life products within DC plans, they need to fully understand their options if the sponsor changes investment vendors or if they leave that employer before retirement.

Annuity Fees – No Free Lunch!

Not all is wonderful in the land of annuities. You may have seen an ad in *Forbes* stating "I HATE Annuities. And you should too". These words were uttered by Ken Fisher, Founder and CEO, Fisher Investments. The big gripe: Mr. Fisher doesn't like the fees associated with annuities. Does he have a point?

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Variable annuity costs are usually regarded as excessive. However, enhancements to these contracts with lifetime withdrawal benefits have made them more appealing despite the costs. Some of the costs associated with deferred variable contracts include:

- Mortality and expense risk fees (usually the annuity's largest fee component)
- Administrative charge or contract maintenance fees
- Investment management
- 12b-1 fees (if applicable)
- Rider/option fees for additional features

Incredibly, this combination of fees has the potential to approach 4% or more on an annual basis; however, annuity companies continue to review their product offerings to provide more competitive pricing relative to other investment products.

Don't Surrender!

A surrender period is how long a contract holder must wait before taking money out of an annuity without penalty. An annuity might not have a surrender period, or it may last for up to 10 years. Money may be withdrawn before the surrender period, but one will generally pay a percentage of the amount withdrawn which may impact an overall retirement strategy. Some contracts may allow partial withdrawals without a contract charge during the accumulation phase. Surrender periods allow the issuing insurance company to guarantee that the contract holder will keep money with them, and should be fully understood before making an annuity purchase.

Final Thoughts

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If defined benefit plans were still broadly available, perhaps we wouldn't need this conversation. But, alas, their demise and the greater use of DC plans forces us to seek alternative forms of retirement planning.

Annuities are effective tools for potentially achieving a financially sounder retirement. However, one should always compare them to competing products, and your evaluation and outcome is going to be determined by your specific needs and preferences. Investors are utilizing annuities to take advantage of tax deferral, the pooling of investment risk, survivorship benefits, death benefits, and monthly income for life. But, they are also struggling with the higher costs associated with layering insurance on investments, reduced liquidity and loss of some control over one's money, the tax consequences on annuity earnings being taxed at higher rates than capital gains with some potential fee transparency issues.

There have been some positive developments on the DC side with the recent introduction of guaranteed income for life products by some investment providers and the resulting use of these products by plan sponsors within their investment lineups. Also, Qualified Joint and Survivor Annuity rules, currently required on all money-purchase pension plans and defined-benefit plans, can also apply to profit-sharing and 401(k) plans, but only if so elected under the plan. Since the QJSA rules provide plan sponsors an opportunity to have a discussion with retirees about the merits of lifetime income, those currently not operating their DC plans under these rules may consider adding this feature to their plan document. Don't hesitate to call on us if you have any questions or would like assistance with any plan features.

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