

# Wealth Creation and Preservation

## Special Report

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### *Should you buy an annuity now?*

Many Americans have experienced heavy losses in the stock market investments in 2008. People are looking for safety, but they know they have to keep ahead of inflation if at all possible. For this reason of annuities are becoming more popular. Should you jump on the bandwagon and buy an annuity?

This article will focus solely on Multi-year Guaranteed Annuities. We will not discuss my other favorite type of annuity, the Equity Index Annuity (EIA). Please check my other *Special Reports* for information about EIAs.

#### What is an annuity?

An annuity is a contract made with an **insurance company** which is designed primarily to provide the annuitant with a **steady stream of income** until the end of his or her life or for a certain predetermined number of years.

Annuities offer certain important benefits that distinguish them from other financial products such as Certificates of Deposit. For example, annuities offer:

- **Tax-deferred accumulation** of interest
- A minimum guaranteed interest rate
- **Safety of principal**
- **Flexibility** in payouts including, in some instances, the possibility of a lump-sum withdrawal

Annuities are sold by insurance agents who received a **commission** for making the sale. To cover its costs, the insurance company usually imposes a **surrender charge period**. For example, an annuity may have a declining surrender charge for the first six years of the contract.

There are several different types of annuities offered by insurance companies. They fall into two primary categories:

- Deferred annuities
- Immediate annuities

**Deferred annuities** allow the purchaser to **defer taxation** of income almost indefinitely. All interest accumulates in the contract tax-deferred.

**Immediate annuities** start making periodic payments to the purchaser within 12 months, and there is little or no tax-deferred accumulation between the date of purchase and the date of the annuitization when payments begin. Payments are made to the purchaser on a predetermined schedule. The amount of each payment is determined by the terms of the payment schedule and the current interest rates being offered by the insurance company. Once payments have begun, an immediate annuity can not be surrendered for cash.

There are several types of **deferred annuities**:

- Standard **fixed annuities** offering a competitive, guaranteed rate for one-year and no less than the minimum guaranteed rate for the remaining years of the contract.
- **Multi-year Guaranteed Annuities** (MYGAs) offering a guaranteed interest rate for each year of the contract.
- Indexed Annuities including **equity index annuities** and total return fixed annuities, both of which offer the potential for market-based gains which can be greater than the fixed rate of interest offered by the insurer.

## Comparison of a Certificate of Deposit and a Multi-year Guaranteed Annuity

There are many similarities between CDs and MYGAs. Both "lock in" a guaranteed interest rate for the entire term of the contract between the buyer and the bank or the buyer and the insurance company. Both have **penalties** for early withdrawal; the CD usually assesses a three-month interest penalty, while the annuity will often charge a much more substantial surrender charge. Sometimes CDs pay better interest rates than MYGAs, and vice-versa. CDs can be guaranteed by the **FDIC**; annuities are always guaranteed by the insurance company, which is not a government guarantee.

### Should you buy an annuity now?

There are also good times to buy a CD or an MYGA and there are not so good times to do so. In this respect CDs and MYGAs are similar to corporate and government bonds. **It is best to purchase all of them when interest rates are high and are starting to decline.** That is not the case today.

For example, back in 1980 when the United States was caught in the grip of inflation, US treasury bonds were paying around 13% guaranteed for 30 years. Had you purchased a 30-year Treasury bond in 1980 you would probably have made more money than you would have in any other financial instrument, including stocks.

If you bought that Treasury bond today you might be in for a serious disappointment. 10-year Treasury bonds are now paying around 3% to 3½%, their lowest level in many years. Since banks and insurance companies buy Treasury bonds and notes with some of the money they receive from buyers of CDs and MYGAs, the interest rates that CDs and MYGAs are currently paying is relatively low.

It is true that with an MYGA you are not concerned about current taxation because you are deferring taxes on your interest until you withdraw your money from the contract. That gives the MYGA a minor and temporary advantage over the Certificate of Deposit. However, **I see no reason to purchase either right now**, especially because I anticipate that the current deflation will shortly turn into a major inflation as the cycle changes once again. I believe that those who buy most MYGAs today will wish that they had put their money into a money market fund for a few months and waited until the interest rates being paid on MYGAs were higher.

### What rates are available on MYGAs today?

As of this update, it is possible to find MYGAs guaranteeing **5.8% to 6% for 6 to 10 years**, as long as you are putting in at least \$25,000 and, in some cases, \$100,000. I will not refuse to sell anyone that type of contract, because that rate is much better than that available from money market funds and even Internet banks.

### The best strategy (?)

Perhaps the best strategy, if you really want to obtain higher interest rates now, would be to make a small purchase of an MYGA now and more purchases at intervals of perhaps three or six months. This way, you would perhaps be receiving a higher interest rate on each new contract. This idea is called "laddering", and has been used with some success for many years by financial professionals with vehicles like municipal bonds and treasury bonds.

Remember that you are sacrificing liquidity when you make these purchases, because aside from any free withdrawal privileges, nursing home waivers, and other contract features that permit you to remove money from your contract, your money will be locked in for the entire period of the annuity contract. It is much easier to be comfortable with locking up money for a fairly long period of time when you know that you are getting a guaranteed above-market interest rate on it.

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