

How Well Do You Know... Fixed Annuities?

Back before 2008's cruel lessons about the stock market, many individual investors saw little reason to bone up on boring subjects like fixed-income investments and annuities. And what was less attention-grabbing than the combination of those two topics, the fixed annuity?

Nowadays, boring is better to many investors burned in stock mutual funds. Indeed, sales of fixed annuities soared 79% in the fourth quarter, according to consulting firm Limra International. In a recent quiz, we focused on variable annuities. This month, we examine the fixed variety, helping you understand the appeal and the pitfalls.

The Journal Report

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1) First things first. Which of the following is true of an annuity, fixed or variable?

- A. You hand a sum of money to an insurer in exchange for a stream of periodic income payments that starts right away.
- B. You hand a sum of money to an insurer, with the option to receive a stream of payments in the future.
- C. Both of the above

ANSWER: C. An annuity is a tax-advantaged retirement-income product. The type of annuity that gives you an immediate stream of payments, typically lasting for your lifetime, is known as an "immediate," "income" or "payout" annuity. "Deferred" annuities, on the other hand, begin with an accumulation phase and give you the right to turn your money into a stream of periodic payments in the future.

2) What is a key difference between a fixed and a variable deferred annuity?

- A. Money invested in a variable annuity is allocated to mutual funds, while the money you invest in a fixed annuity typically becomes part of an insurer's general account.
- B. A fixed annuity promises a specified minimum rate of return. A variable annuity's return depends on the performance of the underlying mutual funds.
- C. Both of the above.

ANSWER: C. Variable annuities offer menus of mutual funds, and, as with ordinary mutual funds, the investments fluctuate in value, though many customers buy riders that protect against market declines. The interest rate paid on a fixed annuity is specified for a given period, typically from one to 10 years.

3) True or false: Banks are big issuers of deferred fixed annuities, and the products are covered by the Federal Deposit Insurance Corp.

ANSWER: False. It is true that banks are a major distribution channel, but annuities are issued by insurers -- and they aren't protected by the FDIC.

If an insurer fails, the safety net is a state-mandated guaranty association. Insurers must contribute to such associations in states where they do business.

Coverage limits vary from state to state, but most set basic limits of \$100,000 per person for the guaranteed portions of annuities, according to the National Organization of Life and Health Insurance Guaranty Associations, at www.nolhga.com.

4) Fixed deferred annuities often compete with bank certificates of deposit. Both products have restrictions on early withdrawals. How much of your annuity investment do you typically lose if you yank it in the first year?

- A. 13% B. 10% C. 7% D. 4%

ANSWER: C, declining to 1% in the seventh year and zero in the eighth year and beyond, according to the Insurance Information Institute, a trade group. Such fees are in place for a specified number of years and drop steadily year by year until they no longer apply.

Many insurers will permit you to withdraw as much as 10% of your money annually without a charge. Withdrawn annuity earnings are taxed as ordinary income. If withdrawals of earnings occur before age 59½, a 10% tax penalty may apply.

5) As of Feb. 25, what was the average annual interest rate on a fixed deferred annuity with a five-year rate guarantee?

- A. 2.7%
- B. 3.7%
- C. 4.7%
- D. 5.7%

ANSWER: B, according to the AnnuityNexus database compiled by Beacon Research of Evanston, Ill. Typically, an insurer invests in corporate bonds, commercial real-estate mortgages and other securities to earn interest to pay your interest.

You can peruse sites like AnnuityAdvantage.com and DirectAnnuities.com to get a feel for rates. Fidelity Investments offers a shopping service with fixed annuities from some well-known insurers. Beware of rates that look too good to be true. Many advisers suggest sticking with the highest-rated carriers to better the chance you won't one day be dependent on a guaranty fund.

6) In buying an immediate annuity guaranteed to last your lifetime, how much larger check might a 75-year-old man get for a \$100,000 investment than one who is 65?

- A. \$961 vs. \$723
- B. \$1,434 vs. \$723

ANSWER: A, according to ImmediateAnnuities.com. Answer B, meanwhile, shows what an 85-year-old would get each month for \$100,000 compared with the 65-year-old.

Buyers can opt for added features that reduce the monthly check. A 65-year-old concerned about a premature death could spend his \$100,000 to get \$630 a month with payments that are guaranteed for 20 years at a minimum, payable to his spouse or heirs if he does die. He also can buy an annuity that, after he dies, would continue the same payment for a surviving spouse's entire lifetime, whatever that turns out to be. He'd get \$592 a month for this type of feature, assuming she also is 65.

7) Numerous studies reach the conclusion that retirees should devote a chunk of their savings to an immediate annuity. What portion do they agree on?

- A. 25%
- B. 50%
- C. 75%
- D. There is no agreement; the amount depends on the retiree's circumstances.

ANSWER: D. Studies, some sponsored by insurers, say immediate annuities are the best product for removing the risk of outliving your savings. The size of an immediate-annuity purchase should take into account facts such as your total accumulated wealth and whether you have an old-fashioned pension plan.

Many advisers recommend annuitizing enough of your savings to cover 100% of basic living expenses. This gives you the freedom to take more risk with your other investments.

8) What percentage of 401(k) and similar retirement-savings plans offer an annuity as a way for retirees to withdraw income?

- A. 45%
- B. 35%
- C. 25%
- D. 15%

ANSWER: D, according to a 2007 survey by consulting firm Hewitt Associates. All offered lump-sum payouts.

9) Of plans not offering annuities for final distribution of a participant's money, what was the primary reason for not doing so?

- A. Administrative costs
- B. Liability concerns
- C. Lack of employee interest
- D. Communication challenges due to the product's complexity

ANSWER: C, cited by 58% of employers, according to Hewitt. Administrative costs and communication challenges were the next most common reasons. Despite the unpopularity of immediate annuities, some retirement-income experts advocate that retirees be required to take some of their retirement-plan proceeds in this form.

10) An indexed annuity typically promises a fixed interest rate plus an amount tied to a stock-market index. How is the return computed?

- A. A "participation rate" limits the percentage of the index gain credited to you.
- B. A "cap" sets a maximum level of index-based interest credited to you.
- C. A "spread" applies: If the index gains 9%, and the spread is 3%, you get 6%.
- D. All of the above are commonly used.

ANSWER: D. These fixed annuities are complex, so much so that the Securities and Exchange Commission voted last year to start regulating them as securities as of 2011. The change means that an insurance agent will need a securities license to sell the popular product.

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Printed in The Wall Street Journal, page R8 (March 2, 2009)

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