Episode 291: Shorter Withdrawal Charge Schedule Annuities Benefits & Risks

Hello and welcome to another edition of Money Script Monday. My name is Sean Brady, and today's topic is shorter withdrawal charge schedule annuities benefits and risks. With interest rates and economic uncertainty, it may make short-term annuities sound really appealing, but it's important to weigh the potential downsides as well. With higher interest rates and the continuing fear of an impending recession, people are seeking out more protection for their portfolios. That's why short term annuities can sound really appealing, if applicable to your situation, and that's why it's important to understand the upsides and downsides.

First, we must define what a short-term annuity is. We define short-term annuities as a contract with a withdrawal charge period of five years or less, and the issuing insurance companies are going to back those rates by purchasing short-term investments. Now, depending on your goals and your time horizon, short-term annuities can be essential. They can be a great strategy for your portfolio, especially if you need access to the money shortly after that withdrawal charge period.

For those of you who do not need access to your money for a longer time horizon, then short-term annuities do carry with them risk. And while that interest rate on the short-term annuity may be strong, the best economists in the world can't predict where interest rates are going to be in the long run in those later years and with short-term annuities. There's always going to be that question of where the interest rate is going to be when that withdrawal charge period comes to a close.

So, what's the alternative? An alternative you may want to consider could be long-term annuities. Now with long-term annuities, the issuing insurance company is going to be able to price that annuity over a longer time frame and they're going to be able to purchase longer-term investments to back that contract. And in turn, you're going to experience those nice rates for a longer period of time.

Now to further illustrate my points and to further back what I'm saying, I want to take a look at a mortgage sector scenario, in particular, the relationship between short-term mortgages versus long-term mortgages, and mortgage companies offer a variety. We're going to take a look at the short-term being the 5/1 adjustable rate mortgage or ARM versus the 30-year fixed rate mortgage.

With five-to-one adjustable rate mortgages, they're going to offer you quite an attractive interest rate. And with that, it's only going to be guaranteed for a specified time frame. At the end of that specified time frame, that interest rate is going to become variable, and that's going to move up and down. Now the risk is if it takes off at the end of that five-year time frame. If interest rates go up, your mortgage payments unfortunately will go up as well.

The alternative would be a 30-year fixed-rate mortgage and with that interest rates are guaranteed for the entire loan term. Your payments are going to remain the same and that eliminates any unpredictable payment increases. Now as recently as early 2022, that 5 to 1 adjustable rate mortgage was at historic lows. During that time frame, you could have picked out a 5 to 1 adjustable rate mortgage for lower than 2.5%, and the alternative 30-year fixed rate mortgage for roughly 3%.

However, as interest rates have sharply risen, as we've all experienced in recent times, the people with the 5 to 1 adjustable rate mortgage, they're going to be poised to experience a significant increase in their mortgage payments.

Now, you may be asking yourself, how does this all apply to annuities? This applies to annuities because just like the relationship between mortgage rates short-term and long-term in early 2022, short-term annuities had a slight advantage over their long-term annuity counterparts. In the back half of 2022, short-term annuity interest rates were slightly higher than what was being offered on long-term annuities. Now with them being better in the short term, long-term annuities on the other hand offer a more stable rate over a longer time frame.

At the end of the day, short-term annuities can be essential. They can be a great part of your overall portfolio. They can offer really strong rates, but they do carry with them reinvestment risk and that's why I urge you to contact your financial professional today. They're going to be the ones that are going to offer you the right solution that for your unique situation. Thank you, and we'll see you again next time on Monday Script Monday.