Episode #308 – An Easy Explanation of Fixed-indexed Annuities

Welcome back. My name is Kyle. We'll be talking about how to easily understand fixed-indexed annuities. I joke around because insurance carriers are great at taking something so simple and making it complex, but picture this before we get started. Let's say you're on a road trip with your friends driving through the Mojave Desert. Everything's great. No complaints. Then you start to add on some miles and all of a sudden your gas tank's looking a little bit empty. Sure enough, the next gas station is not for another 100 miles away. Panic starts to set in, AC gets turned off, now all eyes are on the fuel gauge, but imagine this with people in their retirement savings.

The fear of running out of money in their later years creates this constant state of worry. To avoid this, lifetime income annuities can act as that guaranteed quarter tank of gas, allowing you to get to your destination without having to constantly be looking at the fuel gauge. Fixed index annuities are a great tool to supplement pensions, to supplement Social Security. When you're retiring and are in that red zone with 5 to 10 years out, it's now time to think how to start converting assets into income.

We're going to talk about the two different phases of the contract. The accumulation phase and the distribution phase. We'll start over here on the accumulation phase now where we're going to answer 3 common questions we get from consumers, what's expected rate of return? How does my liquidity work? What are the annual fees?

Now to answer the first one, expected rate of return. Fixed-indexed annuity contracts are built to replicate CD like returns. If people are selling equity like returns, it's time to be cautious. That said, we're going to earn on this accumulation value side anywhere from 3 to 6%.

What about fees? How do these contracts work? Most of the time, there's no drag inside these contracts. In other words, there's no fees during both accumulation and distribution periods, which is great, right?

The third piece is liquidity. A lot of times these contracts have a small percentage that you can tap into, free of any charge and that's typically around 10% of the account value. You'll notice a different account also exists above the accumulation value. That's what's called our income value account. That's used to earmark and determine how our future paychecks or our future pension dollar amounts are calculated.

So day one, you'll notice that the income values is drastically higher than the accumulation value. That's by design. Since this account is artificial, they're typically going to throw premium bonuses your way or interest rate enhancements, or roll up rates that are guaranteed to amplify this account above the accumulation value.

As I mentioned earlier, there's also a penalty known as a surrender penalty. Now these carriers are buying large duration bonds, so they're at risk if you were to walk away from the contract early. So what they're going to do is apply a small charge which will remain level in the first couple of years but then decline and go to 0 after approximately 7 to 10 years. So, should you not need income later in life and you wanted to walk away from the contract, there would be no more fees applicable and you can take your accumulation value and walk away.

If we look at that example, if you put $100,000 into the accumulation value, you'll have a $90,000 day one in terms of your surrender value because of this charge, you'll have $125,000 on the income value given a 25% premium bonus. Over time during this accumulation period, it's going to earn anywhere from 3 to 6%, maybe a bit elevated on the income value side. And there comes a point when you need to activate the income.

What the insurance carrier is going to do is take the income value at that day before you retire, and they're going to apply a withdrawal rate anywhere from 4 to 5%, depending on your age and if it's single or joint life. What that's going to do is initiate your first paycheck. This paycheck, the beautiful part about index annuities with certain carriers, is that it will increase over time. Typically it will increase and outpace the rise of inflation. So what we have here is an increasing income on a depreciating asset that eventually goes to 0. But what doesn't stop, that's the lifetime income you're able to receive from these carriers.

Now, how do these insurance carriers guarantee this income that increases? It's through the help of mortality credits. These insurance carriers are large enough that they know actuarial tables, they know pooled risk, so don't ever worry about whether or not they're going to pay it out. That's dependent on the claims paying ability so it's so important to work with an advisor that can write A-rated carriers, A-rated products, so that concern is completely eliminated from the discussion.

One of the questions we typically get is, this is great, I love guaranteed lifetime income, what about death benefits? I heard once that the carrier locks up my principal and if I die, they maintain and retain those dollars amount. This isn't your grandfather's annuity these days. There is a death benefit associated with the contract. Whether you die prematurely before you activated income or during the income payment stage. That death benefit is typically paid out in a lump sum or in a five year spread option. You'll notice that that income value here on the accumulation side would represent that death benefit paid out over five years, followed by the lump sum option, which would be the accumulation value that your beneficiaries could also choose.

Another question we get is tax treatment. You know, I love the increasing income, I love that it's guaranteed and I won't outlive that income, how does it taxed? Really, it's taxed as ordinary income. There's no capital gains taxed, unfortunately, so this would all be calculated as ordinary income, whether it is qualified or funded with after tax dollars.

So we talked about a lot. We talked about fixed index annuities in general, the accumulation phase, and the distribution phase. There's absolutely a need in everyone's portfolio to provide additional paychecks to supplement pensions, to supplement Social Security, and worst case, eliminate that worry and retirement. We don't want to have you look at that fuel gauge in retirement and having to worry about if you'll run out of gas. Fixed index annuities aren't so complicated as you may think or how they are portrayed, and they absolutely can serve as a necessary, secure tool to supplement and provide security in your retirement portfolio. Reach out to the advisor that shared this video for the questions and see whether or not a fixed index annuity makes sense for you. Thanks.