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Considering an annuity?

By Janet Kidd Stewart, The Journey, Tribune Newspapers

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A 71-year-old reader recently shared her unfortunate experiences with several variable annuities that have far underperformed her expectations.

What went wrong? Was it picking brokers because of the free lunches they hosted? Signing contracts that didn't reflect what she understood about the products?

Both of those things happened, but it really boils down to a mismatch between what the investor needed and what the broker sold.

A dozen guidelines for determining whether an annuity is suitable for a particular investor has been on regulators' books dating back to at least 2002. The list turned up again earlier this year as the National Association of Insurance Commissioners amended its suitability rules.

But they are only guidelines that someone selling annuities is supposed to take into account before recommending a product. They include asking about age, risk tolerance and total liquid assets, but there are no general benchmarks for what's appropriate (though individual firms often have their own benchmarks.)

From a legal standpoint, the list is wide open to interpretation as arbitrators who eventually have to hear investor complaints decide if someone truly met the standards.

"Brokers always say that they considered all the factors and they always come to the conclusion that these products were appropriate for their clients," said Andrew Stoltmann, an attorney who represents investors in financial fraud cases.

Regulators argue they need flexibility in identifying situations where unsuitable investments are sold, but that certain combinations of factors will, indeed, lead to consequences for brokers.

"If a customer has limited net worth and all their money would be tied up in this product, that's a problem," said Joseph Savage, vice president and counsel, investment companies regulation for the Financial Industry Regulatory Authority. "If it has a long surrender period and the consumer is at an advanced age, that's a problem. I think you have to start out by asking, why do you need this product to begin with?"

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What to ask yourself

Age. Consider your life expectancy. Does the surrender penalty last until well past that age? Different types of annuities are more or less suited to different age brackets.

Annual income. Low income, whether from a job or from a fixed retirement portfolio, generally raises red flags about whether an investor should be locking up money in an annuity. In a 2008 settlement with the state of Minnesota, one insurer agreed to scrutinize further any annuity applications for applicants over age 65 who have less than $20,000 in annual income. Insurers often review any proposed policies where the premium is more than four times annual income, and so should you.

Financial situation and needs. Do you expect your income needs will change significantly during the annuity's deferral or surrender period? Another red flag.

Financial experience. Salespeople are supposed to consider how financially savvy you are before putting you into a complex product. For your own purposes, consider this: Have you truly done enough homework? Can you articulate what type of annuity you are buying and recite its major terms?

Financial objectives. As Savage said, why do you need it?

Intended use. Is it for tax planning? Retirement income?

Financial horizon. Life expectancy is one thing, but various pieces of your estate may have their own timelines, so consider the horizon for this particular pot of money.

Existing assets, including investments and life insurance. Will the cost of the annuity over its lifetime exceed 25 percent of your total estate, without considering your home value? That's another red flag, experts say.

Liquidity needs. You need to anticipate how much cash flow you'll need in retirement before giving up a lump sum.

Liquid net worth. The Minnesota settlement called for the insurer to re-evaluate applicants who have less than $75,000 in liquid assets after the annuity purchase.

Risk tolerance. This can be a nebulous area, and consumers often change their risk tolerance with abandon given the current performance of financial markets. Be honest with yourself about how much volatility in your portfolio you can truly handle.

Tax status. Many consumers know that holding a tax-advantaged annuity in a retirement account is redundant, but do you know exactly how this particular product will be taxed? Remember that many annuities are tax-deferred, not tax-free.