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SMART STRATEGIES FOR RETIREMENT INCOME SPECIALISTS

Planners Weigh In On How Bells And Whistles Affect Income Plans

By Jim Connolly

Are product bells and whistles really smoke and mirrors when it comes to developing a sound income plan?

Financial planners contacted by *Income Planning* say that while certain features in products such as annuities can help create an income plan that will last, other features just create confusion, expense, or both.

Questions that interest clients are 'Will I have enough?' and 'Will it last?' says Rick Miller, a founder and certified financial planner with Sensible Financial Planning, Cambridge, Mass.

These questions are what Miller calls first level questions, the first questions that a product must answer when a planner and client are seeking income planning solutions.

An annuity can answer the question "Will it last?" and an inflation-adjusted feature in an annuity can answer the question, "Will I have enough?" he continues.

Other features in annuities such as withdrawal features can answer second or third level questions from clients, if those features can be quantified by a planner and be shown to have value for the client, Miller says.

Miller says he finds a payout annuity backed by index funds and a payout annuity adjusted for inflation helpful in providing income plans for clients.

It is difficult for a planner to place an actual value on many of the features in order to be able to tell a client whether the feature is worth considering, he notes. However, with an inflation-adjusted feature in a variable annuity, value can be put on the feature, he adds.

"Guarantees in deferred annuities are simply irrelevant to the income planning process and merely serve to distract clients from what is relevant which is accumulation," says Bedda D'Angelo, president of Fiduciary Solutions, Durham, N.C.

"The problem is not the complexity of the products as much as it is the number of disclaimers in any contract that make it likely the guarantee will never be paid," she continues.

"I would not call that a problem of complexity. It is a problem of lack of transparency and a failure on the part of the sales agent to disclose *all* material facts (which they are not trained to do and have no knowledge of)."

Annuities with options can be a good idea, but "for the vast majority of annuity

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products, the benefits are more an illusion of a benefit rather than an actual benefit," says Michael Kresh, a certified financial planner with M.D. Kresh Financial Services in Islandia, N.Y.

For instance, he notes, for the client who is very nervous about participating in the market, a VA with a guaranteed living benefit could be valuable.

In the case of withdrawal features, Kresh says that a planner needs to be careful of whether the contract specifies whether it is a dollar-for-dollar withdrawal or a proportional withdrawal feature.

The distinction is important, he continues. If for instance, the contract allows a 6% withdrawal each year, then a client could take out \$6,000 annually on a \$100,000 investment. However, if the contract is a proportional contract, according to Kresh, then in the first year, the \$6,000 withdrawal would reduce the base for determining withdrawals to \$94,000. So, if a client withdrew \$6,000 in the second year, the withdrawal would exceed the 6% permitted in the contract and could risk losing the guarantee in the product.

"The issues are very, very subtle. Some are far more viable as a statement than as a deliverable to a client."

So, a planner would have to look at both the rate offered in the contract as well as features such as dollar-for-dollar and proportional withdrawals, he says. If a planner does not carefully examine the contract language, there could be "an illustration of protection that is not really there. Real benefits have real value."

Care also needs to be taken if a VA is used within an individual retirement account, Kresh explains. While a VA within an IRA can offer flexibility and guaranteed benefits, a problem can arise is the IRA's required minimum distribution is greater than the withdrawal percentage in the VA contract, he says. And that, he continues, could trigger the loss of the guarantee in the VA.

To counter this possibility, Kresh says that there should be other assets within the IRA that are sufficient to cover the RMD.

Eve Kaplan, a certified financial planner with Kaplan Financial Advisors, Berkeley Heights, N.J., says that many clients do not understand concepts such as A, B, and C shares in mutual funds and are even less likely to understand some of the features in annuities. Kaplan says the complexity of features and the growth in features has moved her to consult with insurance professionals before making a recommendation to a client. Planners need "an extra set of eyes," she says.

She cites one person who came to her for advice and had a \$100,000 annuity but did not realize that she held an annuity, according to Kaplan. And, she asks, "What happens to those who don't go to a planner or who go to a planner who misses things? What happens to them?"

And with immediate annuity products, often people don't understand points such as the taxable part of a distribution is recognized before the non-taxable component, he continues.

"A lot of products are great, but they are hard to understand," Kaplan says. So, it becomes more important for the industry to make sure that it explains its products well, she adds.

"A lot (most) of the people who own annuities do not understand them or why they bought them," says Jeffrey B. Broadhurst, a chartered financial analyst with Broadhurst Financial Advisors, Lansdale, Pa. "If they did understand all the bells-n-whistles they would then understand all the fees-n-loads-n-expenses...which would be a very bad thing for the annuity salesman. The same can be said for insurance agents who push VUL and other permanent insurance policies on the

unknowing public.”

“My thought is, simple is better,” he says. “Reduce cost by reducing layers of fees. The performance difference will accrue to the benefit of the investor and not the insurance company.”

Most of the time, he says, people are better off in a globally-diversified, tax-efficient portfolio of low-cost index funds. “But because index funds pay 0% commission and annuities pay 6-12% commission, the public gets snookered by the commissioned brokers and agents,” he adds.

Buzz Livingston, a certified financial planner in Santa Rosa Beach, Fla., says that “annuities can be horrifically complicated and are often used inappropriately inside IRAs. “Since they pay higher commissions than mutual funds salespeople have the incentive to use them instead of lower cost mutual funds,” he adds.

But with immediate annuities, Livingston maintains that some companies are doing a “really good job” of making disclosures.

Disclosure of equity index annuities is more complex and features of the product not always clear, he maintains. For example, EIA indices are often marketed as an S&P Index. But with the S&P, returns reflect reinvested dividends while with many EIAs, this is not always the case, Livingston says.

Livingston comments that commissions often drive the sale of VAs over mutual funds. He has also seen VAs in IRAs--a “real red flag” that he says he sees “more frequently than I would like.”

But Jim Holtzman, a certified financial planner with Legend Financial Advisors, Pittsburgh, says there is a balance to be reached. If products were made more uniform and less complex, then it would be easier to compare apples to apples, he says. However, “you might be losing out on some great products.”

To put order to the complexity, Holtzman says that for variable products, he looks at the investment options available and mortality and expense charges. On the fixed side, he looks at M&E charges, surrender charges and the financial ratings of a company since the relationship will be a long-term one.

Insurance companies should offer a very simple annuity, perhaps simply a no-load that is an annuity wrapper over an S&P index fund or TIPs fund, says Don Martin, a certified financial planner with Mayflower Capital, Los Altos, Calif.

He explains what he means by “complicated.” “‘Complicated’ would be an annuity that has a guarantee of an artificially high return during the initial years, but only if the client agrees to a complicated set of constraints that are hard to understand.”

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