

## Annuities and ice cream: Is mystery a better flavor?

The cornerstone of Baskin Robbins' marketing strategy was its boast of offering 31 different ice cream flavors - one for every day of the month. They now claim to have developed more than 1000 varieties. Dolley Madison was among the first colonists who achieved fame by serving ice cream. Cream and egg yolks were featured in recipes previously confined to sugar, fruits, and water - know as 'glaces.' In the early 20<sup>th</sup> century, former British Prime Minister, Margaret Thatcher, worked on a chemical company team that discovered a method of doubling the amount of *air* in ice cream. This allowed manufacturers to use less of the actual ingredients, thereby reducing costs. The new process also led to the development of soft ice cream. In business parlance, ice cream was commoditized!

The original annuities, just like the original glaces, were basic in design. Offered to consumers by insurance companies, the fixed annuity was designed to provide a guaranteed income to the 'annuitant.' Funds in the contract were promised a minimum interest rate, and grew tax-deferred until withdrawals began. The annuitant might or might not be the contract owner. Defined benefit pensions, for instance, are structured like an annuity. Such plans guarantee a specific income to eligible employees at retirement.

Generally speaking, the ingredients which impact the size of the income paid are the annuitant's age, period of time payments will continue, premiums paid, interest rates at the inception of the payout period, and whether or not a beneficiary will receive funds at the annuitant's death. Consumers interested in a guaranteed income - even for life - can purchase an annuity from a reputable company and thereby help fulfill their financial or retirement plans.

The fixed annuity structure retains all of the investment risk within the company. A certain amount of return is promised to the owner, who is not subject to market volatility or investment risk. The great bull market of 1982 - 1999 dramatically diminished concerns about risk. Insurance companies responded with the promotion of a new flavor, *variable* annuities.

Consumers willingly took on all of the investment risk, in hopes of greater profits. Gone was the guaranteed interest. Variable annuities offered 'sub-accounts,' with names that might be identical to favorite mutual funds. While managed like a fund, the holdings and fees were likely to be different. Owners had increased flexibility regarding when and how to tap into their funds, and were less likely to be required to annuitize - unlike fixed contracts.

Note that one significant guarantee was retained in variable annuities. The original invested principal – assuming there were no loans or withdrawals – was still guaranteed to be paid to designated beneficiaries at the owner's death, regardless of potentially substantial losses of principal due to market downturns. Of course this promise doesn't help the living owner!

Just as Dolley Madison's ice cream was superseded by dozens of flavors, annuity mutations are now so complex and quickly changing that some sales people don't understand what they are selling. However, such sales representatives can possess finesse with respect to their use of the term 'guarantee' in their sales spiel.

Two 'hot' products are *equity indexed annuities* and variable contracts with *living benefits*. The potential profits from equity indexed annuities are tied to a financial market index, often the S & P 500. Common examples of living benefits options are: guaranteed minimum income benefit (GMIB,) guaranteed minimum accumulation benefit (GMAB,) and guaranteed minimum withdrawal benefit (GMWB.)

Company marketing illustrations show how 'profitable' these products *might* be. The acronyms – GMIB, GMAB, GMWB – may lend an air of authority. However, even the guarantees are not straightforward. As *The Annuity Advisor* cogently points out,

*...policy provisions are often the result of formulas and conditions. Rarely can one point to a dollar figure and say - this is the amount guaranteed by this benefit.*

*Anticipated* rewards, and that comfort word – guarantee – drive the purchases of these products. Actual returns do and will continue to fluctuate.

Remember how ice cream manufacturers were able to become more profitable by selling ice cream now filled with air? Consumers who purchase these new annuity products may be required to relinquish control over their accounts at a specified time - in exchange for an income – or, forfeit the promised benefits. Contract owners are paying the company to help manage their risk. These payments continue for as long as they keep the contract. Your money may buy you peace of mind, but beware: there is no free lunch.

As with all important financial decisions, seek the guidance of your financial planning professional before spending your irreplaceable retirement dollars. I enjoy receiving your e-mails with questions or comments.

\**The Annuity Advisor*, p. 155, Olsen and Kitces

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