The "Swiss Army Knife" Of Retirement Planning

I have a real Swiss Army Knife, but it's never been used for retirement planning. But it has multiple uses which is why it's often in my pocket. What follows here describes a financial product you should consider using as you get ready for retirement. It won't cut string, but it might cut the financial pain that often follows if you retire without being properly prepared.

In my many years as a licensed insurance agent and financial advisor, I've been exposed to good ideas, bad ideas, good agents, poor agents, greedy companies and organizations that provide quality ideas and solutions. These people are easy to work with as they offer solutions that allow me to fulfill my pledge to work in my clients' best interests.

Unfortunately, the "bad apples" along the way get the most attention from the press. It results in a pervasive mindset that annuities are always bad choices and should be avoided at all costs. In my judgement, that's a false narrative.

For decades, I've embraced the fiduciary standard. It means my time and energy on behalf of a client, is to first benefit the client. If I get paid for that, good, but the driving force behind any transaction is to fulfill what I consider a moral, ethical, and sometimes legal effort to act in a clients' best interest.

A few years ago, a product emerged and became known as a Fixed Index Annuity, or FIA. To better understand where it falls into the broad definition of annuities, I must offer you a brief summary. Annuities into two basic categories, with dozens of flavors in each. These categories are immediate annuities and deferred annuities.

An immediate annuity is when someone has a lump sum of money that needs to become a stream of guaranteed payments. In almost every case, it requires an insurance company to make that happen. Immediate annuities come in many flavors, including when you want the stream to begin and for how long. The insurance company now owns your money and is under contract to fulfill its promise to you.

A deferred annuity also involves an insurance company. They exist to ensure risks associated with human life expectancy. With a deferred annuity, you might have a lump sum, or you might not. The difference is what ultimately happens to the accumulating pool of money. That decision is deferred until later date.

Deferred annuities have two sub-categories, fixed and variable. Each of those has many flavors, but today I'm only going to discuss the fixed category. Both sub-categories have much in common, but in my opinion deferred variable annuities have limited benefit when it comes to retirement planning.

So where am I going with this? What exactly is a fixed INDEX annuity? It's a deferred annuity and not an immediate annuity. It might become one later, but its real purpose is to serve as a tool to accumulate funds for use in retirement. Sometimes it calls for a lump sum and sometimes it will accept a stream of incremental deposits.

The word "index" results from the methodology used to recognize gain, the amount by which an account balance grows over time. Typically, the source of the money, the investor, is given a choice among indices to choose from. The "fixed" part result from a guarantee by the issuing insurance company that the investors' money or principal is guaranteed. This is unlike variable annuities that offer no guarantees of principal. You the purchaser is given the option of using a guaranteed interest rate for crediting purposes or using the performance of an index to increase the value of your investment.

The "index" offered by company A will likely differ from those offered by companies B thru Z in meaningful ways. That's one reason it's difficult to establish in advance which ones are legitimate and which ones are less so. The crediting methods are also different. Some might measure the index over 12 months, others over 24 or even 36 months. All have unique benefits for the investor. If, over the period chosen, the index rises, there is a corresponding increase in the account value. If it falls and is in fact a negative number, the account value remains the same as before, under a provision of the contract. FIAs guarantee your principal, which is effectively a floor below which the account value will not fall each time a crediting milestone passes.

To summarize, a fixed index annuity is a tax-deferred, long-term savings contract that provides principal protection to the investor. Because of competition in the industry, dozens of flavors now exist in the marketplace. Even those of us who stay up with this every month have a hard time figuring it all out and being confident when we make recommendations.

I'll now expand on the summary and list five reasons to explain the Swiss Army Knife analogy. Here they are:

#1 is safety of principal. If you have a typical brokerage account with money invested in the S&P 500 Index, you might enjoy a profit or you might not.

That's the inherent risk assumed when you invest this way. If the market crashes and you need the money now, too bad.

If you use an FIA that offers the S&P 500 Index as an option, your problem is minimized. All legitimate insurance companies offering deferred annuities have met legal reserve thresholds to be in business. Contract provisions exist, whether you are alive or dead, that provide guarantees. Most of them also guarantee that if the index chosen puts your account value above the floor, your beneficiaries will receive the highest value during the crediting period that applies. Regardless, your account value will never be less than what was originally invested.

#2 is income. Most people still in the workforce expect to retire. Their challenge is to set aside money for the future. It might before-tax or after-tax money. A relative might have passed and left you some money. You might decide to invest in an FIA to supplement other funds you're accumulating for retirement.

When you retire, you're going to need an income in order to pay your bills over what could be 25 years or more retirement. An FIA can do this for you without having to lose effective control of the money. You can choose to turn it into an immediate annuity if you feel the need, but once you do that, you lose control in terms of changing the income stream down the road.

#3 is tax-deferred growth. In any deferred annuity, as the funds grow over time, the IRS will not be looking to collect taxes on the annual growth of your account. That comes later when you take possession of the income you withdraw to pay your bills.

#4 is growth potential. This is where it gets a little complicated. With dozens of companies to choose from, many with very different indices for you to choose from, how do you make an informed decision? Wealth management is an art form. And no one knows in advance which artist is going to succeed more than the rest. Once you open the door and start to explore, it can turn into a crap shoot.

However, there are some artists whose skill sets far exceed others, and some of them can be identified. The challenge is to find an agent qualified to make good judgements and is aligned with those companies who provide clients with access to those artists. It's still a crap shoot, but your odds of a positive outcome are much better.

#5 is Long Term Care riders. Long Term Care (LTC) is a massive problem for those in retirement. As we now live longer lives, the potential for financial pain from LTC is increasing rapidly. Insurance companies now add optional LTC riders to contracts for a fee, which gives the owner/insured the ability to reach into the contract, withdraw income tax free funds, and use them to pay LTC costs.

Roughly one in five seniors today lives in poverty. The cost of health care in retirement leads to many bankruptcies among the elderly. We increasingly need someone to come in and help us get through the day. If it's not a family member or good friend, that someone has to be paid. They exist to make sure you eat today, get a bath, or take your meds on time. So, the addition of a LTC rider is both a valuable benefit to you and a profit source to the insurance company. It provides you a way to leverage your money and pay for something you might or might not need.

So, how does the insurance company and the agent get paid for looking after your money? We live in a free enterprise economy which means that everyone with either get paid or they're gone. Virtually all FIA contracts have what is known as a surrender charge. Under normal circumstances, they are going to get a small percentage of your investment gain, or from fees for things like the LTC rider. Additionally, you subject yourself to the surrender charge if you remove too much of your account value before a predetermined penalty period ends. It usually starts high and diminishes over time to zero.

Companies know a certain percentage of people are going to surrender their policies before the surrender period ends. That money goes into a pot to offset the benefit to the buyer that 100% of the money invested is not subject to upfront fees or commissions.

A relatively new approach to investing money is called Income allocation. It's similar to asset allocation but allocates investment assets to affect a balance across various sources. We know market crashes happen and this approach reduces the worry that such an event will seriously disrupt your monthly income needs.
There's a huge amount of mental noise that surrounds when it comes to planning for retirement. It's difficult to filter that noise and focus on solutions that will truly benefit you and help you achieve your goals.

If you, for whatever reason, don't have the necessary skills to distinguish noise from useful information, you must either find someone you can trust to help you, or improve your financial literacy. I have the tools to help you do both.

I’ll conclude by saying this. If you hope to have a successful retirement, by whatever definition you assign that term, a good FIA contract will help you balance your income to complement your other sources of income. If you are not yet retired, it could offer you a strong return on investment, something necessary if you want to avoid financial pain in retirement.

By Tony Kendzior \ 15 FEB 2020