ANNUITIES VS CD'S

"Find Out What Your Bank Does Not Want You To Know"

<u>6 Reasons To Buy An Annuity Instead Of A CD</u>

Introduction

As adverse market conditions force more investors into seeking alternatives that will provide more stability and certainty to their retirement portfolios, annuities have, once again, moved to the forefront of the investment landscape. Annuity sales topped $200 billion for the first time in 2011, and are expected to grow by double digit rates as tens of millions of Baby Boomers approach retirement. But, annuities, one of the oldest and most reliable financial instruments dating back centuries, are not without their controversy.

The financial planning community has long been divided on annuities and whether their benefits outweigh the costs. Critics point to high fees and commissions, questionable sales practices, and their unsuitability for older investors as the reasons why they should be avoided. Yet, according to an August 2012 survey by Cerulli Associates, financial advisors reported that clients requested annuities more than any other unsolicited product. And, 92 percent of Baby Boomers who own an annuity report a much higher degree of confidence in their retirement future.

Any debate over the benefits of annuities inevitably invites comparisons to alternatives with similar attributes that may be less costly, or more liquid, and, generally, more suitable for one's retirement savings needs. Most notable among the alternatives are bank certificates of deposits (CDs) touted for their absence of fees, their safety (FDIC), and their relative liquidity (when purchased in shorter maturities).

Anytime a question is posed as "are XYZs better than ABCs?" it invites controversy especially when it involves a comparison of "apples and oranges". No one will argue against the notion that annuities, or, for that matter, any particular investment vehicle, isn't for everybody. This presupposes that, using the same rationale in reverse, CDs are also not for everybody. The only way the question can be answered meaningfully is when it's posed in the context of any one person's personal financial situation. Only with a good understanding of your client's financial objective, needs, priorities and tolerance for risk, can you truly make the comparison.

As with any investment, the answer lies not in the investment itself; rather in the way and in the situation in which it is applied. That is the only context in which annuities or CDs can be evaluated. It also requires an understanding of how the investment actually works. While it is true that annuities are more complex than CDs, it is through their complexity that their unique properties can provide unparalleled benefits in the form of tax savings, guaranteed returns, and guaranteed income. But, as with CDs, annuities may not be right for everybody.

This report provides an in depth look at annuities from several vantage points for a comprehensive understanding of how they work and how they can compare to CDs..

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Reason #1 - Annuities and CDs – A Straight Comparison

Annuities and CDs are often compared in the same light as if they were equivalent investments. While they do share several attributes, such as guaranteed fixed yields, principal guarantees, and relative liquidity, they're separated by some significant differences, and that precludes a straight across apples-to-apples comparison.

The only basis for any type of comparison between the two are product features. The comparison chart below was constructed from the vantage point of an annuity only because it offers more features that can be compared.

Comparison of Annuities with Certificates of Deposit		
Features	**Annuity**	**CD**
Guaranteed fixed yield?	**Y**	**Y**
Free from principal/market risk and price fluctuations?	**Y**	**Y**
Are interest earnings free from current taxation?	**Y**	**N**
Are accounts insured?	**Y**[1]	**Y**
Are interest earnings reinvested automatically with no current income taxation?	**Y**	**N**
Am I able to make small additional investments?	**Y**[2]	**N**
Tax liability on Social Security income eliminated on deferred accumulation?	**Y**	**N**
Liquid?	**Y**[3]	**Y**[4]
Flexible?	**Y**	**Y**
Penalty free withdrawal?	**Y**	**N**
Funds not reduced by commissions?	**Y**	**Y**
Does this investment automatically avoid the expense and delay of probate?	**Y**	**N**
Protected from legal and creditor claims?	**Y**	**N**
Guaranteed lifetime income with tax advantages?	**Y**	**N**
Income excluded from Social Security tax calculation?	**Y**	**N**
Is this investment free of annual fees and expenses?	**N**	**Y**

1 Annuities values are secured by state guarantee funds
2 When your Tax-Deferred Annuity is a Flexible Deferred Annuity versus a Single Premium Deferred Annuity; small additional deposits are allowed.
3 Surrender penalties may apply
4 Early withdrawal penalties may apply

Such a comparison, while useful at a high level, barely begins to draw the stark contrast that exists between the two investments. The remainder of this report delves into several of the key aspects of each that are often used to contrast the two.

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Reason #2 - Not all Guaranteed Fixed Yields are Created Equally

The annuity product that draws the obvious comparison with CDs is the Multi-Year Guaranteed Annuity (MYGS). In fact, it is often referred to as a CD Annuity because it offers a guaranteed fixed yield for varying maturities. However, the "maturity" period for a MYGS is more accurately described as the length of the surrender period beyond which there are no more surrender penalties. So, a 5-year MYGA is likened to a 5-year CD for that reason.

The second commonality is that both investments guarantee a fixed rate until maturity, or, in the case of an annuity, the end of the surrender period. In both cases, the longer the maturity is, the higher the fixed rate. Generally, the fixed rates that are credited tend to follow in the direction of prevailing short-term interest rates. But that's where the similarities end.

Annuities have the Edge in Fixed Rates

Generally, the fixed rates insurance companies credit to annuities are higher than those that banks credit to CDs. On average, the disparity can range between a half a point and a point and half depending on the interest rate environment. At any given moment, the disparity between the highest fixed rates available on specific MYGAs could be as wide as 2 points.

Why the disparity? Some CD advocates would have you believe that the lower yield is the "premium" savers pay because CDs are safer. Annuity advocates would argue that annuities are just as safe (more on this debate in the next section).

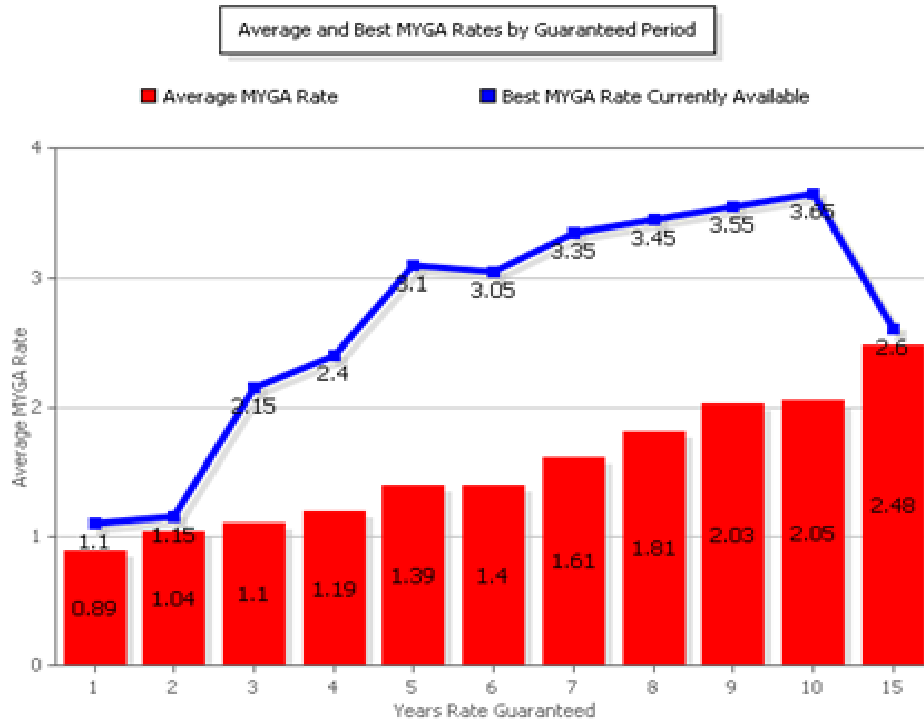
In reality, the rate disparity has nothing to do with the safety, and everything to do with the way the fixed rate is determined.

The fixed rates for CDs essentially mirror the short-term interest rates that banks earn minus a margin. A 5-year CD rate reflects the interest rate banks earn on short term loans, and a 30 day CD rate would more closely follow the banks prime lending rate. When a CD is rolled over at maturity, the new fixed rate will reflect the prevailing interest rates at the time. In a volatile interest rate environment the credit rates can change quickly.

With a MYGA, the premium deposits are invested by the insurer into high quality bonds and fixed income investments with a duration to match the length of the surrender charge period. So, for a 6-year MYGA contract, most of the money is invested in assets with yields that are fixed for 6 or more years. Based on the yields that are available, the insurer then sets the crediting rate. As interest move up and down, the yield on the insurer's portfolio remains fairly stable. For this reason, renewal rates on annuities will follow the changes in the market rates, but they won't increase or decrease as much.

The following chart shows the yield curve of MYGAs as of October 2012. The bars indicate the average yield of all MYGAs for different maturities, and the top line shows the best rate available at that particular time.

Copyright 2012 - Annuity Think Tank – All Rights Reserved



Source: annuityratewatch.com

Now contrast that with the average 5-year CD rate for the same period which, according to Market Rate Insights, had fallen to a historic low of 0.99%, the first time it has ever dropped below 1%. Of course, this does reflect the low interest environment, however, Market Rate Insight also attributed the unprecedented decline to soft lending conditions which have forced banks to reduce their funding costs.

Summary

So, not only are CD rates determined by the prevailing interest rate market, they can also be influenced by business conditions. For this reason, CD rates tend to fluctuate much more than annuity fixed rates, and there is really no floor for how low they can drop.

Annuity rates are determined by investment yield with adjustments for market conditions. So, annuity rates tend to be more stable and higher than CD rates for the same time period. In addition, MYGAs do include a minimum rate guarantee to protect investors from severe rate declines upon renewal.

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Reason #3 - The All Important Safety Factor

Few questions have driven more debate in financial circles than the one that asks whether CDs are safer than annuities. Of course, the responses are divided along institutional lines with bank reps on one side and insurance agents on another, and then the financial advisors split somewhere between the two. While one side attempts to settle the debate with the mention of FDIC insurance for bank CDs as the deciding factor, others would have us consider other factors such as structural integrity of the two different types of financial institutions, the overall safeguards in place for life insurance companies, as well as the actual performance of financial institutions during times of economic distress.

The Case for Bank CDs

The argument for bank CDs as the safer instrument usually comes down to one single factor: FDIC insurance. The FDIC – Federal Deposit Insurance Corporation – is an agency born out of the massive failure of the banking industry that led to the Great Depression. Its purpose is to reassure the public that the U.S. government stands solidly behind its deposits in banks that meet FDIC requirements. Ironically, the "I" in FDIC stands for Insurance, so the strength of this argument is based on the power of an insurance company that happens to be government owned, controlled, and backed.

The Limits of FDIC
The insurance only covers one account, per individual, per bank. So, if an individual has on deposit more than $250,000 with any bank, the amount in excess of $250,000 would not be covered. Conceivably, an individual with a $1 million in savings would be fully insured as long as his deposits were spread among four different member banks. The FDIC also provides separate coverage for deposits made with different forms of ownership. So, a person could have an individual checking account and a joint checking account both covered for the full amount.

Adequacy of FDIC Reserves
The great stress placed on the banking system as a result of the recent financial turmoil has raised new questions over the solvency of the FDIC reserve. Currently, for every dollar of deposits, the FDIC has just over 1 cent of reserve available to cover any bank default. The failures of hundreds of banks over the last several years has raised concerns as to whether the FDIC, which is not backed by the full faith and credit of the government, is capable of covering the losses of major banking institutions should they occur within a short time frame. To give some perspective, since 2008, over 400 banks have filed bankruptcy. See the full list here - http://www.fdic.gov/bank/individual/failed/banklist.html

The Case for Annuities

Annuities are issued by life insurance companies, and while these financial institutions have also felt the strain of distressed economies, their overall record of solvency dwarfs that of the banking industry. During the Great Depression, as banks failed all across the map, the life insurance industry, stood as a stabilizing force of the financial markets and the economy. In recent times, several life insurers have succumbed to insolvency, however, in no case has a policyholder or annuity owner ever lost a dime as a result. Moreover, during the same period from 2008 to present, we have not found a single insurance carrier that has had to announce insolvency and there are certainly no websites that had to be created to list the failed insurance carriers…

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Legal Reserve Requirements
In many respects, life insurers are held to higher standards and stricter requirements than banks or other financial institutions. For example, life insurers are required to maintain a legal reserve of liquid assets that will cover 90 to 95 percent of their obligations and future claims. Banks, depending on the reserve ratios set by the Federal Reserve, are only required to maintain a reserve of 3 to 10 percent.

State Guaranty Association
Insurance companies are regulated at the state level, and each state has established its own State Guaranty Association which protects annuity deposits and life insurance cash value against insolvency. The guaranty limits vary by state ranging from $100,000 to $300,000. As with FDIC coverage, the guaranty fund only protects one policyholder per insurer. However, if a policyholder has contracts with two different insurers, both receive the maximum coverage.

Institutional Financial Integrity
Generally, life insurance companies must operate at a higher level of financial integrity than banks. Insurers are required by state regulators to maintain much higher reserves and capital surplus than banks. Insurers are also restricted to the amount and quality of investments they can make which mostly consist of a portfolio of high quality debt securities.

Finally, the life insurance industry is closely monitored by independent ratings agencies, such as A.M. Best, Standard & Poor's, and Moody's. They track the financial strength of the company and assign ratings that reflect their outlook of an insurer's capacity to pay all of its claims and obligations well into the future. A life insurer with a AAA rating from Moody's is considered to have superior financial strength, while an insurer with a B rating may have some problems if economic conditions deteriorate in the future. Although life insurer insolvencies are rare, consumers would be well advised to choose from among the three dozen companies that are rated 'A' or better.

Summary

Very few things in life are absolute, especially when it comes to the fallibility of institutions, both government and private, that offer guarantees. Can it be said that any financial instrument is absolutely safe? Not with any honest measure of certainty. The best one can do in determining the degree of safety of any financial instrument is to consider all of the factors and all of the safeguards that are in place.

Reason #4 - Taxable CDs versus Tax-Deferred Annuities

With the issue of taxation, there really is no direct comparison between CDs and annuities. The earnings on CDs are taxable as ordinary income, and the earnings on annuities are not currently taxed. The real issue is how important tax advantages are to any one individual. Although tax advantages are among

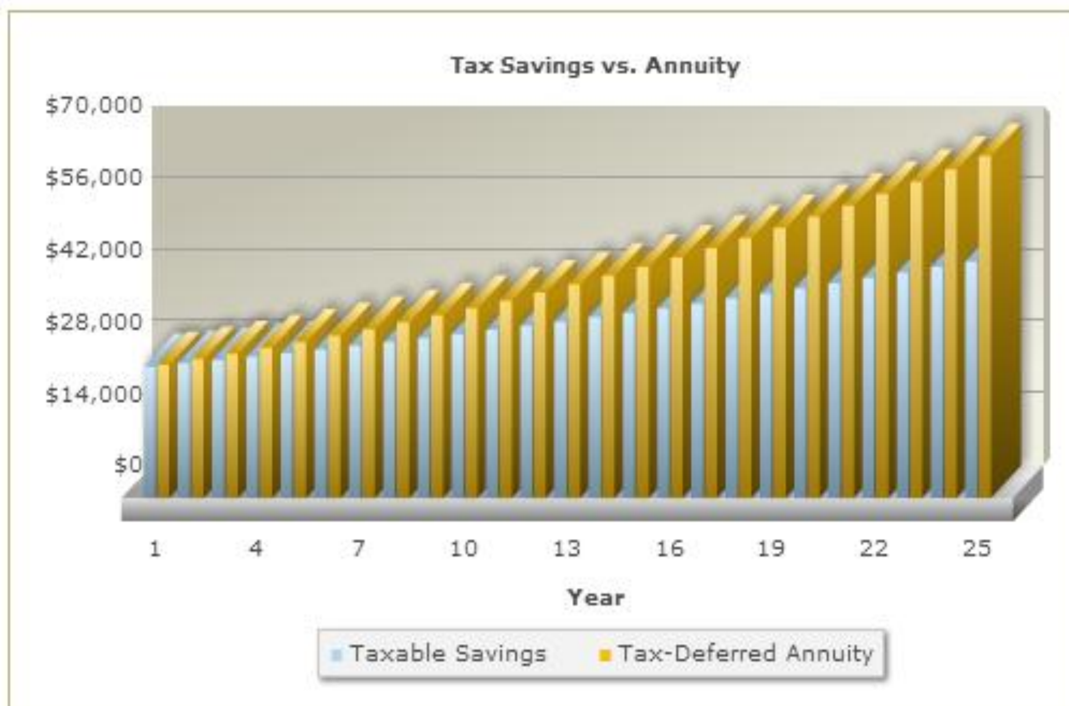
Copyright 2012 - Annuity Think Tank – All Rights Reserved

the primary reasons why people buy annuities, only those in the higher tax brackets will realize any significant benefits of tax deferral. On that basis, the only significant comparison to be made is how an annuity with tax deferral performs over time versus a taxable CD for any one individual.

The Magic of Triple-Compounding Interest

Tax deferral actually produces a triple-compounding effect, which can have a significant impact on the growth of an investment. Earnings not currently taxed increases the amount of money that is reinvested which generates increased earnings that continue to grow tax deferred, and that will always generate a faster rate of growth than earnings that are taxed before reinvestment. The only issue is how much faster, and the primary determinant of that is the individual's tax bracket.

For example, if an individual in the 38% tax bracket invests $25,000 in a tax-deferred investment at a rate of 4%, it will grow to $66,646 after 25 years. Assuming a 25% tax bracket in retirement, the investment would be worth $56,234 after taxes as compared to a taxable equivalent that would grow to $46,123. The more than $10,000 margin is significant.



Applying the same factors for an individual is in the 25% tax bracket, the tax deferred investment would still grow to $66,646 resulting in $60, 399 after tax versus $52,344 in a taxable investment - still a significant margin but, smaller. The margin would decrease for individuals in lower tax brackets.

Both of these examples assume that the individual will be in a lower tax bracket at the time of withdrawal in retirement and they presume there won't be any early withdrawal penalties.

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Tax Advantages for Retirees

The tax advantages of annuities don't end at retirement. Not only do the earnings inside annuities continue to grow tax deferred, but they are also excluded from the insidious Social Security tax calculation.

Since 1984, earned income, certain unearned income and a one-half of Social Security benefits have been included in a provisional income formula to determine how much of your Social Security income will be subject to taxes. Here's the actual formula:

1. One-half of Social Security income
2. Plus adjusted gross income (including employment earnings, capital gains, dividends, interest earnings, pension income and annuity withdrawals)
3. Plus tax-exempt bond interest

If the total exceeds a certain threshold, a portion of Social Security income, up to 85%, will be subject to taxes.

Filing status	Security formula result	% of Social subject to taxation
Single	$25,000 to $34,000	50%
Single	Over $34,000	85%
Joint	$32,000 to $44,000	50%
Joint	Over $44,000	85%

This means that any interest earned from taxable and tax-exempt vehicles, regardless of whether it is received or reinvested, is includable in the provisional income formula. However, earnings reinvested inside a non-qualified deferred annuity are excluded from the formula. Retirees, who hold significant assets in taxable, interest-bearing investments such as CDs, could reduce their exposure to Social Security taxation by repositioning their asset into deferred annuities.

Annuity Income also Reduces Social Security Tax

Section V more fully explores the tax advantage of taking income from an immediate annuity. In short, income received from an immediate annuity is partially excluded (referred to as the Exclusion Ratio) from income taxes because a portion of the income payment is a return of principal. That portion of an annuity income payment is also excluded from the provisional income formula.

For example, if an immediate annuity pays out $10,000 per year and 60% of the payout is a return of principal; only $4,000 is included in the provisional formula. That alone can make the difference in keeping the total provisional income below the 85% threshold.

(More on Immediate Annuity income in Section V)

Summary

For high income earners, taxes can be the biggest impediment to growing and preserving wealth. In terms of preserving purchasing power, retirees who rely on a fixed income need every advantage

Copyright 2012 - Annuity Think Tank – All Rights Reserved

available to minimize both income and Social Security taxes. Non-qualified deferred and immediate annuities are uniquely structured to maximize after-tax earnings during the accumulation phase and provide essential tax relief during the income distribution phase. Finally, not even the die-hard bank CD advocates' debate the power that annuities have in regards to taxes. And if you don't think that taxes are going to play an important role in the future with our ever growing debt, then think again.

Reason #5 – CDs and Annuities as Retirement Income Vehicles

Immediate annuities are gaining the attention of many Baby Boomers who, after having their IRAs and 401k plans decimated by two market crashes (2001 and 2008) and a decade of stagnant stock returns, are fearful of the prospect that they could outlive their income.

The basic annuity concept is fairly straightforward. Essentially, it is a contract arrangement in which an individual exchanges a lump sum of money for guaranteed income payments over their lifetime or for a specified period of time. The insurance company calculates the amount of income that can be generated from the lump sum and guarantees a stream of payments consisting of a return of principal and interest. Immediate annuities also include an option (for an additional charge) to link income payments to inflation. For countless generations worldwide, annuities have remained one of the only contractually guaranteed lifetime retirement income vehicles around.

By contrast CDs can be purchased with varying maturities to generate income based on prevailing fixed rates. Retirees who invest in CDs often create a "ladder" that is comprised of CDs with staggered maturities in order to stabilize the income. In period of rising interest rates, the ladder can generate increasing income, and in periods of declining interest rates, the ladder will generate less income. In either case, there is no protection against inflation.

One of the main arguments against an immediate annuity is that once you deposit your premium and income payments begin, it is committed to the life insurer, whereas, with a CD, you can get your original principal back once it matures. The argument ignores the fact that, annuity payments consist of both interest and principal, so the principle is being returned over time. It also disregards the use of joint life annuities that include an installment refund provision that pays any remaining principal to the beneficiaries. Finally, there are many newer versions of annuities such as fixed indexed annuities and fixed annuities with living benefit lifetime income riders that accomplish the same goal with added flexibility and control.

CD – Annuity Income Comparison

A married couple has $200,000 to invest for income purposes. The husband is 65 and the wife is 64.

	Income Payout Rate	Monthly Income
5-Year CD	1.6% *Fixed Rate**	$267

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Immediate Annuity – Joint Life w/ Installment Refund	5.24% Annual Payout Rate**	$874

* Highest available rate for 5-year CD as of October 2012, Source: Bankrate.com
** Source: immediateannuities.com

With the immediate annuity, the couple will receive $874 per month, guaranteed. At the first death, the income will continue to the surviving spouse, and after the second death, their beneficiaries will receive the remaining principle with interest in installments. An inflation rider will ensure that the income keeps pace with the rate of inflation.

With the CD, the income is only fixed until maturity, at which time it can increase or decrease depending on the prevailing interest rates.

But that's only part of the story…

The Annuity Income Tax Advantage

Because only a portion of the annuity income consists of taxable income, that portion which is a return of principal is not taxed. Therefore a percentage of the $874 monthly payment is not taxed. To determine the non-taxable portion, the IRS applies an exclusion ratio based on its life expectancy tables. In this example, joint life expectancy is 24 years. With a monthly payment of $874, the annuity's contract value is calculated to be $249,646. Their exclusion ratio is 80% ($200,000/249,646). Therefore, 80% of the $874 monthly payment, or $699, is excluded from taxes.

CD-Annuity Income Comparison – After Taxes
(25% tax bracket)

	Income Payout Rate	Monthly Income
5-Year CD	1.6% *Fixed Rate**	$267
Immediate Annuity – Joint Life w/ Installment Refund	5.24% Annual Payout Rate**	$830

In addition, the income from the CD adds $2,844 to the provisional income calculation for Social Security taxes, while the immediate annuity income only adds $1,572 providing additional tax relief.

Summary

Most people, and even some financial advisors, are not aware of the income tax implications of retirement earnings on Social Security benefits. The notion that a benefit for which people have paid into all of their lives could then be taxed as high as 85% should be bothersome to most people. With

Copyright 2012 - Annuity Think Tank – All Rights Reserved

proper planning, and the use of deferred and immediate annuities it can be possible to at least avoid the 85% threshold. At a time when retirees need to be able to maximize their income, they will need every advantage available to them.

Reason #6 - CDs and Annuities as Financial Planning Tools

In the previous sections CDs and Annuities are compared, in depth, for their ability to provide safety, minimize taxes and maximize retirement income – all key components of a well-conceived financial plan. In this section we examine them in the context of some additional financial planning considerations.

Asset Protection

Under state and federal statutes assets such as pension plans, life insurance and annuities are protected from civil liabilities, liens and debt claims. It is an accepted practice for individuals to arrange their assets in a way that will shield them from claims so long as it is not done with intent to defraud. In some states, assets held in annuities are fully protected against liability claims, but in others, their exemption in limited to a specific dollar amount. In a few states, annuities are not exempt and, therefore, they are vulnerable to claims.

Liquidity

Both CDs and annuities offer access to funds but with penalties attached prior to their maturity. CDs must be held to maturity in order to receive the full amount of interest credited. Early withdrawals can result in the loss of six months of interest. Annuity funds may be accessed anywhere from once to multiple times annually, free of penalties as long as the amount doesn't exceed 10% of the account value during the surrender period. After the surrender period, any amount of your account value can be withdrawn without penalty, however, withdrawals made prior to age 59 ½ are subject to both income taxes and a 10% penalty tax.

If you place $100,000 in a CD you can't just access a part of it – the whole certificate would have to be redeemed. With an annuity you can withdraw $10,000 without penalty and without having to surrender the contract.

Estate Planning

Absent estate planning tools such as a living trust, non-qualified assets, such as CDs, are subject to probate proceedings, which can be costly and result in the delay of asset transfer. As with life insurance proceeds annuity proceeds pass outside of probate.

The tax deferral aspect of deferred annuities also make them attractive options for funding certain estate planning components such as the A part of an A-B Trust and Charitable Remainder Trusts.

Copyright 2012 - Annuity Think Tank – All Rights Reserved

Summary

Combined, these six well documented areas of comparison between an annuity and a CD, make it tough to argue the reasons to purchase a cd over an annuity. The most compelling reason that we hear to buy a bank CD is the fact that it backed by the FDIC, which is a true statement. But considering that since 2008 over 400 banks have declared bankruptcy (it has been a busy 4 years for the FDIC) and in that same time frame not a single insurance carrier has declared bankruptcy (insolvency), that reason alone is not enough to convince us to buy bank CD's over any annuity. Moreover, due to the reserve requirements that insurance companies are forced to follow, even the smallest insurance carriers have more reserves (proportionally) than any bank in the US.

Finally, we hope you found this paper enlightening, educational, and thorough. The use of annuities to address any financial need should be considered only with the guidance of a qualified financial professional. Also, the use of annuities has tax implications which should be reviewed with your tax advisor before ever making any financial decision.

Disclaimer – This article in its entirety is purely educational and nothing in this article can be or should be considered financial advice. It is imperative to speak to a Retirement Income Specialist before ever making a decision to purchase an annuity or a cd. You are free to email this article, post this article in its entirety to your website or blog, and any other form of distribution as long as there are NO changes whatsoever to this PDF. To contact Annuity Think Tank about distributing or copying this article, please email them – info@annuitythinktank.com

Copyright 2012 - Annuity Think Tank – All Rights Reserved