Episode 83: More on Annuities with the Author of Annuities for Dummies - Part 2

00:00
Bob French
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00:40
Bob French
Welcome back for the second part of our conversation with Kerry Pechter. And yeah, the jokes are still for Dummies.

00:48
Alex Murguia
What do you think is the to say the biggest is not fair to you, but on a personal level, what do you think are some of the largest misconceptions of annuities when it comes to retirement income? Developing a plan that you sort of break it down a little bit in your book.

01:10
Kerry Pechter
Well, the first most general, most significant thing is that there's something out there called annuities in general. And if you're ever reading anything, I would say I would speak to the public if they're listening. If you read somebody speak generally about annuities in a newspaper article, it's probably not useful for you because that means that the person doesn't really understand what they're talking about. It's like saying, oh, I'm taking my child to a game. We're going to go watch a game. How about that? Okay, a soccer game, a baseball game, a football game. Oh, no, it's a game.

02:16
Alex Murguia
You're not all the same way. You've never played pickleball.

02:21

Kerry Pechter
Or I'm going to buy a car. I'm going to go buy a conveyance. It's a great conveyance. I heard conveyances are conveyance.

02:31
Alex Murguia
How'd you even come up with that word, conveyance? Because I know I totally agree.

02:41
Kerry Pechter
No, I had a Latin teacher once, and I also had a motorcycle, and he walked by me in the parking lot at school, and he talked in a very formal way, and he said, Is that your conveyance?

02:57
Alex Murguia
He's prepping you for the Sat or something. Anyway, I agree with you. I think just that annuity, it's almost like a signal that you don't know what you're talking about. If you frame it in general, yes.

03:15
Kerry Pechter
Because that takes you immediately down the rabbit hole. Well, say tell me further. Oh, well, they're a fixed and deferred fixed and variable and immediate and deferred and blah, blah, blah, and then you're racing down the wrong chute. So at every point in the book, I tried to make it a consumer book.

03:40
Alex Murguia
I remember you said something that was interesting when I was listening to your interview, and it was like, oh, yeah. And it's obvious, but when you say it, said it was like, oh, yeah, just legally, why is something called annuity? And this goes back to and were saying it earlier because I think another misconception is people don't really realize, no, there's actually a writer that provides the income usually and rarely do people annuitize from that standpoint. And so then it's like, well, why is it called annuity? And it's almost like there's a legal reason why things are called annuity, to be able to provide that backstop even though you may not utilize it. You follow where I'm going with that?

04:25
Kerry Pechter
Well, yes, and once you start pulling on that thread, it goes on and on because something is what comes with the word annuity is a whole raft of characteristics. One only life insurance companies can issue annuities. So you're going to be working with a life insurance company. Annuities are contracts, they are

not investments. Annuities are insurance, they are not investments. Annuities are regulated by the states and can be sold by people who are licensed by states. And of course, it gets more complicated than that. There's the general definition of annuities as money that you get year by year. But the annuities that most people buy are not money that you get year by year. They're a kind of investment. And where we've been going over the past couple of years, as the annuities are becoming more and more investment like, as the companies that sell them become more and more investment like.

05:45

Kerry Pechter

So I establish in the book very carefully which annuities are for investing and for certain time periods and are open ended, and then which annuities are for actually getting retirement, planning on retirement income. And the book is a bit heavy because of my prejudice towards using annuities, actual annuities as income producing annuities. There's an emphasis on the single premium, immediate annuity because I think that's the one that people need to hear more about. I think that it's a tremendously valuable product, especially in the way that you can customize it. That might be a segue into my annuity.

06:39

Wade Pfau

Yeah, absolutely. I did have some other questions on this point too, but I think this is touching upon and it's something we never really have gotten into, but in terms of just like the general sales numbers, what types of annuities are actually popular in terms of selling, I think we do want to have the conversation about the single premium, immediate annuity. But I had this question in mind before that this is going to reveal that, for example, they don't have big sales numbers. So what, annuities are actually popular, what are people going to be hearing about just through advertising and so forth?

07:20

Kerry Pechter

Well, it's interesting that you use the word popular because when I see that word in an article in a newspaper about annuities, I think annuities the second thing that I was told when I got into the annuity business was that annuities are sold, not purchased. People do not go looking for annuities. I mean, I hope once they read the book that when they feel more agency about it, that they will look for annuities. But annuities are I won't make any friends in the industry by saying this, but the type of annuity that is sold, the type of annuity that is created by the life insurer is dictated by the business model of the life insurer. And I don't want to get into the weeds on this, but it matters for the individual only because I make the point in the book that you have to look at who's issuing the annuity and the business model, because the business model of the insurance company dictates its culture, its products, its distribution, its regulation, everything.

08:38

Kerry Pechter

And then if you're not looking at the company and the way it's run and its goals, then you won't understand the context of your product. And also then once you get past the company and you find out who's distributing it, who's selling it, then you have to look at, well, an insurance agent can sell indexed annuities, but not variable annuities. So if you're talking to an insurance agent, and if an insurance agent gets commissions, and it is no coincidence that the most popular, quote, popular, unquote or highly sold product is the product that pays the agents the highest commission, that's a blunt thing to say, but there's no way around it. There's no way accounting for the fact that because they tried after the financial crisis, they said, okay, we are going to really go straight. We're going to become consumer oriented and we're going to sell no commission annuities.

09:56
Kerry Pechter
Well, no commission annuities were not sold. They did not happen. They did not sell because people have to sell them and they are hard and insurance is very hard to sell without getting esoteric. Insurance is an expense. It's an expense that reduces risk and expense in other parts of your life or your portfolio. But it is an expense. It's hard to sell. It's like selling. Selling insurance is selling prevention and prevention. Everyone knows there is nothing sexy about spending on prevention. I mean, my wife and I, at one point, were approached by one of the big termite companies and they said, oh my gosh, you don't know what's lurking under there. You need a vast system of termite protection. And so insurance is sold basically on fear because there's no other way to get people to fork out money for basically nothing. You get protection, prevention, it is very important.

11:23
Kerry Pechter
I mean, insurance is very important. You cannot go life through life. You have to say, okay, is longevity risk a bigger risk? Yes. Are annuities important? Yes. But they are a cost, and investments are not seen as a cost. And the reason that there is no cost is because you're not transferring risk to anyone. You're taking on the risk. And so to pay an insurance company for taking the risk from you, which from your point of view is prevention is a tough sell. So to make a tough sell, they must incentivize people to do that. And wherever you land on the ethics or the dynamics of that, it's a tough job, but someone have to do it.

12:22
Alex Murguia
So then on a relative basis to answer wade's question is it fair to say that the ones that function, the ones that have more of an insurance component or protection component are probably on a relative basis now? Yes, nominally, maybe in absolute terms, it's a low number anyways. But on a relative basis, the ones that have that insurance vibe are lease sold. The ones that are more investment oriented are the highest purchase. Absolutely.

13:02
Kerry Pechter
Okay. Because.

13:06
Alex Murguia
For the reasons you mentioned earlier, it's a hard thing to do. Human nature, battling human nature a little.

13:16
Kerry Pechter
Bit goes precisely to the low sales of my favorite annuities, is because they are pure. You may not live to 94, and if you don't, this is not going to pay off. And I try to make it clear because I didn't think the story is.

13:37
Alex Murguia
Unfaid off economically, but it paid off in terms of the security while you were living. Well, it really sucks if you die, like the next week.

13:52
Kerry Pechter
I see from Wade's expression that he's gone over this topic in his mind and with other people a few thousand times. Right?

14:02
Wade Pfau
Yeah, definitely.

14:04
Kerry Pechter
Reoccurring theme and then your Risa formulation helps explain why some people would and other people wouldn't be interested in prevention as opposed to upside, potential and risk.

14:22
Bob French
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14:45
Wade Pfau
Before we get to your own kind of personal situation, I think that'd be great to end the episode. But a couple of other questions that I hear a lot that I don't necessarily have good answers for, and I know you're more

connected in that regard, so if we could cover a couple of those. One is you've written a lot about this idea of the use the term Bermuda Triangle, about this idea that private equity is really getting a big foothold in the insurance world. And the concerns that filters through a lot of questions that come in are, is private equity going to ruin all the guarantees in these annuities? And could you comment a little bit on that particular issue?

15:29

Kerry Pechter

Yeah, I guess I should give a caveat in that I'm not a lawyer, advisor or private equity specialist. But when I mentioned a few minutes ago that you have to look at the type of company and the business model of the company that produces your annuity, you have to look at that because it's going to determine an awful lot about the product and about your relationship to the company. And the private equity companies in kind of an evolution after the financial crisis have gone to the assistance of life insurance companies and then partnered with life insurance companies and then bought into and then in life insurance companies. And then finally acquired life insurance companies so that they could sell long dated, like, ten year, seven year, ten year indexed annuities, which was a way for them to borrow money at relatively low rates and at low risk so that they could loan that money to companies in what's called private credit or leveraged loan origination, customer loan origination models.

16:54

Kerry Pechter

So I was alarmed. And people I knew some of the old timers in the insurance business and life insurance business who had been from the old days of the 1990s, were all a little bit alarmed that the annuity buyer was now just they didn't know that they were simply lending money to private equity companies to put at the service of a completely different constituency. And this is a conclusion that I've come to from watching this evolve. And I can tell you that when I've spoken about it, okay, let me go back before jumping into the deep end of that, let me go back and say what the Bermuda Triangle is, which I've written about. The Bermuda Triangle is when a company can start with a life insurer, it can start with a private equity company. It can start with a company that's a reinsurer that the Bermuda Triangle involves issuing fixed or fixed indexed annuities, fixed rate or fixed index, taking in that money as a kind of receiving that money.

18:28

Kerry Pechter

It's called the liability for the life insurance company because they have to pay it back and then reinsuring buying reinsure instead of sort of reinsuring it yourself, which is what an insurance company would do. You move that the risk to an entity in Bermuda where they can revalue the liability in such a way that it lowers the cost of the product. That's the best way of saying it lowers the cost of the product and creates a wider profit margin for the company. And meanwhile, there's an asset manager, the third leg of this triangle, which manages all the money and puts all the money to work in the most effective way it invests the money. I mean, what an asset management company does either manages investments that other people own or it manages its own investments, or it borrows money and to lend it in a kind of arbitrage.

19:32
Kerry Pechter
And so I thought, okay, no, it's in the same way that I like to deal with the principal in a transaction. I don't want to deal with a life insurance company whose motives and goals are dictated by a private equity company. A Wall Street company that I don't know it's. The Bermuda Triangle is a Wall Street investment company. A big one. I won't name many names because they just get me into a lot of trouble that I've written about them specifically so that you have a Wall Street investment company, images, investments. You have a life insurance company that sells annuities, which is the same as borrowing money from people for seven to ten years at low rates and then you outsource the insurance function, the risk holding function to Bermuda where the risk costs less, driving down the price of the product. And so the big question has been, okay, well, maybe the private equity companies are doing this so they can lower the cost of the annuities and make them more valuable for the policyholder.

20:55
Kerry Pechter
And this possibility was brought up in a couple of recent research papers by a couple of former Federal Reserve economists who are looking at the situation. And I thought, you got to be kidding me. No. The private equity company is running this transaction and these are publicly held companies. So for a publicly held company, the shareholder comes before the policyholder. So these strategies, these Bermuda strategies, which I'm and some other people are saying are not really in the interest of the policyholder are being wildly applauded in the Wall Street press, which is The Wall Street Journal or The New York Times. Wildly applauded because these things are great for the shareholders of the companies because the products are more profitable. The profits. I believe there's a problem with that because the policyholders, I do not think are the winners in this. They are losers at the expense of the shareholders.

22:08
Kerry Pechter
The book doesn't go into that too deeply because that arises out of my news coverage of the insurance industry, the Business of Retirement.

22:17
Alex Murguia
Got you.

22:18
Kerry Pechter
So there's a little bit of that in the book as it's relevant to individuals in the section where I say you've got to look at who the company is. It makes a huge difference in the ownership structure and the business model of the insurance company.

22:42
Alex Murguia
It's interesting, Kerry, you come at this annuities in an interesting say. You know, the best parents are those that not only see the pros of their child but also their faults, but you love them nonetheless kind of thing. It seems to me with annuities you really are in a unique position where, listen, you wrote the book Annuities for Dummies. You're a huge proponent of the role that they can play, but you're also able to separate. You're not like this sort of cheerleader, this blind cheerleader. You also see that, listen, there's some infrastructure issues that could potentially lead us astray if we don't get this right. And you're fine bringing that to light because at the end of the day the industry benefits from it. You don't see that too much. You're not an apologist, nor are you a harsh, harsh critic. Dial in the handbasket.

23:49
Alex Murguia
What I'm getting out of this is you're really trying to look out for the best interest of the annuity world because of the benefits that they could potentially bring to somebody's retirement. And kudos to you for that.

24:03
Kerry Pechter
Well, look, it's pretty simple. You've got a consumer who's got, say, for some people they've got $100,000 and that might be a very large sum for them and they are trying to decide what to do with this money or $500,000 or a million dollars or whatever it is. This is the most important person in the transaction and I do not want them to be in the weak position, the weak end of an asymmetric information frame. And there is no reason, I mean, it's their money. They need to know exactly what's going on here.

24:58
Alex Murguia
And I think that's a great segue here for your book. Going back to your book, listen, you heard from the man himself, Kerry. And frankly, if you're going to pick up a book, sort of make you an informed consumer about annuities, no offense, Wade, annuities for dummies. And frankly, if you're going to pick up a book, sort of make you an informed consumer about annuities, no offense, wait, annuities for dummies. It seems to be the way to go. That's just my take on that.

25:31
Wade Pfau
Yeah, I know we're coming up on the hour. There are a couple more things we do want to make sure we cover because we may not get another chance. But another question that we get a lot is just how do we assess this idea of, especially in the indexed annuity world with renewal. And when it comes to the new term, the insurance company needs the flexibility to reset the caps or other parameters. And the concern is they may do so in a manner that takes more from the consumer, reduces the options budget to purchase

that upside, and shifts it over to what the insurance company keeps. And it's hard. What is your suggestion to consumers when they're trying to understand is this company I'm looking at likely to take advantage of me at the time of term renewals or are they a company that seems to be more fair to their customers?

26:29
Kerry Pechter
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26:34
Bob French
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26:58
Kerry Pechter
First is you have to understand back in the fixed annuity, the way it was explained to me by a guy named Bob McDonald, who sort of almost created the market at a place called Life USA, which he sold the alliance back in, the fixed rate annuity issuers were heard by disintermediation. People jumped out of the contracts when there were changes in the interest rates. So the insurance companies, certain insurance companies said, well, how can we fix this product so that we don't lose customers? And so they invented the indexed annuity. We'll index the money to the market and we won't be exposed to so much interest rate risk and people will not be terribly worried when interest rates go up or down. They won't get rid of their fixed annuities. So let's start indexed annuities. And then of course, they ran into a problem if they made a promise they had five or six or seven year, 810 year products and they couldn't, for their own sake, for their own safety, make a promise that they would have to keep for ten years in a fast changing institutional world, financial world.

28:18
Kerry Pechter
So they reserve the right to change their crediting rates from year to protect themselves and stay in now. And renewal rates used to be a big bugaboo because, well, what if they change my rates? And I had once talked to Cheryl Morrow of Wink, the annuity marketing and information company data company, and she said, well if a company won't show you their renewal rates, then you shouldn't buy from them. And I thought, well, that would rule out most of the companies and you're just not going to find those renewal histories. Did they change their rates from year to year last year? Have they done it? Do they have a bad track record about that? And some companies have a terrible track record about it and it's going to be hard to find out except when companies get sued over indexed. So Cheryl said that well, but what has happened, how it has evolved is that the companies now use custom indexed indexes that are risk controlled, that

have the risk volatility inside them so that they change sort of they use these indexes so that they don't have to change renewal rates.

29:55
Kerry Pechter
The indexes do the changing for them because of the algorithms built into them. The crediting rates will change on their own because of the index they're using. This gets into this is a way too complicated part of but the indexes index annuities have gotten much more sophisticated and let's just say that the companies have tried to solve this problem by engineering the index so that the.

30:37
Wade Pfau
Volatility stays level, so that the cost of the option stays the same. But they also have to account for the interest rate changes.

30:46
Kerry Pechter
Yes. And then once people buy into the index, well, it's the index, it's whatever the index is, it's not like we have an index and we missed it. I mean, you get what the index gives you and you don't have to change the renewal rate because that risk is already and so what you get though is you get these articles, these products are now sophisticated and the indexes are sophisticated that you now have layers of providers. You have the proprietor of the index and then you have another layer of risk management and then you have the people who own the intellectual property of the secret sauce of the futures trading mechanism and you've got an awful lot of people in the room now that are dealing with this problem. It adds expense, I think to the I don't think it can help but add expense to the product.

31:48
Kerry Pechter
But the renewal problem has been neutralized.

31:51
Wade Pfau
In that way, although it creates another problem for consumers. Yeah, we suggested in past episodes to just stick to more simple indices like the SMP 500, because you can actually compare between companies and so forth. And with these proprietary indices, there's no transparency to know what the heck they're going to do in the future.

32:14
Kerry Pechter

No, you're going to see way less see that you'll never get the S P index, the straight index in these products. At best, you'll get this S P price index. It's only in the Rylas. I think it's in the registered index length annuities that you will still see the simpler indexes. Okay, we are for complex reasons, so.

32:51
Wade Pfau
We're going long on the article or on the episode. We did promise your case study. So maybe in 100 words or less, how did you end up approaching the issue of your own, whether there was a need for annuity or what did you end up doing with your own financial plan as you approach retirement?

33:13
Kerry Pechter
Well, I was concerned about longevity risks. My grandmother lived to be 100. I had long life in my family. I was certainly doing everything I could to try to live a long time, which I think is a factor for people to consider. If you're paying for Pilates and you're paying for vitamins and whatever you're doing, if you're investing that in living a long time, then maybe you should think about investing in annuity that will cover your expenses for being alive. So that was one consideration, my own longevity risk, and also that I was what David Machia calls a constrained retiree that I could not well, like almost everyone is constrained. I had more things I wanted to do with my money than I had money. I wanted to leave something for my kids. I wanted to live a long time, and I wanted to travel, and I had a house to maintain, which is expensive.

34:22
Kerry Pechter
And so I was a constraint. I had more things to do with the money, so I had to think about protection. And I also had a spouse who had very different ideas about retirement because her dad had a corporate job with a pension and free cars and retirement and free health care and all of these things. We had none of those things I wanted to take some of the risk out of and what we ended up doing. But my wife was very concerned about the risk of a single premium media annuity. That was life only. So what we ended up doing, long story short, is that I did something that I can't necessarily recommend to everyone, because I became very familiar with a person who I trusted, who sold secondary market annuities. And I was able to get a 15% discount on the income that I needed by purchasing this term annuity for the first ten years of retirement.

35:37
Kerry Pechter
And so what I decided to do, it's pretty simple. I decided to buy this term annuity, which you don't have to buy in the secondary market, you can buy from any life insurance company for ten years that would start on my retirement date so that I did not have to worry about retiring right into a big drop in the stock market. Right? Isn't that what we talk about, that infinitum about the retirement red zone? So, yeah, I'd been writing and reading about this for 25 years, and so it was pretty ingrained. And the stock market was going way up because of the low interest rates. And I thought, well, this is probably going to break right

when I run and retire. I don't want that. So a few years in advance of retirement, I bought this term annuity so that for the first ten years of my retirement, I was not going to have to think about the starving or selling.

36:50
Kerry Pechter
No, not starving. That's silly. About having to sell equities in the face of a down market.

36:55
Wade Pfau
Okay.

36:57
Kerry Pechter
For income. Okay, let's just take that. Let's worry about the other problem, living too long on the back end. And Bill Sharp has a system that recommends that you sort of wait and see how things go before you jump into a life contingent annuity, a deferred income annuity. And others have written about this, too. So I took that at risk off the front. I took out the retirement, what we call the sequence risk, and let the longevity risk wait a bit while I saw what happened with my other investments, at which point I'll probably buy some kind of life annuity that begins at the end of my term. Now, you have to remember that part of this discussion. I had to do it with my spouse because, believe me, that always makes things. You now have two people having to decide, and she was concerned about the life annuities starting now, and they're taking away something from the legacy goals for the kids, et cetera, and the risk involved, because it was a risk that many people have about losing money on a life contingent annuity.

38:33
Kerry Pechter
So we said, okay, we'll do a term annuity. And like I said, that resolved. So the book talks about this kind of thing of starting to look at the geography of retirement in periods of years. You've got sequence risk at the front end, you've got overspending kinds of risks in the middle, maybe, and you've got longevity risk at the end.

39:02
Alex Murguia
So it's interesting you were able to sort of take those sort of, let's say, life milestones that everyone goes through and just apply them to your situation, you and your spouse's situation, and you slot it in the annuities when that peg fit the hold, if you will, with regards to your milestone. I think that was pretty cool.

39:28

Kerry Pechter
I could do it because I read 100 books. Wade and Moshe Malevsky, I want to.

39:35
Alex Murguia
Ask you, can I do it if I read Annuities for Dummies.

39:40
Kerry Pechter
Yes. My book is much more consumer oriented.

39:44
Alex Murguia
Than We're Good than there.

39:46
Kerry Pechter
I would say that what Wade has done with his book. His books. Wade has provided advisors and consumers with exactly the kind of mathematical foundation that they need in order to advise about retirement income.

40:07
Alex Murguia
Sure.

40:08
Kerry Pechter
And they need a very different kind of foundation speaks to them before they can do this than the foundation that I provide in a consumer book. That's Wade's not a good word. No. Over the past ten years or 15 years, that has been Wade's almost unique contribution to this field. He has done this service for advisors. And that's a completely different part of the story from my story, but it's certainly an essential part.

40:54
Alex Murguia
Well, then I guess we'll end the episode with Wade's book.

40:58

Wade Pfau
Thank you.

40:59
Kerry Pechter
Yes. My book and Wade’s book. Buy them together and save oh, yeah.

41:03
Wade Pfau
Get them bundled on Amazon.

41:04
Alex Murguia
Where can you get the save your retirement. How's that? Save your retirement.

41:11
Kerry Pechter
You can preorder it on Vanguard, on Amazon or Barnes and Noble and other places like Goodreads. And it should start showing up in bookstores next week.

41:25
Wade Pfau
Yeah. Amazon shows the release date as July 20. The first edition is still for sale, so if anyone's looking, make sure you define the second edition. And just a quick note, we talk about all the vocabulary with annuities. What you were referring to as a term annuity in past episodes. But thank you so much, Kerry. But thank you so much, Kerry. It's been great having you on the show. And I hope everyone will check out the second edition of Annuities for Dummies. Thank you so much. Take care, everyone.

41:57
Alex Murguia
Thank you, Kerry. Appreciate it.

41:59
Bob French
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be

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