Episode 88: What to Look for in Annuity Illustrations and Contracts (Part 2)

00:00
Bob French
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to Risaprofile.com Style and sign up to take the industry's first financial personality tool for retirement planning. Without further ado, let's get on to part two.

00:44
Wade Pfau
Hi everyone. Welcome to retire with style. This is the special Friday edition that we're doing over the summer. I'm Wade. Again this week we are not joined by Alex. He's on a family vacation, but I am joined as a part two, continuing the conversation with Jason Rizkallah and Brian Bass, both of whom are financial planners at McLean Asset Management. Thanks so much guys, for coming back for a second episode because there's so much to unpack with what were talking about and we want to continue that conversation.

01:18
Jason Rizkallah
Thank you.

01:18
Wade Pfau
Wade yeah, and we missed Alex. We don't have the small talk portion of the episode, but we've got so much content that we'll just fly through that and dig in. So on the last previously on Retire with Style were talking about variable annuities in this episode. We're talking about illustrations and then contracts. We're still talking about the illustrations on the variable annuities. It could be a 15 page long document approximately depending on the company, and may shown multiple return scenarios. But the idea of the illustration is it's meant to show you how the product would perform if you got the returns shown in the illustration. But it's more an example of how the product could perform in practice. So we talked about the returns are going to be shown somewhere and you both suggested focusing more on a lower return number. That doesn't necessarily lead to any step ups in the contract.

02:21
Wade Pfau
So you see what the minimum guaranteed amounts are, but you've got some return numbers and then you have the evolution of the contract value, which is how the contract's value will evolve with those returns, but then with fees taken out, net of the fees and also net of any distributions that you take. And we talked about how the withdrawal value of the contract could be less. And that would be if you decide to end the contract, not keep it over the long term, there may be with a surrender charge and possibly in a VA, but more so in the fixed index annuity that we'll talk about today, there could be a market value adjustment and that really brings us up to speed. So to continue the conversation from there, the other types of columns that you'll generally see in an illustration, there's going to be some that relate to showing what the benefit base is.

03:13
Wade Pfau
And that's the referring back to past episodes, the hypothetical value used to calculate the allowed guaranteed income from the contract. And then there'll be some columns showing what the income is. So starting with the benefit base, Brian or let's go with Jason, because I think Brian had a good point to make about the withdrawals that were talking about. So with the benefit base, Jason, what's going on with that number? How might that increase over time? How might it not increase? What do you want to be looking at in an illustration with the benefit base?

03:49
Jason Rizkallah
Absolutely. So if you have an income writer on your contract, you're going to see something like an income benefit base associated with it. And really what that is that's the figure that your future income check will be based off of not necessarily your account value, but the income benefit base is what your check is going to be based off of when you decide to start it. Now, if you've elected an income rider, typically with that, there comes a step up in your basis, in your income base that occurs, and usually on annual basis, and that's a minimum amount that they're going to credit to that particular value within your contract.

04:34
Wade Pfau
It has nothing to do in past episodes. What you're referring to now we call the roll up rate. I'm sorry. Roll up the audience.

04:42
Jason Rizkallah
Okay, yeah, you're right. Sorry about that. Roll up rate. See, there's so many terms to keep. Okay, so the roll up rate with it. So your contract I'll keep it very straightforward. As an example, let's say the contract says you'll get a minimum of a 5% roll up rate on your income benefit on every year that you defer taking

income. Right. When you initially start your contract, all your values are essentially going to be the same. If you started it with $500,000, your account value will start off at 500. Your income benefit base will start off at 500, but it'll go, let's say one year later. So one year passes and your account was flat, didn't do anything, didn't earn any credits or any kind of market return in the variable annuity or nothing. So you're still looking at a $500,000 account value. Your benefit base would increase by 5% because that's the minimum that they said that they would credit you on any given year.

05:40

Jason Rizkallah

So let's say you started income at that particular moment. You said, okay, I want to start to receive my income. They're going to base the amount that they pay you off of that 500 plus 5%. So 525 versus the 500 that is the account value. And so that income benefit base will never go down due to market conditions or anything. It's just going to continue to roll up by that 5% as long as you continue to defer or your account value, if it ever surpasses it's going to be the higher of that your account value after at the end of each year or that 5% credit, and it's just going to keep rolling up excuse me. As you do that.

06:18

Wade Pfau

Yeah. And in those past episodes, that highest value that's what were calling step up.

06:24

Jason Rizkallah

That's called the step up. Correct. So it steps up to the account value if it surpasses what that roll up amount would be.

06:35

Wade Pfau

Both talk about just assuming you're not going to get growth, you are allowed to get the roll up rate, because that is, even in the worst case scenario, part of what you receive before you turn on the lifetime income. You just wouldn't want to assume you're going to achieve any step ups. You don't want to assume that there's going to be growth that exceeds the growth of the roll up rate effectively correct.

06:57

Jason Rizkallah

So when you're generating your illustration and you illustrate your income start date and let's say it's five years out, you would want to see what it would be like with just the roll ups, no step ups taken into consideration because that essentially is what your guarantee is. That's what they're guaranteeing to you. That roll up is a guarantee. The step ups are not. So you would want to go by the guarantees as we've referenced a few times throughout. So that's what it's based off of, that income benefit.

07:26
Wade Pfau
Yeah, and it's guaranteed. It's not the contract value, which we talked about earlier, but it's the guarantee of what they'll use to then calculate your guaranteed withdrawals. And so Brian, the next columns are going to start digging into that. How are those guaranteed withdrawals calculated? What should people be thinking about there in particular?

07:49
Brain Bass
So the important thing on the variables that differs from the fixed index and a couple of different other types of annuities is the way they calculate your withdrawal rate. So variables tend to have a wider swath. So it might be a five year period. So it might be, let's say, just as an example, from 45 to 50 they're going to give you and these are just pie out of sky numbers, there's no reasonable anything, no reason to assume these are correct. So 45 to 50, let's just say, is a 5% withdrawal rate, from 51 to 55 might be 5.5. And so the variable annuities, it's really important to understand where you are in those age bands and try as best we can. We're obviously looking down the road 10, 15, 20 years sometimes to plan out when we're going to turn these things on, because you could theoretically cost yourself a lot of money by turning it on even one year earlier than hitting the next bracket for those withdrawal rates.

08:47
Brain Bass
That doesn't really work that way with the fixed index. It's a little less important from year to year. But the variables, it's really important to understand where those brackets are because the later you go and that pairs back to with the planning conversation, the roll up rates are typically only guaranteed for ten years and those will tend to stop. So you'll get that guaranteed five, 6810 percent, whatever it is, depending on when you buy it, you'll get that for the first ten years of that contract and then that will stop. So even calculating or until you turn it on.

09:22
Jason Rizkallah
Correct.

09:23
Brain Bass
Yeah, as long as you deferred it would give you that ten years. Correct. And so, looking at those things, there's a whole bunch of different variables that go into the planning conversation. But that, again, is a really important one to keep in mind when you're looking at the variables and really figuring out when you want to turn that on.

09:42
Wade Pfau
And so you've got that age based withdrawal rate that can be higher if you wait to higher ages multiplied by the benefit base. And that would show you the income.

09:50
Brain Bass
Exactly.

09:50
Wade Pfau
And then that contract value they show you is effectively then just evolving as the returns, but less assuming you take those. They do assume you take the allowed guaranteed distributions and then less fees, which we'll start to unpack those fees as well. There's probably not going to be a column on the illustration showing the fees, but the fees would be part of those calculations that you'll see in the illustration. That's most of the columns, I mean, there can be variations from company to company. But am I missing any main key columns that I should be thinking about?

10:28
Jason Rizkallah
Death benefit maybe?

10:30
Wade Pfau
Oh, yeah, good.

10:31
Jason Rizkallah
Yeah, that's a very common column. And all that's simply illustrating is that if all people entitled to income or owners of the contract were to pass away, if the contract essentially ends because the people have passed away, what benefit amount, if any, would be left to beneficiaries in any given year from that? That's simply it.

10:57
Wade Pfau
Okay. Now, I did mention the previous episodes. I've learned a lot about these just by recreating those illustrations and making sure I understood all the calculations. Usually a lot of these annuities, they have some marketing brochure that's detailed enough that it helps you understand how that illustration was

created or you may dig into the contract if necessary to see the full set of details. But there is well, we've talked about the illustration. Now let's shift into the contract. And this is where, well, the illustration will show fees. So I guess we're not completely leaving the illustration yet, but somewhere on that illustration, it's going to show a list of fees. What kind of variable annuity fees in this one? Let's start with you, Brian. What might we see on the fee list with the variable annuity?

11:48
Brain Bass
Yeah, I mean, the fees are going to be dependent on the suite of services, really. There's so many bolt on different types of riders and different types of things. You can add to these annuities that are really going to dictate the overall fee. But really, when you look at it just from a bare bones perspective, you're going to have different companies call it different things, but the M and E fee is usually the big one. And again, depending on where you buy it and what type you're buying, somewhere around that 1% number, you get that fee and then you're going to have your rider fees. So if you bolt on any kind of guarantees, those are going to have fees also. And then strictly the variables are only going to have fees for the investments because again, the fixed index don't have investments, the speed don't have investments per se.

12:37
Brain Bass
So the variable, they're going to have a fee which essentially gets paid to the asset managers to manage those mutual funds that are underneath the surface. So there's a whole bunch of different layers of fees in the variable to consider. And again, it really just depends on what the experience you're looking for because those fees are charged to the market value. Right. So that's essentially the value of that contract that's yours, quote unquote, that has nothing to do with the income side. That just strictly the market value to the death benefit we just talked about. That's where they really start to apply those fees in the calculations.

13:09
Jason Rizkallah
And that's why on an illustration, if you look at a zero rate of return, the zero rate of return page, you'll see your account value technically go down. It's depreciating and it's because of those fees as to why those are.

13:27
Wade Pfau
Under.

13:27
Jason Rizkallah
That correct. And the writer fee, yes.

13:31
Wade Pfau
It varies from company to company, but it may be charged on the higher benefit base since the guaranteed income is determined by the benefit base. Correct illustration worked. You may wonder why in the deferral period the fee is rising and it's probably because the rider is being charged off of the benefit base, which is rising with a roll up rate.

13:55
Jason Rizkallah
Yeah, absolutely.

13:56
Wade Pfau
All these pieces interconnect and at the end of the day, it is possible to understand how these work. But of course, again, it is also important to work with a financial professional who has a lot of experience, because when you're doing it yourself, everyone makes mistakes. But you don't have the chance to effectively learn from your mistakes since this is something you tend to only do one time in life. Whereas the financial professional already knows the mistakes that can be made and knows how to avoid those and help to avoid that type of situation.

14:30
Jason Rizkallah
I often use the example of typically you buy and sell more homes in your life than you do annuities. So it's a transaction you don't do very often and they change quite frequently over the years. Or they could change, I guess I should say.

14:47
Wade Pfau
Yeah, okay, well, let's now move into the we've looked at this illustration and we're convinced, so we want to move to the purchase stage and we're going to be getting into the contract phase of the variable annuity. What should people be looking for there? And this could be a pretty long document. What kind of details are in variable annuity contracts? That maybe we hadn't yet seen in the illustration. Jason, to start sure.

15:20
Jason Rizkallah
So you're going to see which may there's going to be some overlap of what's presented in the illustration to what is actually in your contract, such as like definitions of terms that's going to take up a lot of the contract, them explaining to you what they are essentially showing you in the contract. But besides the normal information that you would see, like in a SPIA, like your personal information, your date of birth,

where you live, your name, the beneficiaries again, anything like that's been put on. Besides the normal information that would be on a contract, you're going to see what the underlying investments that you initially selected when you went into the contract listed there. You're going to see all of the different layers of fees. This is why it can become a quite thick contract for variable annuities. And then again the definition and explanation of how the surrender works, withdrawal provisions that are within it, death benefit provisions, the more kind of bells and whistles that Brian explained that you add on, the thicker that contract is going to know over time for that.

16:29

Jason Rizkallah

But then you will also see what those bands are that Brian was explaining between the payouts. You're not going to see that on the illustration. You're going to see that in the contract where it says if you start income between this age and this age, it's this percent versus the next five years or the five years after that. That's all present in the contract, not the illustration. Just in comparison for that.

16:53

Wade Pfau

Yeah, on that point too Brian, we're talking about a living benefit here. So those age based payout rates would be linked to the living benefit. But another thing you'll see in the contract that might be confusing, there's probably going to be annuitization table buried somewhere in the contract. What's that all about?

17:14

Brain Bass

Essentially just looking at it, applying what the rates are at different ages. You're applying that to again, whatever the value is, whether you're using the living benefit writer, using the market value, if you don't have the living benefit, you're actually just using whatever the market value is on the day of the annuitization. So it's two very different things. Annuitizing the contract on a variable with no income writer is essentially the same thing. You're using an actuarial table to figure out how much money they're going to pay you every month versus the living benefit writer where you have kind of a defined you kind of can pretty much calculate where you're going to be on a worst case scenario and what they're going to give you. Annuitizing the contract is just a very different story. They're basically giving you back your own money once you turn that on until you burn through whatever that market value was.

18:05

Brain Bass

And then from then there on they're giving you the insurance company is giving you their own money at that point, versus a living benefit writer, where it kind of gets into the weeds of where is the money actually coming from for the distributions and how they're calculating those things. So that's very important to understand. What you're actually doing when you turn these contracts on versus income is income. Is income. It's not always like that.

18:33
Wade Pfau
Yeah, every annuity can be annuitized, and so that contract will have these annuitization tables. But in practice, aside from SPIAs and dias, usually annuities are not being annuitized. And if you're using the lifetime income, it's the living.

18:50
Brain Bass
That's very important, too, because when you get to that point, you have to submit paperwork to turn these on. They don't just automatically turn on and start sending you checks. So when you fill these paperwork out, when you fill the paperwork out, there are sections in there that say, are we annuitizing or are we turning on lifetime guaranteed income stream? So it's very important to even understand at that point, and typically that's when you're in your late sixty s, seventy s, and maybe even 80s when you're turning these on, you may not even understand what you're signing. And so you've paid for this living benefit writer for X amount of years, 10, 12, 15 years, and then you choose the wrong option when you go to turn it on, you could have a very different experience than what you're expecting. So the paperwork on the front end and the back end, when you turn it on, is so important to understand.

19:36
Speaker 5
Are you looking to make sure your reliable income is, well, reliable? Schedule a call today with Jason Rizkallah at McLean Asset Management to review how your annuities fit into your retirement plan. To get started, go to McLeanam.com/review. Again. That's McLeanam.com/review.

20:04
Wade Pfau
Great. And Jason, another part of that contract that probably wasn't in the illustration was the idea that fees can be changed in the so maybe they're going to add some details on what the maximum possible values or what information would you want to make sure you understand with regard to future changes in fees?

20:26
Jason Rizkallah
Yes, make sure that one, the contract that was issued to you is in alignment with what the illustration stated was certain rider fees that are verifiable with the illustration. But make sure you understand what the fees could potentially go up to, because again, you do still have this free look period with variable annuities that if things are not what you're comfortable with once the contract issued, you can change that. You can change your mind on it within that period. But the fees, like the mortality and expense that Brian was talking about, m e, even the rider fees and operating expenses on the underlying funds, I mean, they're all variables. They can change. Will they know not every company changes it every time. They can, but they

do have the ability to do so and a lot of times that has to go into what Brian was saying, why certain companies issue out certain speas and not others.

21:26
Jason Rizkallah
They have to look at their book of business and see what risk is on the table when they're guaranteeing these. Because when they issue this contract today, they're guaranteeing you this for life, is what they're doing. So they want the flexibility to be able to adjust fees as needed. And they have that in the contract if you read and it'll tell you what they can adjust them up to like a maximum fee, which generally isn't the fee that it's being issued at. I can tell you that right now. The contracts I've read today are much lower than that. But that is a variability that you do have to pay attention to and make sure that you're comfortable with. Because it could happen. Doesn't mean it will, but it could.

22:06
Wade Pfau
Okay, I just had another thing I wanted to talk about on this. What else could be in the contract? And I'm completely blanking on what that was. More details of what's in a VA.

22:23
Brain Bass
I think while you're thinking about that, if we step back to the application process of these, you do have a whole bunch of decisions to make around the actual investments that you choose. And that part of the application can get rather robust as well. Typically there will be 20 to 30 managed funds where you have just we're going to pick an allocation, it's 60, 40, 70, whatever that is, and you get a suite of, I won't say a specific asset manager, but you're going to get XYZ. Asset manager is going to manage every one of those funds. You can buy ten or twelve of that asset manager's funds versus the next asset manager. And then you can really get into the weeds too, of designing your own asset allocation. So it's not just kind of for the people who get into the weeds. There's a ton of variability in the variable annuity.

23:15
Brain Bass
And so understanding that piece and I guess how hands on you want to be in designing these products, typically once you select that allocation, you're locked in for a certain amount of time on those. So it's not forever, but you can change them, but you are locked in. So it's important to kind of go into these products understanding what am I looking for from this experience? Do I want to do this on my own? Do I want to just pick an asset manager, or do I want to just pick let's just the insurance company typically has their own mutual funds, their own stuff that's in there. You could also choose those things. So even on the application process you're going through, you're making a lot of very important decisions. I guess it behooves you to do your research, understanding what's available to each one, because different annuity providers in this space will have different investments available to you.

24:03
Brain Bass
So it's important to do your research there as well.

24:08
Jason Rizkallah
And also consider the risks because you don't have principal protection within variable annuities like you have within fixed index annuities FIAs. So you have to be mindful of know in the VA.

24:23
Wade Pfau
Absolutely. And thank you for saving me there, Brian. It did give me a chance to remember what I wanted to talk about. Something else you need to understand in the contract, the idea of the free withdrawals. Now, most annuities will allow you to take out a certain amount without triggering surrender charges. Often that's up to 10% of either the initial premium or the remaining contract value before any surrender charges are triggered. So that's one aspect of it. But another is if there's the living benefit, you're allowed to take out amounts that are not lifetime distributions. So before you turn on the lifetime distributions, you could take out one of these non lifetime distributions without turning on the benefit. And then even if you have the benefit turned on, you are allowed to take out more than the guaranteed withdrawal amount. But whenever you do that, there's going to be an adjustment to the benefit base to reduce your subsequent guaranteed income, which is logical.

25:24
Wade Pfau
Just think, if I'm spending for my investment portfolio and I take out more than I was planning, I'm going to have to adjust my spending in the future because of that. But can you talk a little bit about what that might look like, Jason, in terms of what to be looking for? Just in the case that you do need liquidity, that you do need to take out more than the guaranteed withdrawal amount, do you understand how your subsequent guarantee would be impacted?

25:52
Jason Rizkallah
Yes. So because these are not when you go into them, they're not annuitized. Right. So you do have some value accessible to you with them and to avoid a surrender charge only comes into play when you take out more than this free withdrawal amount. Let's say 10%, because that's average, that's common. Or you cancel the contract entirely if you're just taking out that 10% free withdrawal amount. They call it free withdrawal because there is no surrender charge associated with it. So if you put in $100,000 and six months later you need to take out some money from it. There you go. The details about when that is allowed and what that 10% is based off of can vary from firm to firm or carrier to carrier, product to

product. Even some allow you to take that 10% within the first contract year. Some make you wait one full contract year.

26:50
Jason Rizkallah
Some base it off of the market value. Some base it off of the initial premium that you put into it. It can have some variability around what is that based off of. So that's important to understand if that's something that is of a concern to you or something that you think you may need to utilize at some point, then you would want to understand the details around. What is that 10% based off of and how often can you get it if you need it. And then ultimately, also, as Wade had said, what is the effects of taking it out not just on the market value, but on your income benefit? That ideally, is what you got into this annuity for the income benefit that it provides. So does it affect it dollar for dollar? Is it just a reduction of a certain amount of it?

27:37
Jason Rizkallah
Understanding how that affects the income benefit is also very important, which is explained in the contract when you get it. So when you get the contract and you read through that, make sure you read through that section carefully. And again, it can be different from contract to contract, carrier to carrier. There's no blind kind of way that those things run. It's how the product was designed. So that is something very much to pay attention to.

28:00
Wade Pfau
Yes. Great. And so that's what I had on my list to talk about with variable annuities. Can either of you think of any important details?

28:07
Brain Bass
I would just add one thought to that. We talked last time about in our last episode about the importance of choosing carriers, the variable annuity, and to an extent the fixed index annuity, but the variable annuity especially, you want to understand who you're getting into bed with. There are really great companies out there that will provide amazing service. And this is one of those examples where you're going to need to be able to get in touch with the carrier to understand things and have someone really explain them to you. And there are some companies out there that have really horrible customer service that you can call and never get in touch with anyone. You're going to get in touch with a call center somewhere. So choosing a variable annuity carrier is very important for this very reason, right? So if you decide the planning fails, things went wrong, I need to get money out of this, it's very important to call the carrier and have them rerun your illustration with this new withdrawal to show you exactly what happens to the income.

29:04

Brain Bass
Because ultimately we're not buying this for the market value, we're buying it for the income benefits. And so taking money out of the market value has a very negative effect on the income stream, right? So being able to get in touch with your carrier, having them run illustrations and run multiple illustrations, if it's 5% or up to 10%, show me what that looks like, what does that do to my income stream? And again, choosing the carrier in the spot that's going to be there for you when you need them is vitally important because you don't want to make these decisions just off the cuff. You want to see what it's actually going.

29:37
Jason Rizkallah
To do.

29:40
Wade Pfau
Absolutely. Great point. Thank you. Let's move into the fixed index annuity world, which will have a lot of overlap with what we've been talking about, a lot of the same terminology and so forth, but also some differences. And again, I hope we can talk a little bit about what a fixed index annuity illustration is looking like and also anything to pay attention to with the contracts as well. So fixed index annuities we've already talked about in past episodes. They have some sort of crediting method, principal protection, and then some exposure to participate in market upside. Jason, there's going to be a lot of crediting options or even indices and crediting options to choose from, and you may even be able to allocate between different options. So when you see that illustration, I guess a good place to start with the fixed index annuity is what do you want to look for in terms of what are they illustrating for you?

30:43
Wade Pfau
Which indices did they choose, which crediting options did they choose, which term did they use, and what are people going to be looking for with that particular aspect as a starting? Sure.

30:57
Jason Rizkallah
So, like the variable annuity, it's imperative to get a zero return scenario within your illustration. That way you see again what that minimum guarantee is under a worst case scenario. What's that minimum income amount I'm going to receive if this thing doesn't earn a dollar the entire term? And then from there, you can back into, again, setting either flat rates of return, an average rate of return to it to see what would happen under certain growth assumptions. But there's going to be usually a more limited selection of underlying I don't want to use the word investments because they're not really investments indexes to choose from, if you will, than the variable annuity offers. And in this case, as Brian had mentioned before, that you're not actually invested in these options, physically invested in them like you are in the variable annuity. The credit that you receive is based off of the growth of these underlying indexes.

32:03
Jason Rizkallah
And there's generally two different ways that they can illustrate that. It's by a cap rate or participation rate. It's those two methods that they use. The cap rate is basically, if you pick, let's say, an S and P 500 index to model your crediting after, basically your growth is based on what the S and P 500 does and you pick a cap rate, well, you're going to get what the SP does up to that cap. So if that cap is 5%, you'll get 5%. If it earned 5%, okay. If it earned 6%, you're still getting five. That's the way that cap rate works. So you will get whatever the growth is up to, whatever that cap is, the participation rate is different. You're going to participate in what the S and P 500 does up to a certain percentage. Let's say that percentage is 30%.

32:55
Jason Rizkallah
That means that if the S and P 500 actually performed 10% that crediting period, let's just assume it's sorry, price return.

33:03
Wade Pfau
We've said that a lot on the past episodes, but it's always something that it's not the total return, it's the price return.

33:09
Jason Rizkallah
Correct price returns. No, the devil is in the details. So that is important. Yes. So, yes, the price returns 10%, you'll get credited with 3% 30% of that 10%. So Caps are what you can earn up to, but nothing above participation, essentially, is you're going to get just a piece of what it does overall. And then there's different terms that you can choose. One year, two year, three year terms. So sometimes you could see and this is all in the illustration, depending on what it is. So pay attention to what they're illustrating to you. You may see an illustration that shows you some returns, not the negative, not the zero rate of return, but maybe some 5% average rate of return. And you'll see that it's every three years, that it's doing something within the account value. That's a three year participate strategy term is what they call it.

34:00
Jason Rizkallah
And you can choose one, two, or three. Again, going through all these options and which is the best one to choose, is very dependent on your personal feelings around things. Are you optimistic about the market? Do you prefer caps? Should you choose the S and P index? Another one? Should you choose a one year or three year term? These are all important decisions for it. And this is where, again, working with a professional agent can help with what is the best ultimate decision to choose from, to help align my underlying strategies with it's a lot of terminology. It's hard to kind of explain again without the illustration

in front of you. But as you can see, there's many options, so making sure you understand what they are and what is being presented to you is of the utmost importance.

34:49
Wade Pfau
And one point to emphasize is what you said, too. If you have a two year term to keep it more simple, it may look strange until you really understand the point, but you'll see an OD number of years, you're always credited with 0%. And then in the even number of years, you're credited with that's when you receive the crediting at the end of the second year in a two year term. And so that crediting you receive in year two isn't just based on the year two return, it's based on the cumulative performance of the first two years. And that's an important detail. And then, Brian, I asked you about this in the context of variable annuities before, but it's probably even more relevant with the fixed index annuity in the scenario where you are looking to take out more than the free withdrawal. If you're not going to hold this contract over the long term, in the early years of the contracts.

35:42
Wade Pfau
And it's only in those early years, and we talked about somewhere maybe five to ten years, the withdrawal amount may be less than the contract value due to the surrender charges and or market value adjustments. Could you refresh us since that was in the last episode? And it's particularly relevant with the fixed index annuity, what those two factors are all about.

36:04
Brain Bass
It is, and I think it's important to call out to your point, these are long term investment vehicles. If you're taking these opportunities to take money out, it's because something bad happened, the plan went wrong, or there was a cash need or something that wasn't foreseen popped up because it's rarely advantageous to start pulling money out of these contracts before you turn them on. Just as the kind of caveat there, the adjustments happen when markets move around, right? So the market value adjustment is in the first, let's just say it's ten years. We have a ten year surrender period. Somewhere in that first ten years, we need to take out that 10% free look. So we're going to pull that 10% of the value of the market value out. The insurers will go in and adjust that for rates because ultimately, at the end of the day, this is a fixed product.

36:57
Brain Bass
The fixed rate of return, a part of that return stream is based on what they're going to give you in that fixed interest rate on the contract. And that's labeled in the illustration. It's in the contract. It tells you kind of where it is that does float around. So as interest rates go up and down in the real world, that has a negative effect on the actual day to day, quote unquote, value of that contract. If you were to pull money out of it, they're going to go in and adjust it for where interest rates have gone up or down. Rates go down, they are going to adjust it up, rates go up, they're going to adjust it down. Right? Same kind of math as fixed income

works in the real world. Rates up, price down. So that's the adjustment that's very important to pay attention to.

37:41
Brain Bass
And again, the last place you really want to go for liquidity purposes is these annuity contracts because again, you are going to get negatively affected by taking money out.

37:56
Wade Pfau
One point to say here, and when I say this, it's going to make me sound like I'm annuity salesperson or something. But it's a valid point that if you're pretty sure you're going to be a long term holder of a fixed index annuity, you might actually prefer having a higher surrender charge schedule because that's just creating more ability for the insurance company to buy less liquid, longer duration, potentially higher yielding type investments to give you a better performance. Now, if you end up needing to take more than the free withdrawal out, you might feel bad about picking the higher surrender charge schedule. But again, for those who are going to hold these over the long term and are using them for living benefits, which implies a lifetime relationship here, surrender charges, especially in the context of a fixed index annuity, are not necessarily a negative.

38:49
Wade Pfau
This is where, again, I don't mean to sound like a salesperson, it's just they can be a positive to the owner of the contract over the long term because you're not going to be affected by the surrender charges, and it's giving the insurance company more flexibility to go into higher yielding type investments with the premiums.

39:08
Brain Bass
Yeah, that's a great point, too, when you're evaluating the insurance companies you're going to purchase these contracts from is look at their general account, look at their investment performance. I mean, that's all public knowledge of kind of how they're doing and the way they invest their money. The more aggressive the company, the more likely things are going to go wrong. And there are really reputable companies out there that have a great credit rating, and part of that credit rating is the performance of their side account, their general account. And so those are all things that kind of go into the calculus of who you choose to I mean, again, this is a lifelong commitment to this company, so it's important to understand how they're going to invest ultimately, how they're going to pay you these guarantees, because that's what these are. They're the guarantees of the insurer to pay you back this money for the rest of your life.

40:01

Speaker 5
Schedule a call today with Jason Rizkallah at McLean Asset Management to review how your annuities fit into your retirement plan. Schedule a call today with Jason Riscala at McLean Asset Management to review how your annuities fit into your retirement plan. To get started, go to Mcclainam.com review. Again, that's McLea Nam.com review.

40:31
Wade Pfau
With these contracts. So fixed index annuities is probably rare to see a benefit base, but nonetheless, if you have a guaranteed lifetime withdrawal benefit, there's going to be some columns on the illustration that are showing how that works. And O'Brien you talked about with the VA, it's very similar. It's an age based set of payout rates multiplied by, in this context, the contract value, but which is principal protected, at least gross, of any writer fee that may be part of the contract. So you want to understand that detail. And then if the illustration is showing any sort of increases in that guaranteed income, you want to understand why. And also to the point both of you made, it's often the case with fixed index annuities that there's even a stronger case to be made for assuming there is no growth beyond what's guaranteed, especially if the cap rate isn't high enough to offset the distributions that are allowed.

41:34
Wade Pfau
You're never going to get any step up correct. But the way that withdrawal rate might work is you're going to take that age based factor and multiply it by the contract value, which with enough growth could increase over time. But once you start taking distributions, it becomes a real slog to have that contract value still increase net of distributions. Yep. And Jason, I saw you, I was.

42:00
Brain Bass
Just going to say the illustrations for fixed index and News are pretty clean for the most part across the industry. I mean, you typically have one page you get to your point, the payout rate. It shows you age to age and they'll give you a range. If you illustrate this to take out money in the 8th year, they'll start with that year and they'll show you the next sequential ten years and what that payout rate is. It's not nearly the dramatic changes like you get in the variables and you'll have a guaranteed column. You'll have a non guaranteed column. So you can kind of pick and choose how you want to illustrate that across that one page, which is very simple, it's very easy to understand. You apply your payout rate to the guaranteed base or the non guaranteed base and you can kind of see what the differences are.

42:45
Brain Bass
It's very clean, it's very easy. The underlying and the way you get the crediting and all the things are very complicated. But the illustrations are usually pretty clean and pretty easy to follow along.

42:58
Wade Pfau
So now, moving into the contract again, we've looked at the illustration, we've decided to move forward. We're going to at some point here in this process receive a contract for the fixed index annuity. Part of this is a refresher because a lot of the things are the same. But what do you want to be looking for in that contract? And then we can also talk about what are some unique aspects of the fixed index annuity in the contract as well. But Jason, let me turn to you for that. When you receive the contract regarding the fixed index annuity, what sort of features should you be checking in that contract?

43:37
Jason Rizkallah
Sure. Just as I said about the previous ones. Make sure all your personal information is correct on it. Always needs to be the case. Beneficiaries are correct. Premium amounts credited were the amount that you provided to them. One important factor is the structure and this is actually true of all of them. But just paying attention to the FIA right now is when you're choosing living know withdrawal benefits, when you're choosing those kind of benefits, how you structure the contract. As Brian actually had said earlier.

44:14
Wade Pfau
Some.

44:14
Jason Rizkallah
Carriers have a specific way. There are some policies that are owner driven, some that are annuitant driven and you have to know this and how you're structuring the account, especially if there's joint lives being covered. And then the titling of it, whether it's a trust, individually owned, IRA owned, has also to do with it. So making sure that begins at the application process with the agent that you're working with, making sure that is and even sometimes that information isn't clear when getting it directly from the insurance carrier. It happens, but that the contract is reflecting what the application ultimately said, which was the correct way to structure it. That is very important because that determines how your benefits and for how long and who your benefits can be received by. So making sure that's all aligned with what is appropriate and your agent should be reviewing the contract before delivering it to you to make sure of that.

45:08
Jason Rizkallah
I mean, that's a role to make sure that all was what it should be when it's given to you. But beyond just your personal information, making sure that the structure is appropriate and then also that any income riders or any riders, it could be death benefit riders, anything like that you did elect is reflected in the contract. And again, that the fee that was presented to you for those at the onset of the contract is what was presented there as well.

45:35
Wade Pfau
And then maybe one of the factors Brian, in the contract, that would be the sort of the section on the minimum interest rates or just more generally saying that an FIA is principal protected. It's true, but it's a little bit of a simplification around how the process truly works with regard to the interaction of surrender charges and so forth. But can you talk a little bit about this whole idea of a minimum interest rate as part of the contract and how that might start less than the premium, but by the time the surrender charge schedule ends could end up. If you decide to leave the contract at some point in the future, you might have slightly more than the principal protected based on what that minimum interest rate is.

46:20
Brain Bass
Sure, yeah. And that's in the very back of the contracts where they show you all the fund numbers. It is. So the longer you hold it Jason, have you ever seen one below 1%? So the longer you hold it jason, have you ever seen one below 1%? It's typically right around that 1% number.

46:43
Jason Rizkallah
No. Yeah, it's about typical.

46:47
Brain Bass
Again, you're not buying these things because they're going to run through the roof with amazing growth. You're buying them for the guaranteed things that go into them. So it does have a guaranteed interest rate. The longer you hold it, you are guaranteed some price appreciation. Again, that's not why we're buying these. It's not like you're buying a 30 year treasury where you're going to get whatever. I don't even know where the curve is right now. Two and a half, 3% on the long end and that's going to just accumulate over time. You are going to get a very low interest rate because again, if you look at it from the other side of the table, the insurance company is essentially guaranteeing you these payments well beyond any money you've put into it. If you live to be 140, they're still on the hook for those payments.

47:30
Brain Bass
When you're 140 years old, obviously the actuarial tables and everything don't go nearly that far. So for that protection, they're going to say, okay, well, bond interest is 5%. We're going to give you a guaranteed one. That's the delta. That's where we're going to make our money. That's where we're going to do our thing for giving you these opportunities to have this money for longevity protection. That's ultimately why we're buying this, is if I outlive all the projections, I still have this guaranteed income. And who foots the bill for that? It's the insurance company.

48:08
Wade Pfau
Especially with the fixed index annuity, if you're using it for the living benefit, you can be pretty much rest assured that you're going to spend down the entire contract.

48:17
Jason Rizkallah
Absolutely.

48:19
Wade Pfau
It's going to work a lot like a SPEA with a cash refund in terms of might do a little bit better than a SPIA with a cash refund, but by the time you're getting to life expectancies, you should anticipate the contract value will be gone. So if you have this planning age of I want my financial plan to work into my 90s, there is not going to be anything left. And so at the end of the day, the evolution of the contract value is not all that important or relevant. It's much more what that guaranteed withdrawal amount is, because that number does continue after the contract value is depleted. And I suppose it is worth emphasizing that point and that's sometimes these get used for accumulation tools, but when you're using it for income, you want to focus on the withdrawals.

49:12
Jason Rizkallah
You also have an exclusion ratio with those on the taxable side too, as well. But the taxation of it is not as predictable as it is with a SPEA because there is growth potential and things like that. So the predictability of the taxable portion of payments is less in an FIA than it is in a SPEA. Just keep that in mind, too, sometimes. I have seen one or two illustrations where that's actually illustrated in a way not common. You're not going to see that too common, but I have seen that before on some OD ones.

49:48
Wade Pfau
Yeah, it's more complicated. Just gains come out first and then your premium, and then once you've exhausted the premium, it's all gains after that point. That's when by that point you're in that settlement phase getting that guaranteed lifetime income. All right, I think we've covered most everything I was thinking to do with fixed indexed annuities. Any last thoughts from either of you on the fixed indexed annuity topic?

50:18
Jason Rizkallah
No. I mean, they're appealing to a lot of folks because they do offer principal protection, yet a potential for

upside growth of income and give a lot of predictability there. So they can be oftentimes a popular option for folks to kind of gravitate towards because they offer you some of the benefits of a SPEA, which is like, predictability some of it of a VA, which is like growth potential. Some people view it as like an in between the two option that you could go with. And a lot of insurance companies have been putting a lot of resources into FIAs recently. You'll see kind of where they see the market going by what resources and what options are available out there. I would say that in my experience, the FIA market has drastically improved over the past ten or so years. The options that are available, the features available has gotten better over the years.

51:15
Jason Rizkallah
Just my opinion of actually working with these things for the past 1517 years.

51:21
Wade Pfau
And another question this brings up for me. So there is anomaly where sometimes FIAs can have higher payout rates with the living benefits. The living benefit on a fixed index annuity could be higher than an equivalent SPIA or deferred income annuity. Have you been seeing that recently, where that anomaly is out there right now? And if so, we should probably mention just briefly why that happens, although implicitly it came up earlier in the conversation. But right now are you seeing that very often?

51:54
Jason Rizkallah
I can go with that. I've seen a lot of illustrations. I would say that from a comparison between an FIA and a SPEA. So fixed index annuity to a SPEA, the immediate payout, if you were to start income immediately, is not that far off from each other. There is a slight reduction on the fixed index annuity side versus the SPIA, but it's almost negligible at this point. What I've seen in today's market, which is what we're looking at today, the FIAs, if you're deferring income, seem to be for the most part surpassing what the Speas are willing to offer for deferral. Even so, if you're looking 3456 years out, you're going to most likely find a better option with the fixed index annuities than you will the Speas right now. This wasn't the case last year. Last year wasn't the case with that. The Spears were offering a better immediate payout and then in some cases under the shorter duration terms, a better payout.

52:55
Jason Rizkallah
But the market has flipped. I mean, these are heavily weighted on interest rate environments. And where they're at again, where the insurance companies see that they have room to be able to offer more payouts and higher benefits under certain products rather than others. And that's all reflective into the essential price that you pay for the income that you're getting. And right now, FIA seem to be doing a really good job of, if not matching, surpassing what the speed is, are giving.

53:23
Wade Pfau
Okay, theoretically shouldn't be the case.

53:28
Brain Bass
Yeah, I've seen it as short as twelve months. If you have twelve months to defer a lot, I'm thinking of one very specific contract. A twelve month deferral is beating a Spee at this point using the fixed index annuity yeah. So, I mean, that's very short term.

53:43
Jason Rizkallah
That's as short as twelve months.

53:46
Brain Bass
And that kind of hammers home the point. I believe it was the other episode. We talked about this, but it's so important to be able to have someone in your back pocket to go into the market and really evaluate all these different types of products because there's such variations in the principal values, the timing of the income, the different types of products. Even on a day to day basis. These carriers are so fast and they all adjust. To your point, Jason, about the interest rates as rates change, I guarantee even today we got a 25 basis point hike yesterday. I guarantee you there's different contracts and different payouts, and they've already readjusted everything for contracts that you get illustrations on today versus yesterday and the day before. So it's a fluid environment. There's no one size fits all where this is always going to win or that's always going to win.

54:34
Brain Bass
It's so important just to get the quotes, do your research, understand what you're doing, and then really go out there and figure out what the best way to do the one thing you're trying to implement today. How do we best do that?

54:47
Jason Rizkallah
Can I add something to that, too? We find this a lot in the planning engagements we have is when we are recommending annuity strategies, oftentimes the question will come up, well, should I wait to implement this like market time? Exactly. In a way, our philosophy on that is that if the numbers work today, with what's available with you today, you should move forward today. You shouldn't wait to see if it gets better, because it could get worse. And what we do know is that today's numbers work for you. The interest rate

that they're paying today, the premium you have to give up to get the income that you need, all fits your plan. You should move forward today. Implementing today is better than implementing tomorrow and hoping that it's a better know hope is not a plan at all. And so you just want to go with just as Brian had, just know if it works today, move know, and hey, interest rates could go up three months from now, a month from know, we don't know.

55:47
Jason Rizkallah
But you can't really base it off of that. You have to base off of what we do know today.

55:52
Brain Bass
And you also don't always get the expected mean. If you're looking at trying to from an interest rate play if you're looking at interest rates going okay, well, interest rates are going to be higher. This FIA is going to pay me higher tomorrow or next week or next month. Whatever it is you're trying to game out, you might get the expected interest rate experience and not get the expected experience from the annuity contracts. It's not an intuitive one to one ratio where rates go up, payouts go up. It doesn't always work that way. I mean, these companies, we kind of went into this earlier, they are protecting their own books of business, they're looking inside themselves, going, okay, where do I want this exposure? And so even if you are correct in your gamble of rates are higher, rates are lower, markets up, markets down, whatever, it may not translate into the experience you're expecting with these annuity illustrations.

56:40
Brain Bass
It just doesn't always work that way. So to your point, Jason, if you get something that works inside your plan today, let's lock it in and go because you don't know what tomorrow is going to do. Even if you're right, you don't know what tomorrow is going to do.

56:51
Bob French
That's correct.

56:54
Wade Pfau
And that locking in that commitment to a strategy is a preference we see with those income protection and risk wrap styles. If you go to the McLean website, so our homepage, which is McLeanam.com McLea Nam.com, you'll see on the right hand top corner a Get Started button.

57:23

Jason Rizkallah
If you go to the McLean website, so our homepage, which is Mcleanam.com McLea Nam.com, you'll see on the right hand top corner a Get Started button. If you click that button, just fill out some quick information. Usually it's your name and contact information, email or phone number, and you're able to include a message there too as well. And you can specifically ask to speak to Brian or myself if you would prefer to speak to one of us directly and then our team will get it, give it to Brian or myself and we'll follow up with you and be happy to answer any questions you have.

58:01
Wade Pfau
Awesome. Thank you again so much to both of you for joining us in these past two episodes. I hope this helps cut through a lot of the fog and confusion that exists out there with annuities. These are contracts, these are illustrations that a lot of times people just throw up their hands and say it's too much. I don't want to even think about this, but it's not insurmountable. Definitely talking with either of you can help anyone through that process who may be interested in at least learning more about annuities or again, any other aspect of financial planning as well. So thank you both. Thanks again, Jason and Brian from McLean Asset Management. Wade and Alex are both principals of McLean Asset Management and Retirement Researcher.

58:47
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 appropriate for you, consult your financial advisor. All investing comes with a risk, including risk of loss. Past performance does not guarantee future results.