Episode 86: What to Look for in Annuity Illustrations and Contracts (Part 1)

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. While Alex is off swimming in the Norwegian fjords, wade sits down with Jason Rizkallah and Brian Bass from McLean Asset Management to talk about what you need to keep in mind and understand when reading annuity illustrations and annuity contracts.

00:55
Wade Pfau
Hey, everyone. Welcome to retire with style. I'm Wade and this week I am not joined by Alex. Alex is on a family vacation. It is summertime. But to make up for his absence, I have two of our great advisors at McLean Asset Management who are going to help with this episode. Jason Rizkallah and Brian Bass. Welcome both of you to the show and you've been here before, but let's just start with letting you give a little bit of background about both of yourselves to understand your role. And then what we're going to talk about today is getting into the specifics of annuities. So it's not concrete anymore. If you're thinking about the annuity and you speak to someone, you'll see an illustration, you'll see a contract of what we're going to talk about today is how to read these, understand these, interpret them, and so forth.

01:44
Wade Pfau
And so can you just fill us in a little bit before we get started on your background and how you're going to be very useful to explaining some of these real world details with annuities.

01:56
Jason Rizkallah
Sure. I'll start.

02:01
Jason Rizkallah

As some of you may know me from past podcast. My name is Jason Rizkallah, and I'm managing Director of Financial Planning here at McLean. I have about 17 years of experience in the industry, always on the individual advising, planning and investment management side of the business. I am married, I do have a nine year old son, and what I spend most of my time here at McLean doing is actually creating and presenting holistic financial plans that oftentimes include strategies like annuities being recommended to better a situation or provide benefit to the individuals that we work with. And I've worked with annuities, I would say, my entire 17 year career in one capacity or another. So very familiar with how they work, very knowledgeable. More importantly, know when to use them, when not to use them. But that's a little bit of background about myself.

02:54
Wade Pfau
Great. Yeah. Thank you, Jason. And thanks. I remember last time you were on the show, you didn't mention your family, so you've learned a lesson.

03:04
Jason Rizkallah
Learned that. Yes, I did.

03:07
Brian Bass
Brian, it's always a pleasure. Wade, thanks for having me back. I'm Brian Bass. I'm a managing director on the other side of McLean Asset Management. I deal with the wealth management side, so we do comprehensive planning where Jason is more on the one time planning. I deal with ongoing planning. So the idea is helping people through retirement all the way from the start to the end, and then obviously managing wealth through the decades as well. I also have been dealing with annuities for a very long time, ever since I got into the business. I was very fortunate to study underneath you, Wade, so I cut my teeth. I got my master's degree underneath you. So thank you for all your tutelage over the years. So I'm very well versed in annuities. Same kind of token with Jason. We work with them. We look at when to use them, when not to use them, and then how to best choose the right product for the right situation.

04:03
Brian Bass
There's obviously a lot of pitfalls. There's a lot of places you can go wrong. There's a lot of adventurous salespeople out there that like to just kind of put things out and don't really care where they fit or how they fit. So that's kind of our role also is filtering out some of the nonsense that's out there and really helping people understand what they're getting into and give them the right guidance and then implement the right products for the right situations.

04:30

Wade Pfau
Yeah. And indeed, that was a side benefit of teaching in the Master's program at the American College. Get to meet the best students and bring them over to McLean Asset Management. So we do have yourself and also Stephen Pomanci, who are both from the Masters.

04:45
Brian Bass
I'm glad this is recorded. I'm going to put this in the archive and I will pull it out at a later time.

04:53
Wade Pfau
My star students. Okay, so, getting into the episode, as you mentioned, Brian, of course, annuities are not for everyone. And the way this is now, we're getting far into our arc on annuities. So to briefly catch everyone or get everyone up to speed, you think about the retirement income style awareness. Is your retirement income style more along the lines of an income protection or risk wrap? That's when annuity may resonate better. And then you do some financial planning and you look at, is there an income gap if there's not enough reliable income to fill the income gap to make sure you have your essentials covered, however you define your essentials, whatever you want to have reliable income to support. If there's a gap in your retirement income style suggests annuity might be something that resonates to fill that gap, then you're moving into the stage of how do I pick annuity?

05:49
Wade Pfau
And we've talked about how different annuities work, and in these episodes, we will stick to talking about first, it's hard to know how to order all this, but single premium immediate annuities are deferred income annuities, and then variable annuities, and then fixed index annuities. And now we really want to get into the specifics where you're talking to someone, they're giving you like, okay, here's a particular annuity you might like to look at that usually involves receiving an illustration and then from there eventually getting to the stage of looking at a contract. And that's really what we want to focus on today. We will start with the single premium, immediate annuities or deferred income annuities, the simplest kind of annuity. You exchange a lump sum for an income with them. There's not so much in the way of an illustration because there's not so many moving parts.

06:42
Wade Pfau
Nonetheless, when you're getting a quote, it's going to include a lot of details. So let's really get going here with talking about and let's abbreviate it as SPIA. So an immediate annuity, deferred income annuity, a qualified longevity annuity contract, they're all part of the same family. If you're going to pull a quote for somebody to give them information about a SPEA, what kind of information do you need to actually run? That quote is maybe a good starting point.

07:13
Jason Rizkallah
I'll start with that. So for SPIA it's quite simple. We definitely need your date of birth is an important factor because it's one of the determinants in the payouts your name as well. The state you live in is also very important because that can dictate what options are available to you. Insurance products are very state driven and some states have limitations that others do not, which could affect the offerings at the end of the day. So state of residence is a very important piece of information to have too. One of two things also. Either the amount of funds you are looking to put towards annuity and then you want to back into how much income you can get for that, or if you have an income amount as Wade had alluded to. Earlier. If you've done financial planning and know what your gap is, what you're trying to solve for, you can then back into how much premium would it take to get that?

08:11
Jason Rizkallah
So one of those two figures, either the premium that you're willing to use or the income that you need, and either one of those can be used to derive the illustration or generate the illustration. We also use company ratings in there as well. You would want to set a minimum rating so that it helps filter out any companies that you're not interested in.

08:30
Wade Pfau
And then Brian, also just the funding source there in terms of is this going to be from non qualified or taxable type brokerage account or what are the options in terms of I have to pick the funding source? And that's another question. Of course, now that's more of a financial planning question that this particular episode isn't going to go into as much depth with. But you do have options there and how can people think about what type of funding source and how that could potentially influence the pricing that they receive?

09:05
Brian Bass
Sure, I think it's important to kind of lay out too that this industry is extremely competitive and so eventually when we do drill into, we get the plan in place, we know what kind of income or we know how much premium we're looking to deploy. Going in and pricing these things out is very important because even at different price points, some companies will take the lead at, let's say $250,000 in premium, or half a million in premium, or a million in premium. You see very different rates and very different numbers from different companies. So it's super important to really understand that maybe going to one company is not always the best option. It's really going out into the market, pricing these things out. Looking to your point, waive qualified versus non qualified, which is really just IRA or four hundred and one K dollars versus taxable dollars, you get very different experiences and very different quotes come back.

10:00

Brian Bass
So again, when we do look through those things, it's important to jason, your point. Some of the providers that do come back, maybe it's not really one you trust or really want to put all your eggs with. So looking at the ratings, looking at the insurers themselves, understanding their financial positions, because at the end of the day, these are commitments that have to be honored by the insurer. The only real guarantees behind the scenes are is this insurance company going to be able to pay this for the next 20, 30, 40 years? It's important to really do your research.

10:39
Wade Pfau
That was a great point, Brian, Too about the premium could impact which company offers the best pricing. There can be a lot of anomalies as like another issue where theoretically we know what the pricing should look like, but it could vary. Is the specific annuity type in terms of is it life only? What kind of other options are there? Life only is not very popular. There's no sort of beneficiary amount available, but what other kind of options you see there and how do we expect the pricing to work? Sure, but there may be anomalies, yeah.

11:16
Jason Rizkallah
I can run with that a little bit. Well, you have life only. Then you have life with period certains that are built in too, which are very popular because they do add a beneficiary option to it. And that can range anywhere from ten to 20 years, 10, 15, 20 years. Then you have cash refund also, which is a similar but different metric there. Adding those types of parameters into asking for quotes and illustrations from insurance carriers can also yield back a different result. At the end of the day, it's really what line of work a certain carrier is willing or what line of business a certain carrier is willing to accept, and then they'll let you know what the premium or the income amount for a set premium would be and it can change. You can look at a life only and one company is number one.

12:02
Jason Rizkallah
You look at a life with ten year period certain and another one becomes number one or two with that income. Start date is another big factor. Some companies are willing to defer out longer than others with what they have.

12:15
Wade Pfau
Available and the point about which company comes out on top. It may be a particular company that has the most competitive pricing, may not offer the life only option. So it's anomaly. You look at the Life with ten year certain and the best company payout is higher than the best company payout on the life only, which is one of those weird situations.

12:39
Jason Rizkallah
It is.

12:41
Wade Pfau
Now, speas are generally more like commodities in terms of when you're comparing between different companies, it's really a monthly payout and a credit rating. So a lot of times people will see that list of here's ten different companies, here's the monthly payout that they provide. Now in that regard, they'll be listed from most monthly income to least monthly income. Jason, you mentioned putting in a filter to limit the credit ratings, but how does somebody think about this issue and do they always want to go with the company that has the highest monthly income or might they want to look at not necessarily the highest amount? How should people think about that?

13:29
Jason Rizkallah
Sure. No, the short answer would be no. You don't want to necessarily go with just the person who's willing to give you the most income for the cheapest premium or vice versa, whatever it may be. That helps to create essentially running the illustrations help to create what offerings are available. And it's from there that the research really starts on determining which to go with. A lot of it can come down to just personal experiences that we have as advisors and have been doing this for a long time have where narrowing down that list can be quite easy because we have experience with these firms and these companies and we know which ones are easier to deal with than others. The qualifications that it would take to get a policy over another policy from another carrier. So oftentimes working with a professional helps in determining which is ultimately the best choice and which may not be the number one spot there.

14:27
Wade Pfau
Okay. And Brian, usually as well, you're going to see when you ask for these quotes on a particular date, they're going to list the quote, but then there's some sort of expiration date on the quote and they're not always the same. So that's something to also be wary of. And if you wait past the expiration date on that quote, you're in a situation where you may have to start over.

14:52
Brian Bass
Yeah. And two, unfortunately the insurance world right now is very slow and so paying attention to they're called the rate locks, right. They give you a lock on, let's say it's 30 days or 60 days to get it to the client, explain it to them, get the paperwork done, get it all submitted, get the premium submitted and so it's really important to understand what those deadlines are and make sure that we do our best to push things through. But yeah, there are a ton of moving parts to all these things and really understanding them from

the get go is important. So to Jason, your point, working with the professional, understanding someone that understands the business and can kind of navigate the waters a little bit and help work on the client's behalf with the providers is so important.

15:41
Jason Rizkallah
And just a thought too, to keep in mind working with a professional doesn't affect what the annuity is paying out to you or anything. It doesn't have an effect on that. The same offering should be offered through however channel you get to it. There isn't a discrepancy by working with a professional or not working with one.

16:05
Wade Pfau
Right. Just legally there isn't really this idea of direct to consumer annuities somewhere there's always going to be a professional. How interactive you are with that professional. I think the point is that doesn't impact the pricing. If it seems like you are purchasing direct to consumer, it's just they've streamlined, that all, with automation from your perspective. But you're not necessarily or you're not getting better pricing that way. That's important point for sure. Now you're going to see this list, it's going to be the company name and then it's going to show either monthly income or a payout rate. And I have seen people confuse this point. They think, well, they take the monthly income and they divide it by ten or something like that. But you have to remember, if it's monthly income and you want to see annual payout rate, this is more of a reminder thanything.

16:59
Wade Pfau
But you multiply that monthly income by twelve, not by ten, and then divide by the premium, but another number you'll see. Now, if it's a qualified annuity, you won't see this because it all comes out as taxable income. But Brian, could you talk about in a non qualified framework? There's an exclusion ratio and often these lists will show not just a monthly payout, but what portion of that payout is taxable.

17:28
Brian Bass
How does that especially specific to the Speas and the Diaz where it's really just an actuarial calculation? They're essentially giving you an interest rate or a piece of interest that they divided over the course of the projected lifetime of the annuitant. Right? So it's all built in. There's no moving parts to, there's no index rating, there's no crediting, there's no get, there's X amount of income that's going to come out. A piece of that income is going to be principal and a piece of that is going to be the interest that they credited back to your account, essentially. And so what they look at is how much of that per month is coming out as a return of capital and how much of it is going to be quote unquote, interest. And so the exclusion ratio would be 85, 87, 88, depending on how long the longevity is and essentially how much interest they gave you to purchase the annuity.

18:20
Brian Bass
And so when you get the 1099 at the end of the year, it'll have your entire income paid out, and then it'll have it sectioned out as return of capital and interest. And the interest portion is what ultimately you would pay tax on as you run through your cost basis. Obviously, if you outlive your projected lifestyle lifetime, excuse me, then it all becomes taxable at the end. But ultimately you do experience a return of capital over the course of 2025, 30 years. However, that baked in the numbers.

18:54
Wade Pfau
Yeah, through like they're spreading that out to life expectancies. We talked a lot at the Retirement Researcher Academy workshop on the idea of cost basis. And it's the same with that annuity where your premium that you've already paid taxes before you had the chance to purchase the annuity, and so you don't have to pay taxes on that. Again, that comes out tax free, but you get an element of tax deferral because you are only paying a portion on that interest in those years leading up to life expectancy. Yeah. So you see that, you see the monthly income, you see the exclusion ratio or the portion of that's taxable, and then you see a credit rating, and you may see ten different quotes. We already talked about not necessarily going with the highest payout. But why do these quotes vary so much? You may look at like the best quote may be offering say, $430 a month.

19:56
Wade Pfau
The worst quote may be $380 a month. Do we have any kind of frame of reference for why these numbers can vary so much? Or what's going on behind the scenes may just be speculative.

20:09
Brian Bass
I've actually asked that question to different providers before. And the canned answer you get is essentially when the actuaries behind the scenes that actually work for the carriers run the numbers on their actual book of business, the products and the money that they have on the side to pay for these annuity contracts, they very methodically section out how much risk they want to take. So they're looking at the longevity profiles of all the different people that own their annuities. And at some point, let's just say it's a 70 year old male with a joint life annuity living in the southeast. They get to a point where they don't want any more of that business, and so they'll price it very aggressively and give you a really low rate so that ultimately, if you're doing your job as advisors and as consumers, you wouldn't pick that anymore.

21:02
Brian Bass
So ultimately they're controlling their risk on their side so that they don't get overloaded with a certain

demographic in a certain area of the country or a certain age or a certain they've got it broken down a thousand different ways, but ultimately it's a risk control measure on the part of the insurers.

21:20
Wade Pfau
Okay. Yeah. And like you said earlier, too, it's about they may want to be more competitive in particular areas. They're just not interested in other areas. They still may put out a quote, but it's not necessarily a competitor.

21:31
Brian Bass
Right. And the quote they put out, they know they're going to make money on it. Even if they get burned on the people living longer than expected, they know they're still going to make money because they priced it with such a rate that they know that they can go out and invest those funds better than the rate they're giving back to you.

21:47
Briana Corbin
Are you looking to make sure your reliable income is well, reliable? Schedule a call today with Jason Rizkhallah 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.

22:12
Wade Pfau
Okay. Yeah. And so we're talking about annuity illustrations and annuity contracts. The annuity illustration. In the context of the SPIA, there's not too much to it. We've pretty much covered it's. That monthly income. Well, if you're seeing it as a list of the different companies, a monthly income, a credit rating and so forth. But let's go now to the stage of you decide, oh, okay, I may want to go with this particular company, this particular SPIA. Now we're getting to the stage of a contract. You'll be sent a contract. What should and Jason, maybe we start with you on this. What are we going to be looking for in the contract? What kind of information is in there? What do we have to make sure matches up and aligns with our expectations? What do we need to make sure we need to understand? Now, these contracts can be lengthy, so there's probably a lot to unpack there.

23:05
Wade Pfau
But certainly what are a few key points to start?

23:08

Jason Rizkallah
Well with? The Speas actually offer the most simple of the contracts that are out there because it is a very straightforward offering. There's no variabilities built into it like some of the other types of annuities that are in place. So with those options come a lot of disclosures, a lot of different features that have to be explained and illustrated with spears. It's very simple. I mean, when you get your contract in the mail or email, however it's delivered to you, after you filled out the application, everything got approved, you funded it. You have your contract in hand as soon as you get it's important to look at it right away because you have what's called a free look period that begins when you have received the contract. And that can vary from state to state and even insurance carrier to insurance carrier. So it's important to, as soon as you get it, look at it right away and read through it completely multiple times because if something's not right.

24:03
Jason Rizkallah
You have this free look period to which you can essentially cancel it if you need to, if something didn't play out the way that you expected it to. But what you're going to want to be looking for is, one, make sure your information is correct. They spelled your name correctly, they have your date of birth correctly, your address is correct. All identifying information that you provided to them is correct in the contract, especially date of births or a big one, because that's what these benefits are based off of. Make sure you look through and you see on Speas that it tells you what it is, that they're going to pay you an income and when it's expected to start, and that it matched what was on the illustration that you went through. Now, here's something, though, as Brian had said earlier, it's taking longer for these insurance carriers to issue out policies.

24:48
Jason Rizkallah
And you would also, during the application process, want to know what their rate lock period is, as Brian said. Because if it takes longer to get your application approved due to the fact that Just information was incorrect, whatever the reason is that it's taking longer, the payouts that were generated to you in your illustration can differ than what your contract is actually issued at. Because a lot of times rate locks don't happen until the carrier receives money funding for that. Then they lock in your rate until they receive funds. Again, most carriers, you can never say, all of them don't lock in rate, so it can change. Make sure you speak with your agent as to if there is a difference. Why did that occur? Doesn't mean that it's wrong. It could mean that's just how it got issued and that's the time frame it got issued in.

25:34
Jason Rizkallah
But just make sure that it's explained and mentioned to you, but just really your personal information that the contract has in it, what was intended to have for it to work the way that you need it to work is how I would look at a SPEA contract.

25:47

Brian Bass
I would also make sure to understand the terms. There's a whole bunch of different terms in there. Annuitants owners. One of the big ones, too, is the beneficiary. If it's a joint policy, for instance, you could have two spouses covered by the same contract. One is going to own it, one would be a joint annuitant. So it gets very confusing even on the application process, what names go where. And really when you get into the weeds of if it's an entity owned thing, like a trust owned contract, it really gets into the weeds. You know, Jason, you and I have both been on calls where sometimes even the carriers don't understand what to put where, unfortunately. So it's very important to really understand the flow of funds and where you want things to go from an estate planning perspective. Again, like looking through the beneficiary if there is a cash refund feature.

26:41
Brian Bass
Which means ultimately, if you die early in the contract, if you die in the first few years, if both spouses were supposed to be covered, both spouses die. The cash refund feature basically takes whatever's left over in the cost basis like we talked about earlier, which is basically just the premium paid minus the income you've received that would go back into the estate. So understanding where that goes, making sure that the beneficiaries are listed correctly, making sure all their information is correct, if it's going to a specific person, or if it's going back into the estate again, there's a thousand moving parts and a thousand things that can go wrong in the application process. So really understanding the terms and understanding how you want things to operate is critical. And they're in the early stages. And like Jason said, you do have a free look period to go through and make sure all those things are correct.

27:26
Brian Bass
So it's not just sign your name is done. They do give you an opportunity to check it and make it all right.

27:35
Wade Pfau
Great. Yeah. So that's Beas and their relatives, the deferred income annuities, the qualified longevity annuity contracts. Let's go from easiest to potentially hardest. Now let's move into the variable annuity world. Yes, variable annuities. Here you will generally see an illustration first and it could be twelve or 15 pages long, and then we'll eventually talk about the contracts. But what's in a variable annuity illustration? Maybe start with you, Jason, in terms of with and without a living benefit, what all are we going to be looking at on a variable annuity illustration.

28:21
Jason Rizkallah
When it comes to annuities? Variable annuities, in my opinion, and probably industry accepted opinion, is that they are the more complex of the kind that are out there. There's a lot of moving parts to it and a lot of pieces that you need to know how they work. The illustration is the beginning part, right? That's where you

first really get to see the product itself in full illustration, hence the title. What you're going to see there is you're going to see a lot of different columns that you've never seen before, perhaps, and terms that you've never heard of before being put here, like guaranteed withdrawal benefits or guaranteed living benefits, death benefits involved with it. So in these columns, you're going to see account value, you're going to see market returns, you're going to see income benefit credits. You're also going to see an income benefit base in there, a death benefit base, and all different numbers across the board.

29:17

Jason Rizkallah

When you're looking at them, you're going to say, wait, this number doesn't match this, and it doesn't match that and what's going on here. So for people just looking at it for the first time, it can be very difficult document to decipher and split up what's going on with it. But I would say. That it is important and it is necessary when looking at a variable annuity to see the illustration. And if you don't understand it, that's certainly where it makes sense to bring in a professional that does, because it's not an easy product to break down and understand completely with it. Each one can be different, though. I mean, companies have different benefits and different features, and so every illustration is kind of unique in its own way. This is where you start to get to the differences between companies and the products that they're offering.

30:05

Jason Rizkallah

The illustration itself looking different, spears, they all look the same from each company, but in this case, because there's different benefits, different riders, it's going to look very different if you're looking at one company versus another. So it's hard to really say in general what would be there, but an account value, an income benefit value, a market return, income benefit based growth, death value, those would all generally be present on them.

30:27

Wade Pfau

And Brian, there's a few different ways that the illustrations can be presented. The idea is they want to show you how this might perform. Either they may use historical data or they may use some sort of fixed rate of return. Could you talk a little bit about that point? Like, what are you seeing in the illustration? What is the point of the illustration?

30:50

Brian Bass

Gosh, how much time do you have? Wait. I guess stepping back from the 30,000 foot view, a variable annuity is just essentially a tax deferred wrapper around an investment portfolio, right? I mean, that's essentially what it is. There is an underlying suite of investments that every single company is going to be different, and you're going to have different options if you're using Living benefit writers versus if you're not. So that's all another section of the illustration is going through and seeing what investments are being used in the illustration, what the allocation looks like. Again, a lot of the companies, if you're using a Living

Benefit writer, are going to limit the amount of equity you can use. Depending on what the product is, you might get shoehorned into a 50 where you have 50% stocks and 50% bonds. I've seen some of them let you go up to 80% stocks on their benefit writers.

31:46
Brian Bass
Some of them are just strictly tax deferral vehicles that allow you to do whatever you want and use a complete discretion across the entire suite of mutual funds and ETFs that are available inside there. I guess the gotcha on these illustrations is really the return streams that they're using for the illustration. One really important thing to keep in mind as looking at it from our side and looking at from the consumer side, is you have the option to tell the insurer, hey, I'd like to see X percentage return. We don't necessarily have to look at it through looking back from a ten year period where they cherry pick the highest ten returning years. And they show you that we can actually go in and say, hey, look, I want to see a really low return. I want to see a 3% return or a 5% return.

32:33
Brian Bass
Don't show me the ten or twelve or 15% annualized returns. Let's look at this thing from a realistic point of view and show me what kind of in my opinion, the way I do it is. I want to see what the worst case scenario is. If there's a floor when you're using these writers, sometimes they cap it out where you don't have any negative years. So show me what a 0% return over the next 10, 12, 15 years looks like. What does that do to the contract? And for me, that's really where the difference from the consumer facing side and then going through an advisor who really understands these things. We can kind of tweak these illustrations and make them look however you want them to look. I mean, you can really whip the data and make it look amazing and you can also make it look really bad.

33:16
Brian Bass
So again, just kind of picking through that's really the gotcha for me is what return assumptions are you using to generate these long term returns? Because again, you're looking at these things as 20, 30, 40 year vehicles.

33:33
Wade Pfau
That's an important point. Oh, yeah. Go ahead, Jason.

33:35
Jason Rizkallah
Wade, I would just like to reiterate the importance of working off of the minimum guarantees that both variable annuities and fixed index annuities offer both of them because they both have growth potentials to

them. And quite frankly, if not every time I recommend annuity, it is based off of the minimum guarantee, it's not based off of growth potential within it. Yes, I can't remember the last one I didn't recommend that wasn't based off of the minimum for that reason.

34:05
Wade Pfau
And sometimes illustrations will even offer multiple scenarios. They may have some sort of historical market return scenario, and then a scenario where the market is returning 0% a year, which exactly, of course, markets could do worse than that. But at least you're going to see what the minimum guarantees from the annuity are if there's never any gain in the annuity.

34:27
Brian Bass
Kind of circling back to the financial planning aspect when we do these scenarios where we're building these income streams. Jason, I know you do the same, so I'm just going to say it. We use a 0% return. Just show me the worst case guaranteed income number so that if we get something above and beyond, that awesome, fantastic, that's great. If we don't, for me, the worst case scenario would be to show someone these annuity contracts, sell it to them, and then ten years down the road we don't get the returns that are shown and we have to have that conversation of, hey, we said it was going to be X amount of income. It's 15% less than that. So sorry it didn't work out for me, that's worst case scenario. So I always want to show the absolute guaranteed minimum value that we're going to get from these things.

35:08
Brian Bass
And then again, anything you get on the upside is just kind of whipped cream on top.

35:17
Wade Pfau
So that 0% return scenario usually would be deeper into the illustration, but I've seen a lot of times at the initial illustration they might pick something like 1995 as the starting year to show how this performs. And if you have, we've talked in past episodes about how guaranteed lifetime withdrawal benefits work, but if you have that benefit base that's going to link to the high watermark, the highest the account's ever been, and then generate income off of that, 1995 is cherry picked. It's like a best case scenario because the next five years that benefit base shoots upwards and then the markets drop. After 2000, the contract value is going to go down, but you're going to see this really high income number that as you're both alluding to of course at that time or at that point, much higher income being generated from that than if you did assume the 0% returns for the contract.

36:14
Brian Bass

Yeah, too, that goes into the conversations around product choice. I mean, if you have an aggressive investor that really wants upside potential, there are gives and takes in these conversations where maybe you're going to take a little bit lower guaranteed income number for a product that has a higher upside versus a really conservative person who doesn't want to do any of that just wants a simple SPEA that's going to usually generate the highest guaranteed income. That's why we have the conversations up front to determine what product we're using, how we're going to use it, and then how you design the investments. Underneath the hood.

36:51
Briana Corbin
Schedule a call today with Jason Rizkhallah at McLean Asset Management to review how your annuities fit into your retirement plan. To get started, go to McLean am.com/review. Comreview. That's Mcleanam.com/Review. That's Mcleanam.com Review.

37:16
Wade Pfau
Right? And that's that whole philosophy about the income protection versus risk wrap. If you're more income protection, you absolutely do assume you're not going to gain market growth when it comes to funding your basics. And therefore right, the Spee will usually offer the highest payout. If you're more risk graph or probability based, you might say no, markets are going to do fine. So then some of these step ups may be available to allow for a higher average income than the SPIA would provide. But as you're both suggesting, don't get too excited about the step up potential, the ability to increase the income beyond the guaranteed rate, because a lot of times you need a pretty strong market.

37:58
Jason Rizkallah
Performance to piggyback on what Brian said, the actual product being placed. Any agent should be looking at the universe of what is available to the client at that time and helping to decide on which annuity ultimately ends up being the best to use. Because there will be some cases where a SPIA is better, some cases where an FIA is better, and some cases that a variable annuity is better. These products exist, and it takes a specific type of situation to fit each. And again, working with a knowledgeable professional in that will help to do that, helps narrow down that universe of what's available to what is the best for my situation. So in some cases, it could be a SPEA, in some cases it could be an FIA or a variable annuity across the board.

38:50
Brian Bass
Yeah, I mean, to your point.

38:52

Wade Pfau
Great. Yeah, I was just going to say.

38:54
Brian Bass
It'S very important to do that work, especially if you have a lengthy deferral period. A lot of times we look at deferred immediate annuities. We look at the Diaz, which is essentially just a deferred SPIA, and we have two, three, or four year deferral period. Sometimes those fixed index annuities outperform the dia. And so even without any market performance whatsoever, that worst case scenario we're talking.

39:18
Jason Rizkallah
About on a minimum basis.

39:20
Brian Bass
So it's not just, okay, we're great. You want an income annuity, we're going to do a B year deal. It's not that easy. Again, market pricing dictates. Sometimes companies get really competitive, and they want that business. They'll actually go out and give you more income, significantly more income on a fixed index annuity versus a speed idea.

39:39
Jason Rizkallah
That's correct. Seen that actually quite often. Recently.

39:42
Wade Pfau
Yeah.

39:43
Brian Bass
So the deferral period is just another variable in the conversation of, do we have time before we need to turn this thing on? Okay, now let's really start to do some homework and go out into the marketplace and see what we can get it. And two price points matter. You'll get different breakpoints with different companies just playing with the breakpoint, even adding 50,000 or $100,000 to the plan. Premium sometimes dramatically changes the payout rates. And so it's important to just kind of play with the numbers and see what's out there and see what you get back when you run these quotes.

40:15

Wade Pfau
Yeah. And I don't know. I've heard so many times the idea of do you want income now, income soon, income later? Because you're absolutely right, which annuity provides the most income now, soon or later, of course, can vary quite.

40:30
Brian Bass
We get super annoying when we run one annuity. We annoy a lot of people when we ask for 2030 different types of quotes. Ultimately, you have to do your due diligence and figure out what's out there, because there are some products that just really blow things out of the water sometimes, and if you don't ask the question, you just don't know.

40:52
Wade Pfau
Now, for our listeners who are more technically minded, a way that I've learned a lot about how these annuities actually work is to recreate the illustrations in Excel that's not for everyone. And that's where, of course, talking to a professional can help you bypass the scenario of recreating. But you can learn a lot from the recreation to kind of go through what are all these columns in the illustration? Usually you've got some sort of market return, which we've talked about. It could be some historical numbers. It could be a fixed rate, hopefully like a lower fixed rate to get a better sense of the guarantees. And then you'll see straightforward the evolution of the contract value, how much is left after distributions and fees and returns. Then I suppose we're talking about a scenario where there is an income guarantee. Well, I guess before getting to the income guarantee, next to the contract value, there may be something that could be called a variety of names, withdrawal value, or you may see numbers that are smaller than the contract value due to people who may want to leave the contract rather than holding it over the long term.

42:09
Wade Pfau
So Jason or Brian? Maybe Jason surrender charges. Brian market value adjustments. Why does the now annuities are meant to be long term contracts? What we're about to talk about now is only if you're trying to get out of the contract in the first. It varies, but it could be five years, it could be ten years, could even be more than ten years sometimes, although I think that's not too common. But why would the value you'd get if you decide to end the contract be less than the contract value column going in the order of what the illustration is probably going to show most of the time.

42:50
Jason Rizkallah
So on annuity, contracts that have the ability to leave the contract so SPIAs are irrevocable, right? So once you start it, once you're past the free look period and it's issued and it's up and running, you can never change your mind on it. I mean, it's there, it's irrevocable. The variable annuities that we're specifically speaking about now and even FIAs, they have what's called surrender schedules associated with them. So

when you hand them the premium that you're giving to them to fund your contract and your contract begins, it starts a clock, essentially, and Wade is exactly right, it usually ranges between five and ten years. Most of the time there are ones that are longer and shorter, but on average, you're looking at 5678, 910 years. And what that is essentially, if you want to cancel your contract within that time frame, let's pick a ten year period.

43:43

Jason Rizkallah

If you want to cancel your contract within ten years of it starting, depending on what year you ultimately cancel your contract in, you'll pay a penalty. What that penalty is determined by the schedule that the company gave you, and it's usually on a declining scale. So the longer you hold it, the lesser that penalty is. But it could start off at 10%, meaning if you withdraw your contract within the first year, cancel it, just say, hey, give me my money back. They're going to penalize you 10% of what the account value is at that time. And the second year might be 9% and 8% and seven and so forth. But they're going to show you that on the illustration, too, that if you were to walk away, as they call it, from the contract, in any of those given years, this is the value you would be walking away with according to that scenario that they're showing you.

44:32

Jason Rizkallah

Now. In addition to that, I think Brian's going to explain the market value adjustment that could come into play, which generally.

44:41

Wade Pfau

Brian, maybe we should save this for the fixed index annuity because it's usually more relevant there. But while we're on the topic, we could just talk about it.

44:49

Brian Bass

I mean, so at a high level when you're using a fixed index, so a fixed index annuity and a variable annuity vary drastically in the way that they credit your return, if you will. Let's just use that word, a variable annuity, you actually own the underlying investment. So you have a segregated account. If you're buying three, four, five mutual funds under there, whatever the a lot of times they have a package deal. You just choose a 70 30 global allocation and they give you whatever mutual funds are there that the manager has chosen. That's usually kind of the way we see things being sold. So you actually do own those shares of those mutual funds, and so you have a segregated account. That's how they calculate the value of things going up and down with the markets. That's what your account value does. It floats up and down with the market returns of those funds.

45:41

Brian Bass
A fixed index annuity, on the other hand, there is technically no underlying investment portfolio, right? You're essentially getting the insurer is using an index of some sort, and there's thousands of those that are out there. All the different big shops on Wall Street have their own custom indexes doing different things. But essentially they use a starting point. January 1 to January 1. You can select the different terms. It could be a one year, it could be a five year, it could be whatever, everything in between for the different creditings. So you'll have let's just use a one year kind of point to point as an example. So from January 1 to January 1 of the following year, they credit out whatever that index does. That's what essentially they give you as your return, right? That's how they credit your indexed value back to your contract.

46:31
Brian Bass
So in between those point to point, you have what's called as the market value adjustment. If you decide to, for whatever reason, surrender the contract or take money out of it, they're going to go back in and figure out exactly where you are inside there because you haven't fulfilled the entire one year of that investment, quote, unquote, commitment. And so they'll adjust the contract value up or down based on essentially where you are inside there as a really layman's example of how to do that.

47:01
Wade Pfau
Really? Yeah. And that's really to protect other owners of those annuities. It's the same thing with bonds. It's like, well, if interest rates go up, I'd rather sell my existing bond and just buy the new bond with the higher interest rate. But as we know, prices go down when interest rates go up because everyone would like to do that. And it's really the same idea in the annuity where if I want to leave the contract early because interest rates have gone up, so I'm looking at some other investment option. Well, to be fair to everyone else, they can't really pay you the full value net of the surrender charge necessarily because the assets in that account are not worth as much at that time. And that's a much bigger issue with the fixed index annuity, but it's not unheard of that. You might also see that with a variable annuity as well.

47:49
Wade Pfau
Now, there's still a lot to talk about with variable annuities and we still have the fixed index annuities as well. I think this is really a two parter episode. If you guys would bear with me, we'll meet up again on Friday to continue the discussion. Very easily through the McLean website if you go to McLeanam.com.

48:18
Jason Rizkallah
So M-C-L-E-A-N as in Nancy A-M, as in assetmanager.com. So M-C-L-E-A-N as in Nancyam, as in assetmanager.com. You'll see a get started button? I believe it's located in the top right corner of the screen. So, very simple, go to Mcleanam.com and get to the Get Started page. So, very simple, go to Mcclainam.com and get to the Get Started page.

48:58
Wade Pfau
Great. And we'll put that in the show notes as well. And I know on that page you can even click that. You heard about it on Retire with Style, so you can click that button as well. Thank you both. And we're going to continue this discussion on Friday. We have this summer where during the summer we are running two episodes a week. So I'm really looking forward to continuing part two with you. We'll finish talking about variable annuities. There's still a lot to cover. We'll also talk about fixed index annuities. And again, the whole point of these conversations is we want to understand what you're going to see in the illustrations as well as the contracts. So thank you so much to both of you and I look forward to continuing the conversation on Friday awesome as well.

49:43
Jason Rizkallah
Thank you, Wade.

49:45
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.