**Un-spinning a Confusing Annuity Pitch - Transcript**

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**Tom:** Welcome to the Mullooly Asset Management podcast. This is episode number 256. Thanks for tuning in. I'm your host, Tom Mullooly, and alongside me is my co-host Brendan Mullooly.

**Brendan:** How's everybody doing? Hopefully better than me because I blew my stack when Tom sent me a video, which we are going to discuss now on the podcast this week. How did you find this atrocity, first off?

**Tom:** How I found this maybe just as bad as what the content was about. It was in my stream on LinkedIn.

**Brendan:** Okay.

**Tom:** And they basically said, "Hey..." Nice person making a short one-minute intro video talking about how you shouldn't have to pay any taxes on your IRA. Yeah, it was a catchy, it was like ...

**Brendan:** The teaser.

**Tom:** ... here's the trick to not pay taxes on your Roth conversion pretty much, and this was on LinkedIn.

**Brendan:** On LinkedIn.

**Tom:** Two things, first off I open this and with a minute of the video beginning, they used the words 'tax bomb' which tipped me off to the pitch that comes later at the end of the video, which is for a product some may be familiar with, some may not be; they're called equity indexed annuities. Why is it that they are able to make a video like this that had borderline promissory language in it? I think the first thing is that an annuity like this is not a product that falls under FINRA or ERISA regulations, so they don't have to conform to the type of compliance that we do.

**Brendan:** State insurance regulators are looking at these kind of products and the people that sell them; a lot more loosely regulated than the financial industry in my opinion in terms of some of the illustrations that get used in policies like this, or the performance that is potentially touted; it's always hedged with the appropriate language as they get to in this presentation.

**Tom:** There's an old story about if you put seven blind economists in a place with an elephant, and they all try to describe what was going on, one would say, "Wow, an elephant is known because it has strong, sturdy legs." And the other economist says, "Oh no, it's because of this long tail that it's got." And then another economist says, "Oh no, it's got tusks. That's how you tell what an elephant is." And then another one says, "Oh, look at this long trunk that it's got; these floppy ears, this rough skin."

So when we look at how these products get marketed, it's not the same way as we would break down how does this compare to the S&P 500, or how would this compare to a typical allocation that we would find in an investment account. There's a lot of ways that these products get spun, and you say, "My goodness, that makes total sense. Why doesn't everybody have an equity index annuity?"

**Brendan:** Right. And so that is one of the tip offs for me when you look at stuff like this. It seems like such a no-brainer when you see the presentation. You ask yourself what you just said, why isn't everybody doing this? Well, it's probably because it's not as good as it's being described as.

And just to back up a second, I'm not against annuities in every, single instance that they could be applied in. I think that they're very poor as an accumulation vehicle, which is what this is being suggested as. And often, they are marketed when they're equity indexed or variable products. I would say better than 95 percent of all annuity products are sold that way as an alternative to the equity market that hedges your downside risk.

**Tom:** Something that gives you all the upside, but none of the downside.

**Brendan:** You get your cake, and you get to eat it, too.

**Tom:** Don't laugh. That was a real part of a pitch back in the '80s.

**Brendan:** Right. And now it's just like a funny thing that we say when we're mocking bad pitches.

**Tom:** But anyway, the premise behind this was that you could use this strategy to take your IRA, which the creator of this presentation says is a tax bomb, and then in the presentation the part that got me was they likened it to an atom bomb, and then had this looping video that played on the PowerPoint slide of a bomb blowing up, as if having an IRA or a qualified account through your employer is the end of the world.

The way that they portrayed this, they made it seem like you'd be better off not having an IRA or a 401(k). That thought actually did cross my mind when I was sitting there watching this video, because I just couldn't believe this. I was like, "Wow, look at all the taxes that someone's going to pay." So here's the two of us, both us been in the industry a long time, even we're getting teased into second-guessing 'gee, am I doing the right thing?' The way that this presentation is put together, and we're not singling this firm out, is the way these things are sold.

**Brendan:** We've seen enough people come into our office and, by playing telephone with them, we kind of get to hear how these are portrayed to people. And certainly, I'm sure we're not getting word-for-word the way that they were sold to people who come in with them, but they're very complicated and so we're getting the version that they heard, whether that was actually what was sold to them or not; probably somewhere in between. But if the client can't understand this stuff, I don't know ...

**Tom:** They have no business putting money into it.

**Brendan:** Just to go back to what they were suggesting, they're saying take your money that's in an IRA or a workplace retirement account, which is in there; you've sent it in before taxes, and they're describing all these features, in my opinion they use framing. So instead of saying that these are features of IRAs, 'you got a tax break for sending money in. One day, you have to pay taxes on this money.' They presented it as huge problems with IRAs. 'There's going to be a huge tax bill that's ordinary income that could add to the taxes you pay on your Social Security and Medicare and retirement,' none of which is false.

**Tom:** It's not, it's true.

**Brendan:** It's just the way it's being portrayed.

**Tom:** Right. When you put money into a 401(k) at work, you're deferring recognizing that income until a later point in time. Hopefully, you'll be in a lower bracket.

**Brendan:** Even if you're not, you're saving for your future. You're going to have money in the future. It's not as if this tax bill has to be paid from some other source. You can net amounts that are taken from IRAs or qualified accounts, and I think that often gets overlooked by people if they have ... If they need $50,000 from their IRA and they have to pay taxes on it, they can just withhold and get the net amount. But in our minds, it's difficult to reconcile that because we want all of the money in the account. I think a better way maybe to look at a traditional IRA or a 401(k) where you sent in money pre-taxes to say 'I have X in there and currently my tax bracket is Y, so I actually have Z in this account if I wanted to get to the money.'

**Tom:** To put it in numbers, if I had 200 grand in a 401(k), and I'm in a net 30 percent tax bracket, after taxes that's probably going to be about $140,000. So yeah, not great, but that's the deal you sign up for when you take an income tax deduction on the front end.

**Brendan:** Right. So something that a lot of people discuss when they discover this is if they haven't done it over the course of their careers, you think about diversifying the taxability of your assets; meaning you've got this IRA, which is all pre-tax money; you can have something like a Roth IRA, which is after-tax money; and you can have your taxable investment accounts, which are subject to long- and short-term capital gains rates. You can have money in all these different places so that when you're in retirement, you can strategically pull from a combination of those buckets to make sure that you're drawing down your assets and hopefully paying as little taxes as possible. Be smart about it.

So the suggestion here was to take your pre-tax IRA or 401(k) and to do a Roth conversion. So you convert this money into a Roth IRA, but it was all predicated upon doing it within this Roth IRA, you're going to buy this equity indexed annuity product where you get this bonus money to sign up for it, and that was going to make you whole on the tax bill, more or less, was the math that the way it worked out to.

**Tom:** So, the illustration they used, basically the bonus that you got for signing up for this contract, what they do is they inflate the starting value of your annuity.

**Brendan:** We've seen this a lot. They toss in 10 or 20 percent, and it sounds awesome.

**Tom:** It is free money, terrific. So the first question we ask when we're sitting down with someone is, "Can you get that money?" And that is always the biggest thing, is that this is ... This is the biggest thing with annuities in general that I think gets overlooked by a lot of people. If you actually intend to annuitize the contract in the future and collect a stream of income from your annuity, whether it be equity indexed or variable, all right, maybe. That's when you can start saying let's consider all the other features of this thing to see if it's worthwhile or not.

**Brendan:** But if your answer to that is no, you're not going to want a stream of income in the future where you give up control of your money and get a monthly check, if that's not on the table for you, you shouldn't even be thinking about an annuity because as an accumulation product where you just want your lump sum of money back, it's not going to work out. The returns are going to be poor because you have to give back the Monopoly money; you have to give back the bonus that they gave you. And if you give back the bonus that they gave you, your returns are often going to be what you could have earned in a bond fund.

**Tom:** Or close to zero. They're very low for the risk that you took. A lot of these products are tied to a specific index; that's why they call them equity indexed annuities. It wasn't clear from the video that I watched whether this was going to be tied to the S&P 500. They mentioned a couple of other mutual funds in there that they use.

**Brendan:** They have this slide where their annuity thing literally quadrupled over the S&P 500 over a period of time, which is ... They didn't have math, they didn't have anything to show on there, so maybe I'm wrong but I don't think that I am. I think that that was a load of BS.

**Tom:** And so they don't have ... they're not regulated products, so they can pretty much make these illustrations any way they want. I saw an article ... We're recording this on a Monday, so it wasn't that long ago. I saw an article on Friday where they talked about some state insurance boards are now deciding that some of the illustrations that were made to sell insurance policies and insurance products like annuities, even as recently as the last six or seven years, used projections that were way too lofty.

**Brendan:** So I think one of the other things, especially variable annuities; you get into this less, but equity indexed ones, you really have to go read the policy and understand the rules that you're signing up for. You usually get a host of indexes that you can select from; sometimes it's just one but it depends, but each of them have different rules. And sometimes you have a spread and sometimes you have a cap, and so what these rules are make a huge difference in terms of how your returns are actually going to pan out in this product.

The insurance company often has an initial set of rules when you sign up; spreads or caps on the performance of the index that you're tracking. So if you're going to track the S&P 500, they might say you're going to get 100 percent of the upside of the index with a cap of four percent or something like that.

**Tom:** Now let's translate what that means. That means that you're entitled to the first four percent that the S&P 500 puts on. This year, the S&P 500 is up 12 percent, something like that, so you've basically captured the first four percent. And then after that, what happens?

**Brendan:** Nothing for you.

**Tom:** Nothing for you is right. You don't get the rest of that performance. But the caveat is that that appeals to some folks, and you've got to read the rules again for this, but oftentimes the rules will say if the index return after you account for the spread that gets subtracted out, or the cap, if it's below zero then your return is zero. So you're not going to lose anything, but you're going to have capped upside. And oftentimes, especially several years into the product, if you're just looking at the accumulation value, you've ended up getting bond-like returns when you were promised equity-like returns because of the caps, and they can change these rules every year. Every year you get your policy update, and they are almost always within their rights to say here are the new caps, or here is the new spread that is going to be calculated on this index, so that's where this can change in the future. And if they made a bad deal with you, they can renege on it and change the rules.

Let's play a game. You're going to give me $100,000. We're going to lock this up until you're 59-and-a-half. And I'm going to basically say I'm going to give you 50 percent of whatever the S&P 500 does each year. But if we have a really good year, I get to change the rules. Want to play?

**Brendan:** Most people aren't going to sign up for that, but ...

**Tom:** But yet there's billions of dollars, with a B; billions of dollars of these products sold over and over and over, and they're sold in retirement accounts.

**Brendan:** So back to what brought us to this conversation in the first place. Some of the things that were said later on in this presentation, now that we've covered a lot of the way that this policy was pitched, at least in this eight to 10-minute video, was it can outperform the S&P 500.

**Tom:** technically true.

**Brendan:** Sure, it's possible that it could, but probably not because there's probably going to be some kind of cap, or a spread that gets subtracted from the S&P's performance. Principal cannot be lost. Most of the time that is true. Again, read the policy rules, so that should be the biggest thing for you if you're doing one of these that you're very afraid of losing even a penny of the money. And the surrender doesn't matter because this is long-term money, because they're pitching putting this into an IRA.

**Tom:** That really bothered me when they said. The surrender period is that period of time where you're going to have a charge if you exit, if you get out of this investment, and they're typically very long surrender periods.

**Brendan:** I was looking at one today that is 10 years.

**Tom:** 10 year schedule, and it'll start with something like nine or 10 percent for the first couple of years or the first year or two, and then it will start to decline. And you're going to have charges in this thing, which, honestly, they really do work. Because you tell people hey, you know what, you're going to pay three percent if you want to get out of this thing, or you're going to pay five percent, or you're even going to pay one percent. People are like, "Eh ..."

**Brendan:** They won't bother.

**Tom:** "I'll just leave it for another year or two and then we'll reassess." That surrender charge really does work. They're like invisible handcuffs.

**Brendan:** It's also interesting when you get these bonuses that they dole out, because if you're looking not at just the accumulation value, but at the income rider and what that value is worth, and you're only two or three years into a policy, it looks like you've been crushing the market. But in reality, that didn't come from the performance of the policy. That didn't mean that 'the rules are great here, the caps didn't matter, or the spreads didn't matter.' We crushed everything. It's because they literally gave you 20 percent of the policy premium right off the bat. The performance over the years, as you get closer to when the surrender period is done, the annualized performance will be getting lower and lower each year that you absorb that initial bonus of the policy. The annualized performance is going to look lower and lower.

**Tom:** I want to just, I know we talked about it a minute ago, but I just want to go back to this bonus thing. Because in the example that you and I both watched, they were giving a bonus of about 25 percent. So, that's why they came up with this scenario that, "Hey, get the money out of your 401(k) and do a Roth conversion." So you're going to pay ...

One of the examples they showed, they showed three different tax brackets; one of them was 27 percent tax bracket, which is almost a perfect match for this 25 percent bonus that you're going to get. And so, they showed if you take the money to pay the taxes out of your Roth IRA, the bonus basically makes you back whole before you even started the contract. And if you found the money from somewhere else, your base starts even higher.

These bonuses are fake numbers. They're basically just starting the line at a higher level where the returns are going to be measured from.

**Brendan:** The biggest thing with the bonus is, again, that if you do not plan to annuitize the contract in the future, then the bonus is irrelevant. If you're going to annuitize it, then you can begin to consider the rest of the policy and its merits. A lot of people don't consider that within that framework, and I think that's a mistake because you can't just pull your lump sum of money back. You're not going to get the bonus money, and you're probably going to have a charge to get out of the contract, too, if it's within the first seven to 10 years in most cases.

**Tom:** So Brendan, one thing that we have not touched on yet is what is the cost of investing through a product like this compared to just investing on your own?

**Brendan:** Steep, for variable annuities for sure; equity indexed, it's less clear because it's not baked into the policy. But I think that if you look at it from a standpoint of can I get my money back, or what will have accumulated by this point in time, you are going to get something like bond-like returns when you were promised stock-like returns with no downside, which is often the case regardless of whether you're talking of an insurance product, or somebody who's going to purportedly do something else to save you from market downside.

**Tom:** So what if someone didn't hear and they're discussing this product, and they say, "A portion of my money does need to be in bonds, so if I get bond-like returns, then I guess it's not terrible." What's the alternative to having money, having a portion of your assets doing this for you?

**Brendan:** If that's the way that they want to look at it, then okay. But again, they have to be sure that they're going to annuitize the contract in the future. And if they're not going to, then there is no point in discussing this product.

**Tom:** So just to be clear, when you annuitize a contract, you're basically giving up control of the asset.

**Brendan:** Right. It's like collecting on a pension. You take your pension option, and you take it over your life, or a joint life, or some kind of in between version of those two, or you can do it period certain and get it over your life with 10 years guaranteed to a beneficiary if something happens.

**Tom:** But you don't have a lump sum; you don't have an asset here anymore.

**Brendan:** There's no lump sum.

**Tom:** There's just a promise that the check's going to be in the mailbox every month.

**Brendan:** Right.

**Tom:** I guess folks that annuitize their insurance products have to be aware that that's going to happen. I think a lot of people just don't understand this. And we spend a boatload of time explaining this to people who already own them, and they've owned them in some cases for years, and the guy or gal that sold this product to them is nowhere to be found. They're on a yacht somewhere, but we're left having to explain the brass tacks to them and show them, warts and all, there are some redeeming features of this, but there's a lot of un-redeeming features of this. You need to know this.

**Brendan:** I don't really like these as an accumulation vehicle, which I already mentioned. If you're within the phase of your career where you're still saving money and growing money, and you're still working, I don't really think that having money in one of these products makes a ton of sense. If you wanted a stream of income in the future when you are looking to shore up where the money's going to come from in retirement, if you'd like to have a portion of that be a guaranteed check that shows up in your mailbox every month, you could accumulate within your regular IRA's investment accounts, and then calculate at retirement what portion of your money you should take and buy a single premium immediate annuity that is going to literally just act like a pension, rather than trying to grow your money within these policies, where these costs are embedded that you don't need to have.

**Tom:** Just say when I'm ready to start taking a check for this, I'm just flipping it into this immediate annuity. That's it, and I'm getting a check.

**Brendan:** Right. So to put a bow on the entire thing, the final thing I wanted to mention was the end of this presentation where it said something along the lines of you need to have a sense of urgency, like act now; get in touch with us because I don't know how long this deal with last. If you ever hear anything even remotely like any of that when you're going to invest your money, just run away. Run away. There's never a sense of urgency, and that is a huge red flag that somebody is trying to pull one over on you. Do not do it, or at least consider all the options first. Take their pitch and go read it. And if in the interim you decide you like it and the offer expires, too bad. I'd rather be safe than sorry.

**Tom:** I agree with you.

**Brendan:** And I don't think the offer will disappear.

**Tom:** I'll just add a P.S. to that. What they kept referring to, besides the phrase 'tax bomb' through the video, was 'magic.' Oh, for goodness sakes. If you hear anyone using the word 'magic' when it comes to money or investing, again, run away.

**Brendan:** The 'tax bomb' and all of the other scare ... the subtle scare tactics that were baked into this presentation were a little gross. They were definitely trying to instill a sense of fear into people and to get them to do something soon. I do not care for that.

**Tom:** They're good products in the sense that people who sell them get paid very well.

**Brendan:** Sure, there has to be an incentive there. Otherwise, these products wouldn't move. Nobody goes anywhere asking for this thing. Most people don't even know what an equity indexed annuity is, or they come to us and they're like, "I have this thing." They never say, "I have an equity indexed annuity." They're like, "Yeah, 10 years ago, I did this thing. Here it is." And they slide it across the table to us, and we're like, "Uh, okay." It's sad when we see these things.

**Tom:** Their money could have been doing something else.

**Brendan:** Right.

**Tom:** Thanks for listening to episode number 256, and we will catch up with you next time with a new topic.