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# Cherry Tree Wealth Management

**CHERRY TREE WEALTH INSIGHTS:** Published by Keith Tufte, President of Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.

## WE REALLY DISLIKE ANNUITIES, AND YOU SHOULD TOO

Most of our clients do not own annuities (thank goodness). However, some new clients come to us with annuities that they bought before working with us from another advisor or insurance salesperson. We do not like most annuities and we believe they are not good investment products.

### WE STRONGLY RECOMMEND CLIENTS AVOID MOST ANNUITIES. WHY?

1. They are very **expensive**. The all-in costs/expenses are typically around 3% per year. The underlying investments in these annuities are typically expensive actively managed mutual funds. Many of the fees (and there are several) are hidden and not well disclosed (not transparent). We prefer low-cost investments and transparent fees.
2. They are **complicated**. Most investors (and many advisors) in annuities have no idea how they really work, what they are actually invested in, how risky (or not) they are, what the total fees are, and how the taxes work on them. Complicated investment products are designed to benefit the seller, not the buyer/customer. We prefer simple investments.
3. They are **illiquid**. Once you buy one you are locked in for 10 years or you must pay a surrender charge starting at 10% in the first year typically. These are difficult to get out of (without paying fees and taxes) once you buy them.

*We only invest in things that are diversified, low-cost, tax-efficient, simple, transparent, and liquid.*

*Annuities fail nearly all these.*

4. They are **commission-based**. Commission-based products create a significant conflict of interest between the advisor and the client. Does the advisor think an annuity is really in my best interest, or does he want the 6% commission he/she will get by selling it to me? We prefer a fee-based relationship with our clients.
5. They are **not tax-efficient**. All the gains you accumulate in an annuity are eventually taxed at the high ordinary income tax rates when you take the money out. Annuities turn capital gains into ordinary income (which have the highest income tax rates). If you were to just invest the same money into an investment portfolio like we use, the gains when you take the money out are taxed at the lower capital gains tax rate, which is often half the tax rate on ordinary income. And, with a traditional (non-annuity) portfolio you may not pay any taxes on the gains if you leave those assets to your kids as they will get a step-up in the cost basis on those funds at death. Annuities do not get a step-up in cost basis at death. Another tax negative of annuities that most people are not aware of is that if you take a partial withdrawal out of the annuity, the IRS rules say you must take out (and pay income taxes on) all the gains/profits first, before you take out any principal. Finally, any withdrawals from an annuity taken out before age 59.5 are likely subject to a 10% IRS penalty on the gain.

I am licensed in insurance and annuity products. I could sell myself an annuity and pocket the commission on the sale myself if I wanted to. Despite this, I own no annuities and I never have. I have also never sold a new annuity to a client. Why? I believe they are poor products designed to benefit the salesperson and the insurance company and are not in the best interest of the client/buyer. We only invest in things that are diversified, low-cost, tax-efficient, simple, transparent, and liquid. Annuities fail nearly all these screens.

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We have helped many clients who come to us with expensive annuity products (bought elsewhere) decide how to "fix" them and/or decide what the best course of action is with the annuity. Below are several possible solutions as to what to do with an expensive annuity.

1. **Cash it out- Sell it.** This can be a good solution for annuities that are held in an IRA, or that have a small gain in them, and that have been owned for 8-10 years or more (past the surrender charge period).

2. **Exchange it for a much lower cost annuity.** You can exchange one annuity for another on a tax-free basis doing what is called a 1035 exchange. We have an insurance company that we use to exchange expensive annuities from other companies to that offers low-cost index-based fund options inside the annuity, no surrender period charges, and often total cost/expense reductions of 40%-50% per year. This is a good option for people who have expensive annuities, with significant gains in them, and they are past the 10-year surrender period, and who plan to hold them for many years before they annuitize it.

3. **Annuitize it.** Annuitizing the annuity just means telling the insurance company to start sending you monthly checks for the rest of your life. This is the main reason most people buy annuities in the first place, to get some reliable fixed monthly income during retirement. Surprisingly, about 90% of annuities never get annuitized. Annuitizing is a good option for many people who are at retirement age (or later), are in good health, and want/need the extra monthly income. Be sure you are getting a competitive or "market" rate when you annuitize it into a lifetime of monthly payments.

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4. **Continue to hold the annuity.** For investors who have an annuity that is still in the expensive surrender period (the first 10 years after purchase) it is typically best to just continue to hold it until the cost to get out declines to something more tolerable. If you are in poor health and are older it may be best to just hold the annuity. If you are just a few years away from retiring and/or annuitizing it, you may just want to hold on a few more years before taking action.

The smartest thing to do with an expensive annuity depends a great deal on each investor's circumstances and will be different for each person. The factors to consider are long and include your age, your health, how many years ago did you buy it (for surrender charges), is it owned in an IRA account or not, how long do you plan to hold it, when will you retire, what is the gain in your annuity, do you want/need the monthly income now, and/or will you have lower taxable income and tax rates in the coming five years. It is complicated. Please contact us if you would like to discuss the best course of action for you.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (President of CTW) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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