

Chapter 18 - Brokerages, Account Types, and Annuities

“I tell ya’ this stock market is bad. It’s even worse than a divorce. You lose 50% of your net worth, but you still keep your spouse.”
– With warm regards to Rodney Dangerfield
(Psst. Have you ever wondered why they call us, “**BROKE**rs?”)

Objectives

In this chapter and the chapter 18 Canvas module and class website, you will

- Be introduced to various types of brokerage firms and other options for holding your securities
- Examine various types of investment accounts including regular taxable accounts and tax-qualified accounts
- Investigate the constraints and benefits of using tax-qualified accounts for long-term investing
- Examine the few advantages and the more numerous disadvantages of annuities as investments

By the end of this chapter and the Canvas module, [class website](#), and [Introduction to Investments Discussion Forum](#), you should be able to

- Describe various types of brokerage firms and other options for holding your securities
- Explain various types of investment accounts including regular taxable accounts and tax-qualified accounts
- Discuss the constraints and benefits of using tax-qualified accounts for long-term investing
- List the few advantages and the more numerous disadvantages of annuities as investments

’Cuz Ya’s Gots’ t’ Put Yer Money Somewhere!

It is time to discuss brokerage firms and the types of brokerage accounts they offer. Hey! Ya’ got’s t’ put yer money somewhere, right? We will also spend a bit of time thwacking those ugly blood-sucking creatures from the black lagoon of the insurance world, annuities. These miscreant contracts entice the uneducated with the promise of a lifetime income. Often too late, buyers of annuities find that the lifetime income they receive is only a small fraction of what they could have received if they had simply educated themselves about the various investment choices or consulted an ethical and competent financial advisor.

Chapter Outline – Chapter 18: Brokerages, Account Types, and Annuities

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Brokerage Firms

There are three types of brokerage firms, full service brokerages, discount brokerages, and deep-discount brokerages. What can you expect to pay for each? What kind of service can you expect from each?

Full Service, Discount, and Deep-Discount Brokerages

[Full service brokerage firms](#) are companies such as Merrill Lynch and Morgan Stanley. Investors can expect personalized service as well as customized research and investment recommendations. Of course, you can also expect to pay dearly for these services. You might also receive services for which you might not expect. In the past, brokerage firms would direct their registered representatives, also known as stockbrokers or account executives, to encourage their clients to buy certain securities for which the firm would be compensated handsomely.

Retail investors often ask how they can get the shares of an Initial Public Offering (IPO) at the IPO price. Customers of full service brokerage firms, especially [accredited investors](#), a fancy term for people with lots of money, are typically privy to the IPOs at the initial prices. You and I won't typically be able to purchase the IPO shares at the initial offering price.

Every brokerage firm is different but do not expect to be treated well unless you are going to bring a substantial sum of money to your account. A few decades ago, these brokerage firms wanted you to deposit at least \$50,000. Of late, many appear to want at least \$500,000 and some years ago, a client related to me that the stockbroker of her parents was ready to set the minimum initial deposit to at least \$750,000.

Does all this full service necessarily translate into outsized performance? On at least one occasion, Your Humble Author encountered a situation where a client was using the services of a full service brokerage firm. The client was recommended Class C shares of various mutual funds, the ones with the higher annual operating expenses in lieu of the front-end sales charge. The client had well over \$1,000,000 of assets in the account. If you remember, with over \$1,000,000, the front-end sales charges of Class A shares are waived. In this situation, the client was paying far more in annual operating expenses that was necessary. After pointing this out to the client, their response was, “I guess I should talk to them about this.” I sure hope they did and gave them hell!

[Discount brokerage firms](#) began to emerge in the 1970’s. After much consolidation in the industry, the largest discount brokerage firm is [Charles Schwab](#). Others include [Edward Jones](#) and [LPL Financial](#). These brokerages traditionally left the stock picking to the investor but now have their own sophisticated stock rating and recommendation services. The commissions were much less than the full service brokers.

The advent of the Internet saw the emergence of [deep-discount brokerage firms](#) in the late 1990’s. These firms emphasized technology to reduce brokerage costs dramatically. Investors using deep-discount brokerage firms typically would never speak to a broker when executing transactions. However, they do have the option of consulting with a registered representative, for which they will be charged similarly to what a discount brokerage firm would charge.

Commissions, Then and Now

Traditionally, virtually all brokerage firms made their money from transaction commissions. Full service brokers would charge from \$70 to \$100 or more per trade. Discount brokerages began with commissions at \$45 per trade but then progressed to \$29, \$19, \$13, and then below \$10 per trade. Deep-discount brokerage firms started at \$5 to \$10 per trade. A few deep-discount brokerage firms experimented with \$0 commissions. One failed and the other raised their commission to \$5 per trade.

One company, Robinhood, has been successful in charging \$0 commissions and earned the love and affection of young traders as Robinhood encouraged tech-savvy younger adults to trade as often as they liked since there are no commissions. “I am trading for free!” is what you will hear from Robinhood customers. Robinhood then earned the scorn of the younger adults when, for reasons that are still subject to controversy, Robinhood halted trading of certain popular “meme” stocks that were the target of groups of traders that had banded together to push the prices up. Robinhood is now a publicly traded stock having gone public in mid-2021. As is typical with Initial Public Offerings, Robinhood is far below 50% its high stock price for the year and well below its IPO price as of April 2022.

Wait a minute! How can a brokerage firm make any money with a \$0 commission schedule? We hope you remember from chapter 3 that the deep-discount brokerage firms are receiving a kickback from the dealers and market makers who buy and sell the stocks from their own inventories. It is innocently called [Payment for Order Flow](#) or simply, Order Flow. Dear Readers, Robinhood is not free! Please refer back to our extensive discussion in chapter 3 about how Payment for Order Flow works. Order Flow is currently in the news as the Securities and Exchange Commission has been floating the idea of banning it. There is even a [change.org petition](#) to ask the SEC to ban Order Flow. Stay tuned!

Assets Under Management (AUM)

Over the years, commissions have received bad publicity, especially when a few brokers would “churn” their clients accounts. A broker is guilty of [churning](#) when they encourage their clients to initiate excessive trades in their accounts for the purpose of generating commission income for themselves. As such, the brokerages have experimented with alternative methods of charging for their services. Many years ago, Merrill Lynch experimented with charging \$3,000 per year for unlimited trades but they do not have that program anymore.

By far, the most popular method to charge for brokerage services today is called [Assets Under Management](#), commonly abbreviated as AUM. An account that is charged Assets Under Management is also referred to as a wealth management account, a [wrap account](#), an investment advisor account, or simply an [advisor account](#). With AUM, instead of charging per transaction, the brokerage firms tack on a yearly 1% or 2% wealth management fee. Do you remember the mutual fund F shares? These types of programs are being pushed by all the major full service brokerage firms and many discount brokerage firms. There are several flavors of this program.

Performance-Based Wealth Management

The latest wrinkle to this method is the new [performance-based wealth management](#) program. With performance-based wealth management, you are only charged Assets Under Management investment service fees when your account advances past the previous quarterly total. Only pay your advisor when you make money! The advisor receives 10% to 20% of your earnings when you make money. The advisor receives nothing when you lose money or do not make anything. It is a variation of the way [hedge funds charge their shareholders](#). These accounts are aggressively marketed to [high-net worth investors](#).

One San Diego-based firm that offers this model is [Dunham & Associates](#). When the Global Financial Crisis of 2008 and 2009 hit, Dunham had to change their model somewhat since it took several years for most clients' accounts to rise to the point they were before the collapse.

Dunham altered their fee structure so they now charge much less when your account does not gain instead of charging nothing.

Both the Assets Under Management and the performance-based wealth management models sound tempting to the potential investor. The investor pays no commissions and with the latter model, they pay no or very low fees if their account does not grow. However, the reality is that you have the potential to pay far, far more for your investment services using this method. For prudent, long-term investors who do not partake in excessive buying and selling of their investments, the Assets Under Management model will most likely be the most costliest of any option.

Your Humble Author is an anachronism. Personally, I do not believe that these accounts are in the best interests of the clients. Prudent, long-term oriented investors will typically pay far more with the Assets Under Management model as opposed to just paying the traditional commissions. However, you will be hard pressed to find investment advisors that do not use these models. Several years ago, sitting at the table while attending an investment seminar, the topic of discussion turned to the commissions versus Assets Under Management models of charging clients. My contribution was, “I simply do not believe that the Assets Under Management model is in the best interests of the clients. Prudent, long-term oriented investors who do not engage in excessive trading are going to pay far more over the long term. I believe we are doing our clients a disservice.”

A gentleman with perfectly quaffed hair and wearing a very expensive suit shot back with, “What are you worried about? You send them a bottle of wine on their birthdays, take them to the golf course and the steak house. They’ll love you!” I decided that it was time for me to cease any contributions to the conversation.

As noted in the comment at the table above, the Assets Under Management model should be far more expensive for prudent, long-term oriented investors who do not engage in excessive trading. If you want to be a speculative trader and buy and sell frequently, then an Assets Under Management model might wind up being more cost effective for you. Of course, as we have done our best to impress upon you, successful frequent buying and selling of securities is difficult, at best, and downright impossible for the vast majority of us. It's not called *The Loser's Game* for nothing, ya' know! Thank you, [Charlie Ellis](#)!

Anti-Brokerage Firms: Dividend Reinvestment Plans (DRIPs)

Fed up with your broker? How about bypassing the middleman and going straight to the companies that you want to invest in? Many of the large, well-established companies offer a way for you to invest directly in their stocks via [Dividend Reinvestment Plans](#), usually abbreviated as DRIPs. As we learned in chapter 3, Introduction to Stocks, some are totally free or very close.

However, DRIPs are not perfect. How would you like having to sift through 18 different statements? Some cost conscious brokerages [InteractiveBrokers](#) charge a monthly fee to allow you to keep all your DRIPs in one place. Many traditional brokerage firms also now offer DRIPs. Prudent, long-term, buy and hold investors should definitely consider the use of Dividend Reinvestment Plans. Remember: Dividends don't lie!

Account Types

There are many types of accounts. Once the major options are reviewed, for most investors, choosing an account is usually straightforward and easily accomplished without the need of professional assistance. However, depending upon the situation, an investor may have need of competent legal counsel from an attorney or professional tax advice from a Certified Public Accountant or IRS-certified Enrolled Agent. Registered representatives, commonly referred to as stockbrokers, are strictly forbidden from giving any legal or tax advice whatsoever, including about how an account should be established. If the account is for an individual with special needs or who is incapable of responsibly managing their money or if the sum is over \$100,000 in the State of California, then it is imperative that an attorney should be consulted. Go talk to the lawyers!

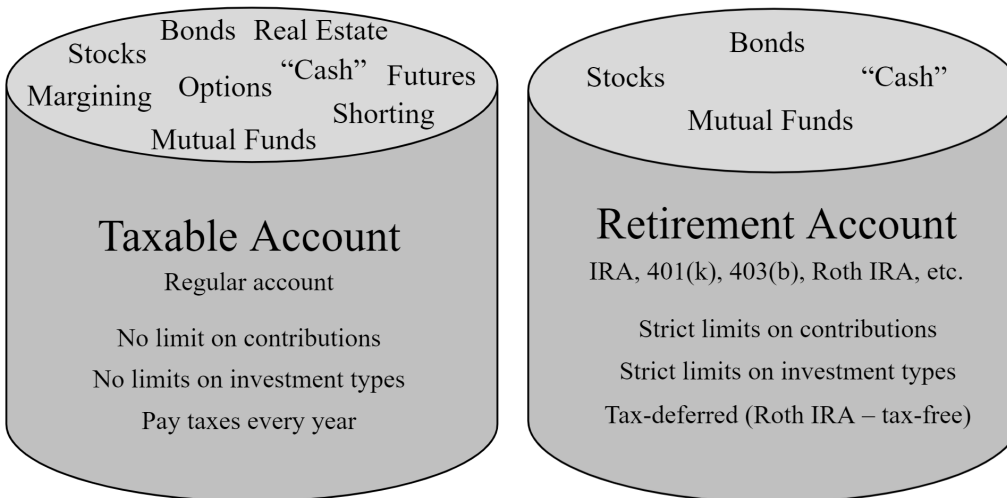
In general, for the vast majority of retail investors who won't need professional assistance, there are two major types of accounts that need to be reviewed, regular taxable accounts, sometimes called regular accounts or taxable accounts, and tax-qualified accounts.

Regular Taxable Accounts Versus Tax-Qualified Accounts

Unless the investor specifies otherwise, the brokerage firm will assume that the investors wants a [regular taxable account](#). With a regular taxable account, each year an investor will receive one or more Forms 1099. The [Form 1099](#) is used to report taxable income such as dividends, interest, or capital gains. The investors will need to include the information from the Forms 1099 on their tax returns and pay any applicable taxes. With regular taxable accounts, there are no limitations on how much can be contributed. There are also no limits on the types of investments that can be placed in regular taxable accounts.

[Tax-qualified accounts](#), on the other hand, are accounts that allow the investor to either defer or forgo paying taxes. Tax-qualified accounts are also referred to as [tax-advantaged accounts](#). There are numerous types and variations of tax-qualified accounts. Examples include retirement accounts, educational savings accounts, and health savings accounts. We will concentrate on the retirement accounts. However, many of the concepts and attributes are similar in other types of tax-qualified accounts. With a tax-qualified account, there is typically a limit to how much can be contributed in any one year. There are also restrictions on what types of investments can be placed into the accountants. However, unlike a regular taxable account, a tax-qualified account

investor will not receive the Form 1099 each year unless money is withdrawn. Your account is able to grow [tax-deferred](#) or in some cases, [tax-exempt](#). (Careful! The IRS does not like the term tax-free.)



The two cylinders in the graphic above are meant to resemble bins or buckets. The taxable account bin on the left can accept all types of investments, stocks, bonds, mutual funds, short-term “cash” investments, real estate, as well as exotic vehicles such as options and futures and allow for buying on margin and selling short. Notice that with the bin on the right, the only types of investments that are accepted are stocks, bonds, mutual funds, and short-term investments. (Actually, there is a way to place real estate into a tax-qualified account but it is not recommended. It can result in disaster if one is not careful.) Although there are many other subtle and not-so-subtle differences, the major differences are how they are taxed by the IRS, how much money you can contribute, and what you can have in the account. Let’s investigate the two major forms of tax-qualified retirement accounts, pre-tax and post-tax.

Pre-tax Tax Qualified Accounts

[Pre-tax qualified retirement accounts](#) are also referred to as before-tax accounts. The contributions that go into the account reduce your income taxable and give you a tax break now. Examples include the Traditional IRA, 401(k) and 403(b) employer-sponsored plans, and the SEP-IRA, SIMPLE IRA and Keogh plans for small businesses and the self-employed. The contributions are deducted from your taxable income which reduces the taxes you pay. The investments grow [tax-deferred](#) until retirement. When the investor money is withdrawn in retirement, the investor pays the income tax.

The most popular personal retirement plan is the IRA, now referred to as the [Traditional IRA](#) to differentiate itself from the newer Roth IRA. Although everyone believes that IRA stands for Individual Retirement Account, the acronym actually stands for Individual Retirement

Arrangement. Of course, if you use the correct Individual Retirement Arrangement, most everyone will look at you funny. Just say IRA.

Currently, anyone with earned income can contribute to a Traditional IRA. There is some confusion because of some of the provisions that will be discussed momentarily and because their counterpart, the Roth IRA, has restrictions on contributing for high-income individuals. However, as the tax code stands now, anyone with earned income, no matter how high, can contribute to a Traditional IRA.

Traditional IRA contributions are normally pre-tax deductible contributions that reduce your taxable income and thus give you a tax break now. This is where some of the confusion we mentioned above starts to emerge. If you have an employer-sponsored retirement plan at your place of employment and make over a certain amount, then your contributions are still allowable. However, your contributions may not be allowable as pre-tax contributions. They would be designated as post-tax contributions. You would not get a tax break now on the contributions. Of course, when those contributions are withdrawn, you would not have to pay taxes again on them. This means you will need to keep tabs on how much of your balance is pre-tax and how much is post-tax. You don't want to pay your taxes twice!

In any event, whether funded with pre-tax or post-tax contributions, your investment grows tax-deferred. You pay taxes on the money as you withdraw it once you are retired. Once an investor reaches 59½ years of age, withdrawals are allowable with no penalty. Mandatory withdrawals, called [Required Minimum Distributions](#) or RMDs, begin at age 72. As of this writing in April 2022, there is a bill working its way through Congress that would raise the age for Required Minimum Distributions. This makes sense since as we have mentioned, people are living and working longer. The penalties for not taking the RMDs are severe, 50% of the amount that should have been withdrawn. What a way to treat old folks!

The Traditional IRA has many pre-tax siblings and cousins. There are numerous types of employer-sponsored retirement plans such as the [401\(k\)](#) for corporations and other private businesses. For public organizations such as schools and hospitals, there are [403\(b\)](#), [457](#), and [401\(a\)](#) employer-sponsored retirement plans. For the self-employed and small businesses, there is the [SEP IRA](#), the [SIMPLE IRA](#), the [Solo 401\(k\)](#), and the [Keogh](#) retirement plans. Another small business plan is the [SARSEP](#). SARSEPs are no longer able to be established but those who had one before 1997 are grandfathered and can continue to provide the plan for their employees. You may be asking, "Where do these silly names come from?" The answer is the United States [Internal Revenue Code](#), all [70,000 pages](#) of code and regulations.

A pre-tax contribution lowers your taxes now. The table below shows what happens when you have \$100 deducted from your paycheck and contributed into a 401(k). The table assumes you

are in the 25% Federal marginal tax bracket and 8% California marginal tax bracket.

You contribute via your paycheck:	\$100
Your Federal tax withholding is lowered by:	\$25
Your California tax withholding is lowered by:	\$8
Total government subsidy:	\$33
Your take home pay is only reduced by:	\$67

Your take home pay is only reduced by \$67 but the whole \$100 still goes into your account. In addition, your employer might match your contribution 50% or 100%. If your employer matched your contribution at 100%, then they would contribute an additional \$100 into your account. dollar for dollar. Okay, so what's the catch?

You pay income tax on any amounts withdrawn in retirement. However, people in retirement are usually in a lower tax bracket. If you are not in a lower marginal tax bracket in retirement, congratulations! It is my sincerest desire that all our students and readers are afflicted with the horrible misfortune of taking considerable amounts of money from their retirement accounts in their golden years.

Of course, if you withdraw the funds before retirement, you not only have to pay the income tax, you normally will be required to pay a 10% penalty. (The IRS does not call it a penalty; they call it an additional tax. Whoopee.) With some types of accounts, there are exceptions for [first time home purchases](#), [higher education expenses](#), medical disability and financial hardship. It is typically difficult to get the IRS to accept the financial hardship exception. Some 401(k) and 403(b) plans do allow an individual to borrow from their account. However, the amount must be paid back in an approved amount of time or the loan will be disqualified and ruled as a withdrawal. Plus if you lose your job, the loan becomes due quickly, typically within 90 days. In general, whatever monies you put into your pre-tax accounts should be considered to be set aside until retirement.

Some individuals may balk at the idea of setting aside money that will not be touched for upwards of 40 years. However, the traditional pension plans that employers used to offer their employees are being replaced with so-called defined contribution plans such as the 401(k) and 403(b). In the traditional pension plans, the employers would set aside funds for their employees' retirement for many decades. Now it is up to you. The good news is if you invest consistently, prudently, with an eye toward long-term growth of capital and income, you will be able to create for yourself a pension that will far exceed what the traditional pension plans offered. On the

other hand, if you don't contribute consistently or panic when the markets fall, well, we know you won't be guilty of those terrible transgressions, right?

Post-tax Tax Qualified Accounts

Starting in 1998, a new type of tax-qualified retirement account, the Roth IRA, came onto the scene. A [Roth IRA](#) is a [post-tax account](#), also referred to as an after-tax account. The Roth IRA does not give you a tax break now. Instead, your contributions are taxed as normal income. However, in retirement, all the contributions and compound earnings in the account can be withdrawn tax-free. (Oops! Sorry, IRS. We meant to say, "tax-exempt.") This ability has since been added to 401(k) and 403(b) plans. Tax-free in retirement is a tremendous benefit.

Let's revisit the same \$100 monthly contribution, but this time with a Roth IRA.

You contribute to a Roth IRA:	\$100
Your Federal tax withholding is lowered by:	\$0
Your California tax withholding is lowered by:	\$0
Total government subsidy:	\$0
Your disposable income is reduced by:	\$100

As you are explaining the Roth IRA to a family member or friends, they exclaim, "What? No help from the government on your taxes? Why would anyone contribute to a Roth IRA?" Here's the answer you will give them, "Because a Roth IRA is so cool!" Tax-free in retirement is a golden opportunity. No other investment account option comes close. Eventually, they will probably be gotten rid of or have severe constraints put on them. Indeed, as of late-2021, there was legislation making its way through Congress that would pare back the benefits of Roth IRAs for high-net-worth and high-income taxpayers. This legislation seems to have stalled, though, as of April 2022.

Another major benefit of the Roth IRA is that you can [withdraw the contributions at any time without taxes or penalties](#). You have already paid tax on the contributions. This makes the Roth IRA also an excellent intermediate-term investment account. You can use it for the down payment of a house or other high-ticket item. They are great for college expenses since currently the monies in a Roth IRA are not taken into account when you apply for public financial aid using the FAFSA form. (Some private universities do take Roth IRA monies into account when calculating financial aid.)

However, the Roth IRA was not meant for everyone. Unlike the Traditional IRA, there are [limits on who can contribute to a Roth IRA](#). Only single taxpayers with an AGI of \$129,000 or less in

2022 and married couples with an AGI of \$204,000 or less in 2022 can fully contribute to a Roth IRA. After you earn over these amounts, the amount you can contribute is lowered until it phases out entirely. If you don't qualify, congratulations!

As is the case with our tax system, there is often a loophole. You can still contribute to a Roth IRA anyway. If you already knew you earned over the limit or if it turns out you find that you have earned over the limit, you can "recharacterize" – that's the verb that the IRS uses – the contributions into a Traditional IRA which does not have the same limitations before you file your taxes and then you convert the Traditional IRA back into the Roth IRA. It is called the [Roth IRA Backdoor](#). I know. I know. Who voted for these bozos? Oh, yeah. We did. As mentioned, there is legislation in Congress that may eliminate this provision.

Contribution Limits on Retirement Accounts

Tax-qualified accounts typically have yearly contribution limits. The limits increase with inflations. Here are the contribution limits for 2022 for the Traditional IRA and Roth IRA. Note that these limits are cumulative. You can contribute to multiple Traditional IRAs or Roth IRAs but the total contributions in all your accounts must not exceed these amounts.

Year	Under 50	Age 50 and Over
2022	6,000	7,000

For the Traditional and Roth IRA, [contributions are limited](#) to the lesser of your gross salary or the maximum yearly contribution. If you make at least \$6,000, you have until April 15th of 2023 to put the maximum into an IRA or Roth IRA for 2022. Your spouse is also eligible for contributions even if he/she does not work.

The contribution limits for 401(k), 403(b), and 457 employer-sponsored plans are much more generous.

Year	Under 50	Age 50 and Over
2018	18,500	24,500
2019	19,000	25,000
2020	19,500	26,000
2021	19,500	26,000
2022	20,500	27,000

Again, [contributions are limited](#) to the lesser of your gross salary or the maximum yearly contribution. In other words, in 2022, if you make \$20,500, you could put your entire income into a 401(k) or 403(b) or 457. As noted above, these amounts are now indexed to inflation and go up over time. There is a loophole in the law that allows those in the public sector to contribute \$20,500 into both a 403(b) and a 457 – or \$27,000 into both if you are 50 or over!

The Roth 401(k) and Roth 403(b)

Starting in 2006, employers were able to offer the Roth option for their 401(k) and 403(b) plans. Similar to a Roth IRA, [Roth 401\(k\)](#) and Roth 403(b) contributions can be made post-tax. However, any monies matched by your employer continue to be pre-tax contributions. This means you must keep good records of how much is pre-tax and how much is post-tax. You don't want to be taxed twice on the post-tax contributions! This is a great option for those who do not need the tax break now. However, unlike the Roth IRA, contributions are not able to be withdrawn without penalty or taxes until retirement. Unless your employer offers matching contributions, Your Humble Author prefers the Roth IRA because of its flexibility as an intermediate-term account. Of course, if your employer offers matching contributions, the Roth 401(k) or Roth 403(b) is the winner. Never turn down free money, Dear Readers!

Tax Credits for Retirement Savers

Retirement savers [may be eligible for tax credits](#). A tax credit is a dollar for dollar reduction of income taxes. The tax credit amounts range from 10% up to 50% of your contributions with a maximum of \$2,000 per individual. The tax credit is based upon how much you contribute and your [Adjusted Gross Income](#) (AGI). If your Adjusted Gross Income is below these amounts for 2022, you should be eligible for the tax credit:

- \$34,000 or less – single filers
- \$68,000 or less – married filing jointly
- \$51,000 or less – head of household

There are some other restrictions. You must be at least 18 years old, not be a full-time student, and not be claimed on someone else's tax returns as a dependent. If you are eligible, then, for example, \$50 per month contributed to a Roth IRA for a total of \$600 per year could result in a \$300 tax credit. That is a strong motivation to contribute. If you do your own taxes, do not forget this. If you have someone do them, make sure to tell them you put money away in a retirement account. Tax software programs such as TurboTax handle these well.

Annuities

An [annuity](#) is a life insurance product designed to provide a guaranteed income to an [annuitant](#). The annuitant is the person who will receive the stream of income. Annuity options include income for a set number of years, or for [as long as the annuitant lives](#), the so-called [life income option](#), usually just referred to as the life option. The life income option can be modified so that it also will pay the annuitant for as long the annuitant lives or pay a spouse or other dependent as long as they live if they outlive the annuitant. The periodic payments depend upon the annuitant's age, which of the above options were chosen, how much was contributed, and how well the annuity's underlying investments, if applicable, have performed over time in the case of a variable annuity discussed below.

There are numerous options and variations of annuities but they generally fall into two categories, fixed annuities and variable annuities. With a [fixed annuity](#), the annuitant knows exactly how much they will receive over time. The life insurance company typically invests the annuity contribution in bonds, fixed investments. With [variable annuities](#), the annuitant chooses various underlying investments, most typically stock or bond mutual funds, and the periodic payments will, of course, vary depending upon the results of the underlying investments.

Once the insurance companies began to offer mutual funds as options for annuities, the Securities and Exchange Commission claimed regulatory jurisdiction. For this reason, life insurance agents who sell variable annuities must also be licensed with the SEC. The agents can choose to take the Series 7 Registered Representative (a.k.a. Stockbroker) exam but often they take a much watered-down version, the [Series 6](#) exam. This exam goes by the unwieldy name, the Series 6 Investment Company/Variable Contracts Products Limited Representative exam. You will rarely hear anyone refer to it other than as the Series 6 exam. It was designed solely for insurance agents who only wanted to be able to sell variable annuities and had no desire to be registered representatives, commonly referred to as stockbrokers.

An advantage of annuities is that contributing to them is very flexible. Unlike retirement accounts and other tax-qualified accounts, annuities can be funded with pre-tax dollars or after-tax dollars and there is no limit on contributions. Interest earned is then tax deferred and similar to retirement account, you pay taxes on any pre-tax annuity contributions and all tax-deferred earnings as you withdraw them in retirement. As with other retirement plans, when you retire you will likely be in a lower income tax bracket.

The Siren Call of Annuities

The life income option is typically the major selling point of annuities. "You will never outline your income!" Given that outliving their investments is always a concern to investors no matter how many resources an individual or couple have accumulated, this provision appears very attractive indeed to potential annuitants. What could be the downside to a lifetime of income?

The Reality of Annuities

It turns out that the downsides are severe. You are paying dearly for that guarantee of lifetime income. Annuities have supersized fees. Recall that fixed annuities typically invest in bonds and variable annuities typically invest in mutual funds that invest in stock or bonds or both. The fixed annuities will typically shave 1% to 2% off the interest income from the bonds they invest in. With variable annuities, they pocket typically 2% to 3% and can take as high as 4% of the yearly investment results. Where is the difference going? You guessed it! The spread is going straight into the coffers of the insurance agencies.

The spin doctors at the insurance companies will invariably craft propaganda along these lines: “Don’t gamble with your money! You may receive mediocre returns by investing in mutual funds, stocks, and bonds. Instead, choose our life income and we will guarantee a stream of income for the rest of your life.”

If the spin doctors were somehow given a truth elixir, the spiel would go something along these lines: “Don’t gamble with your money! You may receive mediocre returns by investing in mutual funds, stocks, and bonds. Instead, choose our life income and we will guarantee that you receive mediocre returns and receive a paltry stream of income for the rest of your life.” On the website is an [illustration comparing the income streams from two different retirement alternatives](#), a fixed income annuity and a balanced mutual fund. There is a very stark difference between the two. (Remember that we are assuming that the investor *does not panic* when markets fall! The case where an individual is incapable of keeping their emotions in check is the only situation where Your Humble Author might recommend an annuity. However, a better option would be to consult a lawyer about a trust fund. What is that? Talk to the lawyers!)

Once annuitants realize their annuity is not all that their life insurance agent made it out to be, it is often too late. They are locked into the agreement for the rest of their lives. In some instances before the life income option is initiated, there may still be time for the [unfortunate individual to break free of the agreement](#). However, the cost will be steep. Do you remember the Contingent Deferred Sales Charges of the Class B mutual fund shares that declined from 5% to 0% over the course of 5 years, for example? Annuities typically have what they call a “surrender schedule” that works similarly. Unlike the Class B mutual fund shares, the surrender schedule starts at 20% or 25% and can take as long as 20 years. Life insurance companies do not relinquish their ill-gotten gains easily.

Of course, if you are a life insurance agent, you are in love with selling annuities. The commissions are very generous indeed. Your insurance company will even send you an [all-expense paid Caribbean cruise](#)! (Ah, we are talking about the life insurance agent going on the cruise, not the annuity client.) It is important to note here, Dear Readers, that Your Humble Author is also a licensed life insurance agent. Personally, I have never found an annuity whose

results have come close to what a prudent, long-term oriented investor could produce with the education from a course such as this and the maturity to not panic when markets fall or the help of a trusted financial advisor. I could sell these abominations but I won't. If someone wanted to buy one, I would do my best to show them alternatives that – assuming the world does not end – should do much better over the long term.

You may also have heard that you can actually invest in life insurance itself. Whole life, cash value, straight life, ordinary life, universal life, variable life, and permanent life policies are all examples of what the insurance industry loves to call investments. They are even worse than annuities. For a more detailed discussion, please refer to chapter 10 of our BUS-121, [Financial Planning and Money Management](#), class, that deals with Life Insurance.

Oh, by the way, if any individuals from the world of insurance are reading this and are tempted to sue me for defamation or libel, by all means, we welcome the suit. During the initial discovery process, we will bring life insurance illustrations and mutual fund illustrations to the court with us. Many years ago, on a few occasions, when challenged about my aversion to annuities and whole life policies, I offered to enter into an agreement with the life insurance representatives. Let's compare comparable investments. If yours are better than mine, I will buy yours personally from you. If mine are better yours, you will buy mine personally from me. No one ever accepted the offer. One individual exclaimed, "But that is not a fair comparison!" My sentiments exactly. Never trust an insurance company with your investments, Dear Readers!

Congratulations – You Have Finished Chapter 18 – Brokerages, Account Types, and Annuities

You have reached the end of chapter 18, Brokerages, Account Types, and Annuities. In this chapter and the chapter 18 Canvas module, [class website](#), and [Introduction to Investments Discussion Forum](#), you have

- Been introduced to various types of brokerage firms and other options for holding your securities
- Examined various types of investment accounts including regular taxable accounts and tax-qualified accounts
- Investigated the constraints and benefits of using tax-qualified accounts for long-term investing
- Examine the few advantages and the more numerous disadvantages of annuities as investments

You should now be able to

- Describe various types of brokerage firms and other options for holding your securities
- Explain various types of investment accounts including regular taxable accounts and tax-qualified accounts

- Discuss the constraints and benefits of using tax-qualified accounts for long-term investing
- List the few advantages and the more numerous disadvantages of annuities as investments

So, where's ya's gonna' put yer money, eh?

In a Roth IRA at a deep-discount broker? With your employer-sponsored 401(k) plan at work? In both? Oh, and yes, you are going to stay far, far away from annuities, right? Good! Dear Students, we are ready to tackle our very last chapter. We will briefly discuss Starting a Business: The Ultimate Investment. Ah, it is definitely not for everyone.