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A VIABLE ALTERNATIVE TO BANKS & THE STOCK MARKET

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Billionaire investor Warren Buffet was once quoted as saying: “Unless you can watch your stock holding decline by 50% without becoming panic stricken, you should not be in the stock market”. In present-day America, more than ever, this seems like prudent advice. However, it also begs the question: if not the stock market, then where? Most Americans would agree that market-based investments– which overwhelmingly take the form of mutual funds—offer the best chance for strong returns. But who among us can stomach the losses associated with severe market corrections that on average, occur every five years? Even a little scrutiny reveals that placing your savings/investments in a bank is far from the smartest thing you could do.

When a typical corporate middle manager is working hard to save and grow money for retirement and/or a retiree is looking for ways to protect everything they’ve got, it raises the question as to whether there are better ways to build and protect our wealth. A very good alternative to traditional market-based investments, as well as to banks, are the products and strategies provided by the insurance industry. Before getting into any specifics though, it’s important to understand the critical differences between the structure of the banking and investment industry, versus that of the insurance industry.

Let’s take a quick look at banks. As an advisor who specializes in working with retirees and pre-retirees, I always ask and am always told that the reason people keep hundreds of thousands of dollars on deposit at the bank, i.e. in CDs, is because of “safety”. More specifically, people feel a sense of assurance that their money is “FDIC insured”. What most people don’t know is that the FDIC—as detailed in their own annual reports—really only has the ability to insure about $1.25 per every one hundred dollars that is deposited at banks. Viewed in another way, this means that given the level of their liabilities, only about 1.25% of your money is actually covered by the FDIC.

In addition to that scary thought, banks are legally required to maintain only about ten cents on reserve per every dollar they take in on deposit. The rest goes out in loans. So not only is money in the bank woefully under-insured, it is also over-leveraged and in recent years it has earned historically low rates of return. Not surprisingly, during times of extremely low interest rates, banks have earned record profits due to the spread between what they claim to be able to pay on CDs and savings accounts and what they continue to charge for auto, home and consumer loans.

Now let’s take a look at stock-market based investments in general and mutual fund investments in particular. Although the market offers the best chance for the highest possible gains, at the same time it exposes the investor to the best chance for severe loss. Catastrophic events anywhere in the world—both natural and/or man-made—have the ability to adversely impact investment performance at virtually any time. So in short, the typical investor is always exposed to market volatility, the risk of potential loss and has no guarantees as to the return on his money let alone of his money.

Not only is there on-going, inherent risk associated with market-based investments, but closer scrutiny of the mutual fund industry in recent years has revealed that Americans collectively spend tens of billions of dollars each year, simply for the privilege of holding mutual fund investments. These costs take the form of: sales commissions, annual trail commissions, annual managements fees, 12b-1 (marketing) fess and on-going turnover costs. John Bogle, founder and former CEO of the Vanguard Group, estimated in 2004 that it costs Americans roughly $72 billion per year to invest in mutual funds and even he can't say where all the money goes.

Although it's not the intent of this article to analyze the many categories of brokerage and mutual fund fees, it's important for people to know that there are serious costs associated with market-based investments in general and with mutual funds in particular. It's also important that people know that there is no law that says: thou shalt invest your retirement plan, IRA or children's inheritance in mutual funds—or the stock-market for that matter. This is particularly noteworthy because Americans currently have about $7 trillion invested in mutual funds.

So then, how is the insurance industry different and how and why can it serve us better? The first critical difference is the many layers of asset protection that are built into the insurance industry, but are not characteristic of banks or investment companies. These consist of the legal reserve requirement, which essentially results in insurance companies maintaining about $1.10 in reserve for every $1.00 in liabilities; consistent, regular oversight and inspection by each respective state's insurance department in which a given company operates; and the development of state guaranty associations in many states, which serve to assume the liabilities of any company which might have financial difficulties.

To put the financial viability and clout of the insurance industry in perspective, Gordon K. Williamson, in his book "All About Annuities" noted that: the life insurance industry owns and controls more assets than all of the assets in all of the banks in the entire world...combined; the life insurance industry owns and controls more assets than all of the assets in all of the oil companies in the entire world...combined; and that during the Great Depression, it was U.S. insurance companies, not the U.S. Government that bailed out the banking industry. While over 9,000 banks suspended operations from 1929 to 1938, 99% of all life insurance that was in force, continued unaffected.

The second critical difference in the insurance industry deals specifically with the type of savings and investment vehicles that are offered and the fact that fixed products (i.e. those that are not invested in the market) come with built in guarantees. Unlike market-based investments where the average investor assumes all risks, fixed life and annuity contracts come standard with a guarantee by the issuing carrier, on principal deposited and interest earned. This essentially transfers the risk from the individual to the insurance company(s).

One investment tool in particular that can help build and fund a comfortable retirement, while eliminating virtually all of the costs and risk associated with typical investments, is the fixed annuity. In the big scheme of things, there are only two types of annuities; fixed and variable. Fixed annuities provide an annual, stated rate of return on the principal in the contract, while variable annuities are simply another form of mutual fund investments. In 1995, the equity-indexed annuity (EIA) was introduced, which is basically a newer version of traditional fixed annuities. They have done an outstanding job of allowing the contract holder the opportunity to participate in gains of the stock-market, yet still fully protect the contract principal in the event of market declines. How is this done?

The fixed annuity account, which is guaranteed at all times by the company, is simply “linked” to one of the many stock-market indices provided in the contract, e.g. S&P 500, NASDAQ 100, Russell 2000 or the Dow Jones Industrial Average. During a given contract year, if the value of the index goes up, then those gains are credited to the fixed account and they are locked in, never to be lost down the road. If in a given year, the value of the index does not go up, or perhaps declines, then there is no gain credited for that year to the account, but the important thing is that neither is there any loss deducted. This particular type of annuity can be used to fund an on-going qualified retirement plan and more specifically to help retirees both grow and protect their life savings.

The standard reply that I hear upon explaining the basics of these contracts is that “it sounds too good to be true”. There are many other details involved, depending upon the particular contract initiated, such as: participation rate, caps and crediting methods. The bottom line however, is that by simply changing the nature of one’s underlying investments, a person can go from a situation where there are on-going fees, market volatility, the risk of loss and no guarantees on his money, to a situation where there are not fees, no risk of loss and his money is fully guaranteed—all while taking advantage of market upside and enjoying protection against market down-side.

Mr. Blansett is a Certified Senior Advisor who specializes in helping clients preserve and protect their retirement assets, minimize their financial risk and reduce taxes on earned income. He utilizes a values-based planning approach to help clients determine the most appropriate strategies for their wealth.

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