Understanding Annuities

Annuities are popular retirement savings vehicles. Chances are you've heard many—possibly conflicting—opinions about them. To give you a better understanding of annuities, here is a brief overview of what they are, why you should consider them, how they work, and if they are right for you.

THE DEFINITION

As defined by the Securities and Exchange Commission (SEC), an annuity is: "A contract between you and an insurance company that requires the insurer to make payments to you, either immediately or in the future."[1]

You buy an annuity by making either a single payment or a series of payments. Similarly, your payout may come either as one lump-sum payment or as a series of payments over time.

The premise is straightforward—you buy an annuity, and the insurance company, depending on the performance of the underlying investment, provides a return. Pretty great, huh? But there are some things to consider before you invest.

REASONS TO CONSIDER AN ANNUITY

Lifetime Income

Periodic payments, an appealing aspect of an annuity, complement other retirement income sources like 401(k)s, Social Security and pension plans by providing a reliable stream of income for a set period, often the remainder of your life.

Income Options

There are various income payment options. These may include lifetime payments, lifetime payments with 10 period certain benefit, as well as with rights of survivorship which are payments that extend over your lifetime and your spouse's lifetime.

Tax-deferred Growth

Similar to an IRA, you pay no taxes on your annuity's investment gains until you withdraw money from it. You invest tax-free, and then withdraw money at a lower tax bracket in retirement. Unlike an IRA however, there is no limit to how much money you can invest into an annuity.

Annuitization

If you choose to do so, you may assign the entire account / contract value to a financial institution, and in return, you receive income for life.

Guaranteed Minimum Withdrawal/Income Benefits

Riders can be purchased to make an annuity more attractive. For example, you can ask for a minimum withdrawal benefit if you do not want to annuitize and assign the contract to the financial institution.

Death Benefits

Your beneficiary may be eligible for a substantial payment(s) in the case of your death.

NOT ALL ANNUITIES ARE THE SAME

The annuity marketplace can be complex, but in general, there are three main types of annuities that suit a variety of needs and goals.

Fixed Annuity

A fixed annuity is the most straightforward on this list. You make a payment, or a series of payments, and the insurance company promises you a minimum rate of interest and a fixed amount of periodic payments in return. However, since your payment is fixed, you have no control over how the insurance company invests your funds and instead must rely on the company's history of making payments. To ensure you are making a solid investment, you should check the insurer's credit rating.

Variable Annuity

A variable annuity is similar to a fixed one in that you make a payment or a series of payments. However, rather than offering a fixed amount in return, with a variable annuity you decide where to invest your money. The annuity pays you a level of income in retirement that is determined by the performance of your investment choices. Because you're in control, you can tailor your investments to your level of risk tolerance. But of course, there's a chance that your investment selection may under-perform the market.

Indexed Annuity

An indexed annuity combines the features of a security and an insurance product in one. With it, your payment contains a promised return that, rather than being based on investments you choose or on a fixed rate, is based on a stock market index, such as the Standard & Poor's 500 Index.

In It for the Long(er) Haul

Annuities are not typically suited to realizing short-term financial goals because they often contain prohibitive surrender charges for early withdrawals. While these fees reduce over time, the reduction is gradual. Fees can start anywhere from seven to 20 percent. Also note that surrender period lengths can be as long as seven to 10 years, so make sure you understand the length of time during which you won't be able to reclaim the full amount of your initial annuity purchase.

Yes, There are Fees

Fees vary, but as annuities offer more benefits than a typical investment product, their associated fees can be higher than other products. Be sure to check and compare fees for competing products, and be clear what you are paying for.

Always Talk to an Advisor First

Of course, there is much more to annuities than the information presented in this brief overview. Before investing, be sure to talk with an advisor. By examining your options within the context of your overall financial portfolio, your advisor can help ensure that you are investing in the vehicle that best meets your needs.

[1] "Annuities." U.S. Securities and Exchange Commission. 2011. https://www.sec.gov/fast-answers/answersannuityhtm.html.