WHAT YOU SHOULD KNOW ABOUT ANNUITIES

Annuities are similar to a pension you purchase for yourself.

Company pensions are pretty much a thing of the past in corporate America. While the ubiquitous 401(k) plan might help workers save pre-tax dollars for retirement, they've also shifted the responsibility for retirement planning to the individual. And as many people saw in 2008, 401(k)s can be fraught with market risk, including the risk of losing too much value, forcing the retiree to go back to work.

Annuities can be thought of as a way to transform savings into income. When you purchase an annuity, you are exchanging a sum of money for an agreed-upon monthly payment, generating a predictable income stream in retirement similar to a pension.

Tax-deferred, qualified annuities.

Annuities can be purchased with pre-tax or after-tax dollars. Sometimes people perform a 401(k) rollover into an annuity with money from a previous employer, or after they turn 59-1/2 years old, when they can access their money without a 10% federal tax penalty.

When purchased with pre-tax dollars, a properly-structured annuity can offer 100% tax-deferred growth, similar to other qualified accounts. You're not taxed on interest earnings while your money stays in the annuity, but once you start receiving payouts, just like a 401(k) or traditional IRA, they are taxed as ordinary income based on your income tax rate at the time. When you hold annuities in non-qualified accounts purchased with after-tax dollars, there are no penalties or mandatory distributions based on age.

They're not right for everyone.

There are a number of reasons annuities might not make sense for some people. Surrender fees apply if you want out of your contract early, and you should learn about any other fees involved with any individual annuity policy before you purchase. A qualified financial advisor can spell out the pros and cons.

But most people are worried about how they'll make it through retirement without running out of money, especially given the increased longevity predicted for most Americans. For them, a portion of their portfolio containing annuities might make sense, depending on their situation and goals.

There are many different types of annuities.

There are many different types of annuities available, including variable, fixed rate, fixed indexed, etc., each having different features. Some of them are popular, including indexed annuities and fixed-rate deferred annuities. Sales for those were up in the first quarter of 2018. LIMRA expects overall annuity sales to increase 5% to 10% in 2018 and 2019.[1]

However, not all annuities are necessarily a good fit, or a good deal. It is very important to work with a trusted financial advisor who can compare pros and cons, fees and costs for you to help you assess suitability based on your unique situation.

Many types of annuities come with guarantees.

One of the most appealing things about annuities is the guarantee. Because annuities are contracts between you and an insurance company, the insurance company often guarantees that your principal will be protected based on their financial strength and claims-paying ability. Some annuities also guarantee a certain amount will be credited to your policy based on contract terms; while many indexed annuities deliver “downside market protection” as well as “upside market potential.” The exception is a typical variable annuity, which may be invested in the market and subject to losing value in a market downturn.

A recent survey by Allianz showed that 57% of investors with $200,000 would give up potential gains for a product that protects a portion of their retirement savings, up from 48% in 2015. For those with more than $200,000, the numbers jump even higher, to 68%. Allianz attributed the results to “simmering anxiety” about market volatility in many Americans.[2]

Some Wall Street experts are now advocating annuities as a replacement for part of your bond portfolio in retirement.

In March of 2018, Yale Emeritus Professor Roger Ibbotson finished a landmark study which ran hypothetical return simulations comparing stocks, bonds and fixed indexed annuities (FIAs) from 1927 to 2016. As a result, he concluded that “fixed indexed annuities have the potential to outperform bonds.” His simulated annualized return figures based on nearly nine decades of market history showed large cap stocks at 9.92%, long term government bonds at 5.32% and FIAs at 5.81%.[3]

While he doesn’t advocate completely replacing bonds in the portfolio, he does think combinations of stocks, bonds and fixed indexed annuities make the most sense for retirees. “You have to de-risk, and we see that bonds are not necessarily the way to go,” Ibbotson says. While FIAs don’t directly invest in the stock market, they offer potential account growth based on the performance of a specified index, such as the S&P 500®. If the index has a positive return, the FIA policy is credited with interest.

The inverse relationship between a bond’s price and its yield pose one of the main risks with bonds. In an already-historically-low interest rate environment set to rise, the risk can be even greater for retirees with a large portion of their portfolio in bonds.

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2 “More Investors Inclined To Give Up Performance For Protection, Survey Says,” FA-mag.com. https://www.fa-mag.com/news/investors-more-inclined-to-give-up-performance-for-protection--survey-says-39061.html (accessed June 12, 2018.)

3 “Ibbotson: Fixed Indexed Annuities Beat Out Bonds,” Wealthmanagement.com. http://www.wealthmanagement.com/insurance/ibbotson-fixed-indexed-annuities-beat-out-bonds (accessed June 12, 2018.)