Annuity Basics

Defined payment streams offer some protection from market risks.

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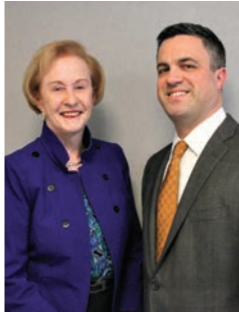


Annuities often are used in retirement plans, but they can be somewhat confusing since they fall into a gray area because they have aspects of both insurance and investment products. Similar to contracts signed with life insurance companies, annuities can offer defined payment streams like other forms of insurance.

At the same time, they also can provide investment opportunities that mimic more traditional assets. In addition, many annuities offer a layer of protection against market volatility, making them potentially attractive to investors with low risk tolerance.

These benefits come with a cost and annuities have long had a reputation for expense rates that are significantly higher than traditional investment vehicles. Below we examine the basics, benefits and costs of the most common annuities.

WHAT IS AN ANNUITY?

An annuity is a contract between an individual and an insurance company where the individual pays a lump sum or a series of payments in exchange for future income payments. The insurance company may invest your premiums as it sees fit, or you may have some control over how the money is invested, depending on the type of annuity.

Annuities can be immediate or deferred. Immediate annuities begin payments as soon as they are opened and premiums are received. Typically, one is funded by a lump sum payment from a retirement plan payout or other financial windfall. Deferred annuities generally go through an "accumulation phase" where regular premiums are paid for a period of time in order to fund distributions that begin at a later date.

Once you reach the "distribution phase," you can begin drawing money from the annuity. These distributions can differ in amount and timing depending on how the premiums are invested and what options the annuity offers. When you begin distributions, you will choose the term or duration of payments. The most common choices are **life** (owner's life only), **joint life** (where payments continue to a spouse after your death) or **period certain** (for example 20 years). The life option provides the highest monthly payout, as it is based solely on your life. Period certain payouts will be lower, as payment will continue if you die before the end of the benefit period.

TYPES OF ANNUITIES:

With a **fixed annuity**, the insurance company guarantees a fixed interest rate on the invested principal amount. This means that the income payments remain the same throughout the agreed-upon term.

Alternatively, a **variable annuity** will offer a menu of investment options where the premiums can be invested, similar to mutual funds. Typically, these offer the potential for higher returns, but also involve more risk since they are subject to market volatility. As a result, the income payments will vary based on the investment returns.

Variable or indexed annuities can also help mitigate the effects of inflation over time.

Indexed annuities offer a combination of fixed and variable features. Rather than directly investing in underlying assets as in a variable annuity, the principal of the annuity grows based on an index linked to the annuity, for example the S&P 500. However, indexed annuities typically offer a minimum guaranteed interest rate, which provides downside protection if the index performs poorly.

BENEFITS OF ANNUITIES

The primary benefit of an annuity is the ability to provide a dependable lifetime income stream. This can be attractive in today's environment when most individuals can no longer expect a pension in retirement. An annuity can help protect against the risk that you might lose your savings, often referred to as longevity risk.

In addition, annuities offer tax-deferred growth during the accumulation phase. This can be attractive for individuals who don't have access to a traditional retirement plan or those who have maxed out their retirement contributions and want additional tax-deferred growth.

Variable or indexed annuities can also help mitigate the effects of inflation over time.

These annuities are tied to the performance of a specific index or investment vehicle and have the potential to increase in value over time, helping keep pace with inflation.

Finally, annuities can provide insulation from market volatility, particularly if they include a provision or rider that limits losses in a declining market. This can provide a real benefit for those with low risk tolerance who want some protection during bear markets.

CONSIDERATIONS AND DRAWBACKS

While annuities offer advantages, it's important to be aware of the drawbacks. Again, because annuities are insurance contracts, they have considerations you may not see in your more traditional investment portfolio.

First and foremost, annuities often come with fees and expenses that are significantly higher than traditional investment products. We examine these costs in greater detail below.

In addition, because these are contracts with an insurance company, you are exposed to what is known as counterparty risk. The financial stability and creditworthiness of the insurance company become important considerations. If the insurance company faces financial difficulties or goes bankrupt, it could potentially impact the annuity holder's ability to receive the promised income payments.

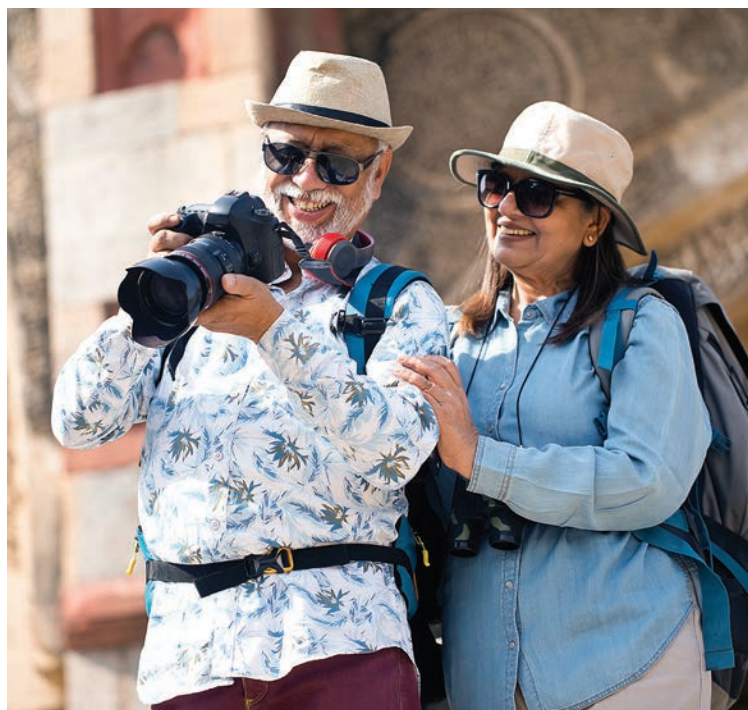
The structure of most annuities also means that they lack liquidity. In a deferred annuity, your money is often inaccessible for the first three to 10 years, unless you pay a surrender charge and/or a penalty. Even after the surrender period has passed, it can be difficult to access larger amounts if you have an unforeseen need. Thus, annuities may not be suitable for those who may need access to the money in the near future or who don't have other assets to use in the event of unexpected expenses.

Typically, annuities offer a limited selection of investment options compared to the universe of investment vehicles available in a brokerage or retirement account. The investment choices within an annuity are selected by the insurance company and individuals may have less control over how their funds are invested.

COSTS

The expenses associated with annuities are complex enough that they warrant a more detailed discussion. These fees vary depending on the insurance company and the specific annuity product, but as with any fee, it is important to understand if the costs are reasonable for the benefits provided.

Administrative Fees: These fees cover the basic administrative costs associated with managing the annuity contract, like recordkeeping and client service. They are generally deducted on an annual basis and can range from around 0.10% to 0.25% of the account value.



ANOTHER MONEY SOURCE. Some retired people turn to annuities as a steady income stream to help support their lifestyle.

Mortality and Expense (M&E) Charges: M&E charges are fees that cover the insurance company's costs for providing the death benefit and the administrative expenses of the annuity contract. M&E charges are also typically a percentage of the account value, ranging from 1% to 1.5% annually. These charges help compensate the insurance company for the risk it assumes in providing guarantees and benefits associated with the annuity.

Surrender Charges: Annuities often have surrender periods designed to discourage early withdrawals and can be significant. The charges are typically a percentage of the amount withdrawn and the percentage decreases over the surrender period until it eventually reaches zero. The most common surrender periods we see are three, seven and 10 years, depending on the annuity contract.

Investment Management Fees: Variable annuities allow the policyholder to invest in various sub-accounts, similar to mutual funds, which typically have investment management fees. The fees can vary depending on the specific sub-accounts chosen and can range from around 0.25% to 2% or more annually.

Rider Fees: Annuities may offer optional riders or additional features that provide enhanced benefits, such as guaranteed minimum income, long-term care coverage or enhanced death benefits. These riders typically come with additional fees. The fees associated with riders can vary depending on the type of rider, the benefits provided and the insurance company.

In addition, commissions are often paid to the agent who sells you the annuity, though these may not be reflected in the schedule of fees. These fee structures can vary significantly among different annuity providers and products.

TAX CONSIDERATIONS

One of the primary advantages of annuities is the ability for the funds to grow on a tax-deferred basis. During the accumulation phase, the growth of the invested funds is not subject to immediate income tax, similar to a retirement account.

Once you begin income payments from an annuity, withdrawals are generally subject to income tax. The tax treatment depends on whether the annuity is purchased with pretax or after-tax funds.

> **Pretax or Qualified Annuities:** If the annuity is purchased with funds from a tax-advantaged retirement account, such as a traditional individual retirement account (IRA) or a 401(k), the income payments are fully taxable as ordinary income. These withdrawals are subject to your income tax rate at the time of the individual withdrawal.
> **After-Tax or Non-Qualified Annuities**: If the annuity is funded with after-tax dollars, such as from a regular savings account, the taxation of income payments follows the "exclusion ratio." The exclusion ratio determines the portion of each payment that represents a return of your original investment (not taxable) and the portion that represents earnings (taxable as ordinary income). The exclusion ratio is calculated based on the payout period and the initial investment.

Similar to an IRA or 401(k), withdrawing funds from an annuity before reaching the age of 59½ may result in an additional 10% early withdrawal penalty imposed by the Internal Revenue Service in addition to any income tax owed on the withdrawal.

CONCLUSION

One of the biggest mistakes we have seen with annuities is the failure to start receiving income distributions. As you can see above, there are considerable costs that you pay in an annuity, in order to receive a dependable income stream. If you don't turn on that income stream, then you have paid the annuity costs without receiving the benefits.

In general, the costs associated with annuities means they are not a one-size-fits-all solution. In fact, many of the benefits (death benefits, tax-deferred growth, risk reduction) may be accessed using other tools. But for those looking for a pension-like stream of income, tax-deferred growth, a death benefit and investments with limited market volatility, annuities may fill a need. It is important to consult with a financial planner to understand if an annuity fits within your financial plan.

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