Ekon Explains: Annuities

The Basics

An annuity is an insurance product in which a contract is formed between the insurance company and an investor. The investor pays an amount of money to the insurance company, thus purchasing the annuity, and the insurance company invests the money, agreeing to pay the investor a series of payments or a lump sum at a future time. Money in an annuity grows tax-deferred until payments are taken and distributions are taxed as income.[1] An Immediate Annuity will begin paying the investor shortly after the annuity is purchased while a Deferred Annuity will begin pay out at a set time, typically retirement, allowing the investment to grow in the meantime.[2]

Within the categories of Immediate and Deferred Annuities, each annuity has either a fixed, indexed or variable payout. Fixed Annuities pay out a set amount which is guaranteed regardless of investment returns. On the contrary, payments in a Variable Annuity are based on the performance of the annuity's underlying investments. Variable annuities also differ as the only annuity type regulated by the Securities and Exchange Commission. Payments in an Indexed Annuity are determined by the performance of an index, such as the S&P 500 Composite Stock Price Index. Indexed Annuities typically have a set minimum for payments, regardless of index performance. Depending on the terms of the annuity, the payment stream can last for the rest of the investor's lifetime or for a certain number of years.[1]

When determining if an annuity is an appropriate addition to a retirement savings strategy, the benefits and drawbacks must be considered.

Benefits	Drawbacks
• Annuities do not have an annual contribution limit. • If choosing a fixed annuity, the investor is not responsible for picking the investments which may be viewed as an advantage by many investors. The fixed payment amount will be paid regardless of the investment returns. • Longevity Annuities, a type of Deferred Annuity, provide investors with protection against outliving their savings.	• Annuities are notorious for high associated costs such as surrender costs, commissions, and annual fees which are often difficult to assess. • Money withdrawn in the first five to seven years after the annuity is purchased may be charged substantial surrender charges, depending on the terms of the annuity. • Annuities are not liquid; money in an annuity cannot be easily pulled out for emergencies or other unforeseen events.

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[1] Annuities. U.S Securities and Exchange Commission. http://www.sec.gov/answers/annuity.htm
[2] Ultimate Guide to Retirement: Annuities. CNN Money. http://money.cnn.com/retirement/guide/Annuities/?iid=EL

Benefits	Drawbacks
• Tax-deferred growth is an advantage if the investor is in a higher tax bracket now than he or she will be in during retirement. • Certain annuities offer a death benefit that pays the investor’s beneficiary a specified minimum payment.	• Any withdrawals made before age 59 ½ are subject to a 10% early withdrawal tax on earnings in addition to regular income tax. • It is possible to lose your principal and investment returns if the insurance company goes out of business. Annuities are not federally insured. A state guaranty fund may be in place to protect annuity owners but the coverage is limited and varies from state to state.

Conclusion

When considering the purchase of an annuity, consider each alternative for retirement savings including Individual Retirement Accounts (IRA) or an employer-sponsored plan which may offer a matching contribution. Carefully analyze the terms of the annuity with significant attention given to investment returns and fee structures.