Annuities

Retirement is about trust. When we choose to give up our careers, we all trust that the money we've put away is enough to get us through the rest of our lives. We have faith that our investments will continue to do well.

Seeing the need for guaranteed income, insurance companies have devised an investment strategy to remove some of the risk to retirees. Annuity plans are investment contracts that promise a certain level of income for purchasers. When used as part of a retirement plan, annuities become something retirees can trust for an uncertain future.

How does it Work?

Insurance companies have created many types of annuity contracts, all designed to provide regular income for their owners. Though each type has its own complex details, the concept behind them is very simple. An investor hands over a large sum of money to an insurer. The insurer then professionally invests it and makes regular payments back to the investor over a given period of time. The additional money gained through the investment is used to benefit both the investor and the insurer.

Annuities have become popular with many diversified retirement portfolios because they are able to promise income. Even if a retiree's investments drop and he or she loses all other assets, an annuity will always be there to provide some form of payment. Despite this guarantee, the rigidity of an annuity's payment cycle makes it less than the ideal vehicle for the entirety of a retirement fund.

Different Types

There are two major factors used in determining the type of annuity available to a person: funding and return on investment. Annuities can be funded with the intention of either immediate or later use. Annuities used immediately are typically funded with a large lump sum payment. An annuity that will be used later is usually funded through smaller regular payments, much like an IRA or 401(k).

The other factor, return on investment, is much trickier to judge when choosing an annuity. Agreements on income are usually made by selecting one of three major types of investment return systems: fixed, variable and equity-indexed.

Fixed annuity – These are annuities that pay at one flat rate. No matter how good or bad the market is, the insurer will always pay out the same amount of money.

Variable annuity – Payments that are largely swayed by the success of investments are the hallmark of variable annuities. Using a specific form of market evaluation, insurers determine the amount of money an annuity principal has earned that year and adjust regular payments accordingly.

Equity-indexed annuity (EIA) – A hybrid of fixed and variable annuities, EIAs provide a minimum interest

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rate along with their standard payments. The insurer promises that this set growth will occur but also makes additional returns if the EIA outperforms the minimum.

Pros and Cons to Annuities

Unquestionably, the biggest benefit to an annuity is the guaranteed payments—the very thing that makes it an annuity. The security of promised returns, usually for the rest of an investor's life, is attractive to say the least. Annuities also stay in a tax-deferred environment, meaning their market growth is exponential, increasing much faster than if their investments were owned outright. Annuities are managed professionally and the insurers are registered with the Securities Exchange Commission.

Like all retirement plans, annuities have some drawbacks that must be weighed carefully. It is possible to overinvest in the security of an annuity. This can occur because the money used for funding becomes tied up for years, requiring "surrender charges" and taxes to be paid if closed prematurely. Though the larger payments are ideal, having only one source of money can hamper a successful retirement.

Additionally, there are several pros and cons between each of the major annuity types:

Fixed annuities require fewer maintenance fees than other annuities and pay a consistent amount; however, completely fixed payments do not compensate for inflation and their true value can significantly drop off later on in life. While some decrease in buying power is generally acceptable as individuals get older, annuity investors must be careful not to underestimate their needs.

Though variable annuities help compensate for inflation through market growth, their guaranteed payments can drop lower than expected during times of economic downturn. Investors should only buy a variable annuity if they can afford a reasonable base rate to their annuity income.

EIAs resolve many of the problems of fixed and variable annuities by guaranteeing a certain amount of market growth. To compensate for this added risk to the insurer, an EIA typically has to have higher fees than other annuities. These are generally the best to buy, but an investor still might avoid one if it would constrain too much of his or her retirement funds.

Customizations and Exchanges

Though the major characteristics of annuities are described above, insurers have created a competitive market with dozens of specialized features that can be added to any given annuity plan. These features allow for investors to get exactly what they want but can also raise the cost of an annuity. Investors shopping for annuity plans must be careful to judge what they need and what is unnecessary.

In Section 1035 of the Internal Revenue Code, the IRS allows for an investor to exchange their annuity for a new one without incurring any income taxes. Though the option exists to let investors back out of a bad annuity plan, it should only be exercised in situations when a different annuity is obviously better. An exchange may not incur a tax penalty, but it could still be subject to fees and adjustments from the insurer.

Annuities and Investment Plans

Because of their rigidity, annuities are best used as a support to other retirement plans. Annuities can provide for skeleton costs, while a managed IRA fund can provide the flexible cash needed to travel or handle sudden expenses. Even if the market plummets or an accident drains other funds, the annuity will always be able to cover necessities.

As with all financial matters, certified advisors are ready to help you make the best decision for your retirement plan. If you have any questions about annuity planning or other investments, contact Coachwise Financial Solutions to schedule a time to discuss your financial future.

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