WHITE PAPER

Demystifying Annuities

A Closer Look at the Pros and Cons

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Annuities have been under scrutiny for years, in part because they're generally not well understood by the general public, nor even professionals. This is unfortunate because annuities can play an important part in retirement planning. They offer safety, upside potential with no downside risk, and income for life.

These financial products come in many forms, including ***variable, multi-year guaranteed,*** and ***fixed***, with an array of options that make it possible to customize the contract to meet the client's needs. The indexed annuity tends to be the more popular choice because of the combination of earnings, income, and safety it offers.

This paper takes a closer look at the pros and cons of indexed annuities, how they compare to other types of annuities, and how they may address some of the needs of today's workers as they plan for retirement.

What Are Indexed Annuities?

An ***indexed annuity*** is an annuity contract with a rate of return based on a market index. This defining feature of indexed annuities distinguishes them from other categories of annuities, including ***variable*** and ***fixed***.

These products are financial instruments that allow you to participate in the upside of the market without any exposure to downside risk. By design, indexed annuities have a built in floor that keeps earnings from going backwards and they offer a minimum guarantee.

What Are Variable Annuities?

A ***variable annuity*** is a type of annuity contract with a rate of return based on the performance of an investment portfolio. There are several investments to choose from called sub-accounts.

Compared to other types of annuities, variable annuities have the potential to generate higher returns and greater income. However, these returns come with a risk. The value of the sub-account rises and falls with the market, so the investment can lose money.

What Are Multi-Year Guaranteed Annuities?

A ***multi-year guaranteed annuity*** (MYGA) is a type of fixed annuity with a guaranteed rate for the entire contract. Similar to a certificate of deposit, a MYGA lets the client invest their money for a specific period of time, during which it earns interest. They also tend to have more competitive interest rates than CDs.

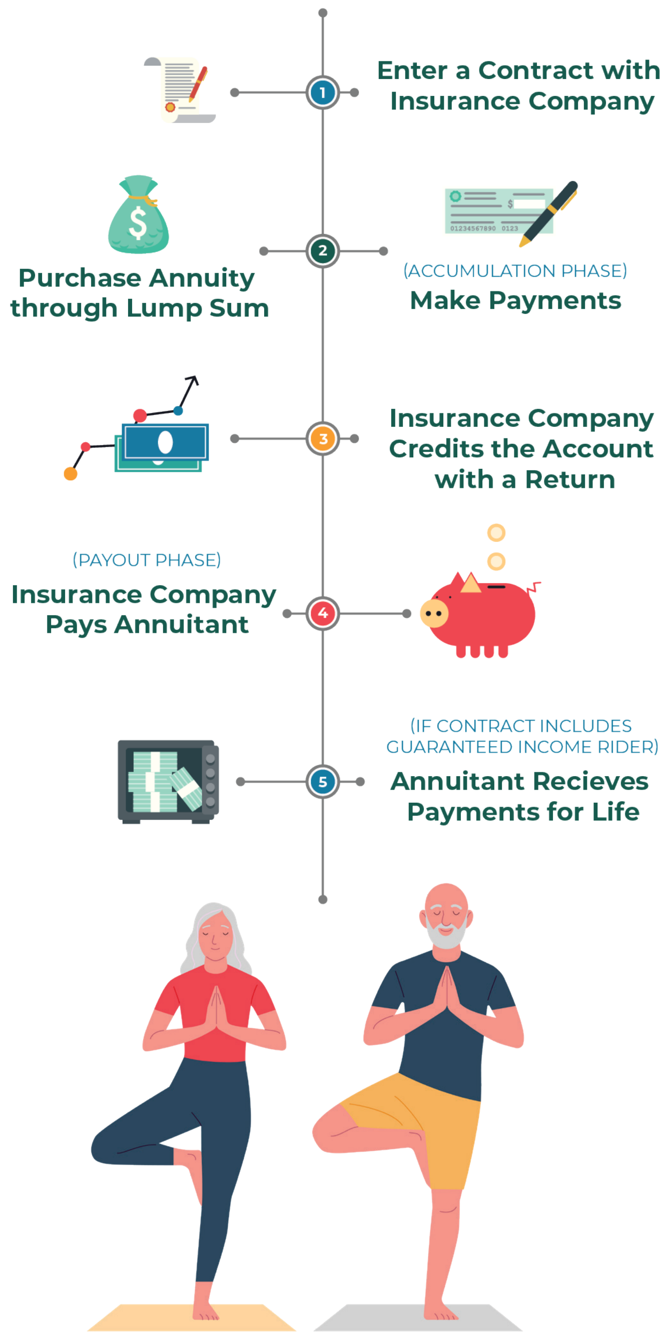
The guaranteed interest rate makes these annuities less risky, but this decreased risk comes at a cost—potentially lower returns.

How Indexed Annuities Work

When an individual buys an annuity, they enter into a contract with an insurance company and purchase the annuity through a lump sum or make a series of payments during the accumulation phase. The insurance company then credits the account periodically with a return. This return varies depending on the type of annuity and calculation method used.

In the annuity's payout phase, the insurance company pays the annuitant the initial investment along with any gains it earned. If the annuity contract included a guaranteed lifetime income rider, the annuitant can receive regular payments for the remainder of their life, even if their account balance runs out.

The design of the annuity provides protection from market risk, sequence of returns risk, asset protection and in some cases protection when a life event happens.



Important Terms to Know

When evaluating annuity offers, it's helpful to understand some of the terminology used to describe the features.

The following terms are frequently applied to different types of annuities:

Floor refers to the minimum interest rate an annuity earns. In some cases, the floor may be 0%, but some states require a higher minimum by law.

Crediting method is used to calculate the return on an annuity. There are a number of crediting methods available designed to credit earnings in different market scenarios. These include point-to-point, monthly average, monthly cap and more. The crediting method is applied to different indices like the S&P 500 and this determines the amount credited.

Participation rate is the amount of the index's gain that the insurance company applies to the annuity.

Rate cap is the maximum interest rate an annuity can earn. For example, if the rate cap is 10%, the annuity will never be credited more than 10%.

Penalty-free withdrawal is the amount that can be withdrawn annually without being charged any fees.

Surrender charge is a fee for excess withdrawals made before the end of the surrender period.

Benefits

Annuities can play a key role in retirement planning—filling gaps and providing a reliable income stream. They offer several client-friendly benefits that often get overlooked.

Tax-deferred Growth

The annuitant does not have to pay taxes on the interest the annuity earns until they start withdrawing money from it. This can be an advantage to someone who expects their tax bracket during their retirement years to be lower than the one they are in while they are working full time.

Death Benefit

An annuity is an insurance product, so the annuitant can name a beneficiary who receives a payment when they die.

Predictable Income Stream

An annuitant knows how much money the annuity will pay during the payout phase. This eases some of the stress of budgeting for retirement and deciding when to start withdrawing from other sources.

Income for Life

If the annuity has the optional guaranteed lifetime withdrawal benefit, the annuitant will receive a payment for the rest of their life, and in the case of a married couple, as long as the last survivor lives.

Living Benefits

A fixed annuity typically comes with built in emergency exits when triggered by life events and creates additional dollars for failing health.

Pros

For some individuals, an annuity offers another tool for a balanced retirement savings portfolio. A closer look at their advantages reveals why they are increasingly popular with people nearing retirement.

Tax Advantages

The money in an annuity grows tax-deferred, which offers some tax advantages. Annuitants can make payments with pre-tax funds. An annuity can be an excellent vehicle for tax-free income or to leave a tax-free death benefit when used as a Roth IRA.

Guaranteed Income Rider

It's difficult to ignore the appeal of having a guaranteed income for life. The annuitant cannot outlive the regular payments they receive from the annuity. Having these regular payments as a supplement to Social Security, a pension plan, or other retirement fund provides peace of mind.

Better Returns

Annuities can outperform bonds and certificates of deposit when interest rates are low. Annuities respond well in low interest rate environments because annuities are tied to the market upside and with the term lock in feature you get higher average returns over time.

Reset

Reset is the method that locks in gains at the end of each term, protecting all your gains from market risk. Further, the new terms index starting point resets as well, which works great when there is a decline in the market.

Cons

As with any investment product, there are drawbacks to consider when choosing an annuity. This is why workers should speak with a financial advisor about their financial goals and how an annuity can fit in with them.

Here are some disadvantages to keep in mind:

Limited Liquidity

Annuities often have surrender fees (usually a percentage of the annuity's value) that penalize the annuitant for withdrawing too much money early. This feature helps protect the annuity by allowing it to grow and earn more interest. Many annuity contracts minimize this through a withdrawal provision that gives the annuitant access to a portion of the annuity without a penalty.

Complexity

Annuities can be considered complex because of the many types of annuities, the moving parts and the terminology

Unpredictable Terms

Insurance companies may change the cap, floor, or participation rate at the end of the period to help afford the guaranteed income you can receive from an annuity. This will likely not change your income payments.

Opportunity Cost

The money an annuitant pays for the annuity could potentially earn more money in an investment product like stocks and mutual funds or in a retirement account. However, these riskier investments do not offer the protection of a floor like an annuity.

Fee Structures

One of the more commonly cited drawbacks to annuities is the heavy fees sometimes attached to them. This is especially true for variable annuities that often have administrative fees, mortality and expense risk fees, and investment fees that deduct from the annuity's value.

Indexed annuities and fixed annuities are comparatively less costly. Insurance companies are less likely to charge annual fees for these accounts and in many cases no fees at all. Annuitants do pay for riders they attach to these accounts, and these costs should be considered when evaluating available annuities.

Surrender fees are standard for all annuities and can be quite costly to the annuitant if they surrender their policy early. These fees decrease the longer the annuity account is open.

Income Options

When the annuity annuitizes, the owner may receive the money as a lump sum or through periodic payments. This distinction is helpful, but it's not the only feature to consider when evaluating income options. The structure of an annuity makes it possible to plan for income throughout retirement. Running out of money is a real fear for some retirees, especially as people are now living longer than ever before and spending more years in retirement.

An annuity often functions as the third leg of the retirement stool, supplementing income from Social Security and a pension or 401(k) plan. This makes it possible for the client to live the lifestyle they want during their retirement years. Some retirees also use an annuity to provide income during the period between the day they retire and when they start drawing on Social Security. This optimizes their Social Security benefits and may allow them to retire sooner rather than later.

Annuities may be complex and misunderstood, but that doesn't mean you should ignore them. To understand the role an annuity can play in your retirement planning, consult with one of our financial planners. They can guide you through your options and recommend strategies to ensure you have the retirement income you need.

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