Pros and Cons of Annuities

By Arvind Ven

Annuities are the Rodney Dangerfield of the financial services industry. They get no respect. Annuities sometimes get a bad rap due to the fact that all the pros and cons are not properly laid out before a prospective client. As in all things in life, whether annuities are a good fit depends on each individual's financial situation and the need for steady income in retirement. Annuities, when chosen properly, can offer risk mitigation and portfolio diversification.

In this article, we will examine Fixed Immediate Annuities also called the Single Premium Immediate Annuity (SPIA). I call it the 'key in the ignition' annuity, as you can turn it on as soon as you want to, unlike other 'deferred' annuities where you will have to wait longer periods to turn on income.

What Is An Annuity?

An annuity, in simple words, is something that you pay into with the expectation that you will receive a steady income stream at retirement. Examples are Social Security, a company pension if you have one. Simply put, with an annuity product, you are entering into a contract with an insurance company to create your own pension.

Types of Annuities

The two main types are the Fixed Annuities and Variable Annuities. Fixed and Fixed Index Annuities offer downside protection while there will be a cap or limit on the upside. Variable Annuities, on other hand, may offer higher upside but there is a risk of more downside during down markets. We will focus on only Fixed Annuities in this article.

Types of Fixed Annuities

There are several variations but the two major types are the Immediate Annuity and the Deferred Annuity. As the names indicate, you can turn on income right away (if you choose to) in an immediate annuity. However, in a deferred annuity, you may have to wait, generally for 7-10 years, before you can start drawing income.

Fixed Immediate Annuities are appealing to boomers and seniors as they offer immediate income and a guaranteed income stream for life. Fixed Annuities offer a set percentage payout every year. Fixed Index Immediate Annuities are linked to chosen market indices and can have potentially higher rates. In the both cases, the principal is protected.

If the payout is chosen as a joint payout, the income stream could continue on for the surviving spouse for the rest of his or her lifetime. Such annuities may offer the following benefits:

1. Supplement retirement income in addition to Social Security and other retirement income sources, if any. Augmenting retirement income sources is important in retirement in case the rest of your assets exposed to the stock market are caught in a multi-year market downturn.
2. For those turning 70 1/2, and if the annuity is part of their IRA's (qualified funds), then this could provide for both retirement income and meeting part of the RMD requirements. The RMD (Required Minimum Withdrawal) starts at age 70 ½ and the law mandates that you start withdrawing a percentage (set by the IRS) every year from these IRA, 401K and other tax deferred assets. This mandatory annual withdrawal amount is taxed at ordinary income levels.

Things to Consider

- Speak with a trusted financial adviser to understand whether an annuity fits with your situation and retirement plan.
- Fixed annuities and Fixed Index annuities will cap your gains on the upside. However, your principal is protected even if the market swoons.
- Check the rating of the insurance company and look at 'A' rated companies. Agencies such as A.M Best, Standard and Poor's and Moody's rank these insurance companies.
- Most annuities have a surrender charge sometimes over several years. Make sure that this is the right strategy for you before you commit.

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