A Comprehensive Guide To Annuities And Annuity Investing

What Are Annuities?
In its simplest definition, an annuity is an amount payable annually. For our purposes, however, an annuity describes a contract offered by an insurance company that allows you to accumulate funds for retirement on a tax-deferred basis. Upon retirement, you'll receive income from the annuity that can be guaranteed by the insurer to last either a fixed number of years, or as long as you live.

An annuity is neither life insurance nor a health insurance policy, and it's not a savings account or a bank Certificate of Deposit. Your value in an annuity contract equals the premium payments you pay in, plus interest credited, less any applicable charges. The insurance company uses this value to calculate the amount of the benefits you'll receive from them when you begin taking distributions.

How Do Annuities Work?
An annuity is an investment vehicle primarily for accumulating retirement savings. Again, you pay premiums to the insurer and, in return, they pay you an income stream at a later date. Based on this description, you'll see that there are two phases to an annuity:

- The Accumulation phase
- The Payout phase

During the second phase, called the Payout phase, the company pays income to you, or to anyone else you choose. Unlike many other retirement savings instruments, you will typically have flexibility in how you receive your funds. For instance, you can choose to receive, say, a 10-year payout, 20-year payout, or even a lifetime payout of income.

How Do Annuities Best Serve Investors?
The two primary reasons to invest in an annuity are:

- You want to save money tax-deferred for a long-range goal (like retirement)
- You want an income stream for a certain period of time.

There are other strategic estate planning situations where annuities may be warranted as well, but these will be dependent on your specific financial situation. The rest of this guide will focus on understanding how annuities work, the various types that exist and what role annuities should play in your financial planning.

What Are Some Types of Annuities?
While annuities might seem complex at first, by breaking them into the following components they become easier to understand.

- How money is paid into the annuity contract
- How money is withdrawn
- How the funds are invested

There are two broad classes of annuities: "Deferred" annuities and "Immediate" annuities. Each class has numerous sub-classes.

Deferred Annuities
A deferred annuity is most appropriate for people who want to:

- Save for future retirement
- Not touch the principal and interest until age 59½ or older
- Find an investment that will earn tax-deferred interest for many years
- Save more than the maximum annual contribution of their IRA or 401(k)
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With a deferred annuity you pay a premium to the insurance company which issues a contract promising to pay interest made on the premium while deferring the income and the taxes until you actually withdraw the money or begin receiving an income.

There are three major types of deferred annuities:

- Fixed Deferred annuities
- Equity-Indexed annuities
- Variable Annuities
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Fixed Deferred Annuity
A fixed deferred annuity pays a guaranteed "fixed" interest rate (based on the current market rates of interest) where the earnings compound and grow tax-deferred. Fixed annuities offer safety of your principal from typical day-to-day market fluctuations in the stock, bond or other investment markets. However, since this rate of return is fixed, it is important to consider the impact of inflation on your investment.

You will also want to consider the financial strength of the annuity-issuing insurance company, since the return of principal and interest is guaranteed by them. Several independent financial analysis companies such as A.M. Best and Standard & Poor's rate the strength of such insurance companies for you.

Equity-indexed Annuity
An equity-indexed annuity differs from a fixed deferred annuity in that the rate of return on your investment is based upon the better of either a) the growth of a named stock market index, such as the Dow Jones Industrial Average, or b) a minimum guaranteed interest rate.

Many equity-indexed annuities offer you a portion (not a full 100%) of the index gains. Still, this type of annuity does allow for potentially higher returns than a typical fixed annuity, since you can participate in a rising stock market, yet be protected on the downside by the minimum guaranteed rate of return.

Variable Annuity
A variable annuity allows the flexibility to invest your funds in a wide range of investment options through "sub-accounts." Sub-accounts are somewhat similar in design to mutual funds, and allow for investing in stocks, bonds, money markets – even guaranteed fixed rate instruments.

The ability to choose, and change, investment options provides you the advantage of participating fully in any market gains (not fractionally), thus potentially providing even higher returns than equity-indexed annuities. However, unlike equity-indexed annuities, many (though not all) variable annuities offer no guaranteed rate of return. Therefore, the value of the variable annuity and its sub-accounts will fluctuate day-to-day, based on the performance of the underlying investments you choose.

Such an annuity may be better suited for those investors with a longer term time horizon, who can afford these day-to-day market gyrations. As with a fixed annuity, any gains in the variable annuity credited to the account are tax-deferred until the funds are withdrawn. Unlike a fixed deferred annuity, your funds are not guaranteed by the insurer against market fluctuations, including risk of principal. A key benefit of variable annuities is the ability to transfer assets among the various investment options, as necessary, in response to market conditions or your changing investment goals without incurring current taxes on any capital gains and/or income.

Immediate Annuity
An Immediate Annuity is most appropriate for people who want to:

- Retire in the very near future, or are already retired
- Begin drawing an income from a lump sum of money that they currently have already accumulated for retirement.
- Receive an immediate and predictable payout
- Receive a steady payout for life (based on life expectancy)
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The immediate annuity allows you to deposit a lump sum and begin receiving regular payments normally within one year after the deposit. It is usually funded with a single premium, and purchased by retirees with funds they have accumulated for retirement. These annuities can provide a predictable stream of payments that will continue for the rest of your life, or for a time period you choose.

Fixed vs. Variable Annuities
The choice of fixed versus variable annuity depends primarily on the specific needs of the investor.
A Fixed Annuity is most appropriate for people who want to:

- Earn a tax-deferred fixed rate of interest without any market risk
- Save on contract expenses and management fees
- A Variable Annuity is most appropriate for people who want to:
- Have the opportunity to make more substantial gains, depending on market and sub-account performance
- Respond to changing market conditions by transferring money to different funding options within a variable annuity, without paying taxes on any earnings you have made. Proceeds from annuities are not subject to probate and may be passed directly to your designated beneficiaries.

Retirement Income Considerations
You will have several options when it comes to deciding how you want to receive your annuity income. Here are a few things to consider before making your decision:

Your Age and Health:
Life expectancy continues to increase. The average person, living a healthy lifestyle, may expect to live longer. Studies show that there is a 48% chance that one member of a couple age 65 today will live to be age 95. It is conceivable that you could spend as many years in retirement as you did working towards retirement.

Sources of Retirement Income:
In the past, defined plans such as Social Security and an employer-sponsored plan were the major sources of retirement income. Today, these plans provide a smaller portion of retirement income requiring you to provide a larger portion of your retirement income.

Inflation:
Inflation, regardless of rate, will erode the value of your savings and reduce your spending power. Taking this into account, it is important that you plan your retirement carefully. You need to review all sources of income so that you can determine whether you will have sufficient income for your entire retirement.