Why Guaranteed Income for Life Might Not Be Such a Great Deal

December 30, 2019

by Tiffani Sherman

Contributor

Guaranteed income for life sounds like a great deal. That's what many annuities promise, yet nothing is ever as good or as easy as it seems.

What is an annuity? An annuity is a contract between you and an insurance company where, in exchange for paying them a sum of money, they agree to provide a steady income stream.

The point of an annuity is to keep you from outliving your assets. The money coming in can act like a paycheck during retirement. In some ways, they are like pensions, providing a set amount of income in exchange for cash.

Annuities aren't investments; they're contracts. Like many contracts, they can get complicated.

"People say they're confusing and they can be," said Andrew Barnett, a certified financial planner with GFA Wealth Design based in Fort Myers, Florida. "They're just not easy to understand and not easy for professionals to understand."

What Is an Annuity and How Does It Work?

When you purchase an annuity, you either pay a lump sum or agree to make a series of payments over time. Disbursements can begin almost immediately or at some designated point in the future. The payouts often last the lifetime of the policy holder.

The funds accrue tax-deferred, so you pay taxes on the proceeds when you receive the payments. There is no contribution limit, but contributions do not reduce your taxable income. There is a penalty if you withdraw funds before age 59 ½.

The ability to defer the taxes is a benefit of annuities. Many people anticipate their tax brackets will be lower when they retire than they currently are.

"The big difference between saving and investing with a bank and doing it with an insurance company is with a bank, the interest is paid out and taxable every year," Barnett said. "Even if you reinvest it and don't take it, banks issue a 1099 at the end of the year and you get taxed on the interest. With an annuity, you don't get taxed until you take the money out."

Annuities became popular during the Great Depression from 1929 to 1933 when people worried about the volatility of the stock market and wanted guaranteed income. As traditional company pensions became less common, annuities gained traction.

Annuities are insurance policies. Like any other insurance policy, an annuity transfers risk from the owner of the policy, called the annuitant, to the insurance company. The amount of the payout depends on the life expectancy of the person buying the policy. The younger you are when you start receiving income from an annuity, the smaller the payments will be since the payout is usually for a lifetime.

When you buy an annuity, you decide if you want income for a guaranteed period of time (called a period certain annuity), a lifetime, or a combination of both.

Some lifetime annuities have a rider that allows a beneficiary to receive a payout for the remainder of their lives should the primary policy holder die first. These are called joint and survivor annuities and are popular for married couples.

Types of Annuities

There are many kinds of annuities, but most fall into several general categories based on how they pay out and how they earn their money. The methods of payout are either immediate or deferred, and the earnings are fixed, variable or indexed.

When Do Annuity Payments Start?

An immediate annuity begins paying out almost immediately after you pay the premium. Sometimes, the waiting period is about 30 days. Because of the quick payments, immediate annuities are popular with people who are either very close to retirement or already retired.

Deferred annuities begin paying out sometime in the future and accumulate funds, tax-deferred.

How Do Earnings Work?

In addition to choosing the payout time frame, people buying an annuity need to decide how it will grow and the amount of risk they are willing to take.

A fixed annuity pays a guaranteed amount based on a fixed rate and is relatively low risk. The returns are modest, and the insurance companies invest the funds in bonds and other high-quality fixed income investments.

Barnett compares a fixed annuity to a bank certificate of deposit, with a term and a set interest rate. “Instead of going to a bank, you go to an insurance company, and typically the insurance company might pay a little more than a bank,” he said.

Increasing the risk is a variable annuity where payouts are based on the performance of the investments. The policy holder can choose a variety of mutual funds to invest in, much like they would with a 401(k). Funds usually go into sub-accounts and the overall return is based on how all those sub-accounts perform.

Indexed annuities are a bit of a combination of both fixed and variable annuities with a mix of risk and reward.

With an indexed annuity, there is a possibility of a higher payout based on the performance of a market index, usually the S&P 500, but the gains are capped at a certain percentage.

"It's not an unlimited upside, it's always limited.The insurance company will tell you if you ask, for example this can only make 3% a year, if the market goes up 40%, you only get 3," Barnett said. "So the insurance company is taking the risk for you and they're taking some of the profits, and you have to be OK with that."

No matter what type of annuity you have, the principal will be tied up for a period of time and you will not be able to access it. If you want to terminate the policy or get to the money, there are hefty surrender charges.

How Annuity Fees Work

In addition to being somewhat confusing, annuities are often panned because of their high and complex fee and cost structure.

There are usually no fees for fixed annuities. Companies often build fees into the other types of policies, so you won't see them taken out or called fees like you may in other types of retirement accounts.

"It depends on how you think of a fee," Barnett explained. "If they tell you the cap is 3% and the index goes up 6%, that's basically a 3% fee."

For every customization and add-on, like a guaranteed death benefit, guaranteed withdrawal benefit, addition of a spouse, etc., there is an extra cost, usually a percentage of the proceeds.

Is an Annuity Right for You?

In general, annuities are good for people with a family history of longevity who are concerned they might outlive their assets and want to guarantee income.

People who want to defer taxes might also like annuities.

"Any growth that you have is non-taxable until you take the money out, which is great," Barnett said.

People who have accumulated substantial assets and aren't concerned about running out of income aren't good candidates for annuities, nor are people with health problems that could make it unlikely they will outlive their assets.

Losing out on possible wealth accumulation is also a downside. Insurance companies make their money by investing your money and often paying you less than if you were investing it on your own, reducing your potential wealth.

"If the market went up 10% a year, you could buy a mutual fund and get that 10%," Barnett said. "But if you have your money in an annuity with 4% fees, now you only get 6% a year. That's really going to end up reducing your wealth, in the long run."

Barnett also warns that annuity salespeople earn high commissions selling annuities and often push their products hard, making everyone think they must have an annuity.

"I don't have anything against paying for insurance if it's something that you need or something that you feel strongly about, you're willing to pay for it, and you understand what the cost is," Barnett said. "Make sure you do your homework, and whether you engage a financial planner to help you or you do research

on your own, don't rush into anything."

Tiffani Sherman is a Florida-based freelance reporter with more than 25 years of experience writing about finance, health, travel and other topics.