Annuities: Basics You Need to Know

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Summary

The key feature of most annuities is the promise to provide you an income for life, no matter how long you live. This paper explains more about how annuities work, what their advantages and disadvantages are, what kind of options you have when purchasing one, and when and how to obtain them.

There's nothing quite like an annuity

Annuities have been around for centuries. Kings and lords would grant an *annual* income to favored subjects, usually promising it for life, and these grants came to be called annuities. Similarly, big lottery winnings are usually paid out in annuities (annual installments), though these are typically for a fixed period of years, rather than for life. Old-fashioned employer pensions that pay retirees for the rest of their lives are also a form of annuity; so is Social Security, though (like most of todayøs annuities) they are paid monthly rather than annually.

But you can also purchase annuities for yourself, or convert certain kinds of existing assets into annuities.

Having one or more annuities payable for your life (or perhaps your life plus the life of a spouse or other beneficiary), means that no matter how long you live, you will never run out of income. Even if you set the world record for longest lifespan ó currently age 126 ó you will still get paid.

There are some pretty obvious advantages:

- This can be of huge benefit to you if you have, as most of us do, a limited amount of savings that you have to make last a lifetime. Since you donøt know how long you will live, you donøt know how long you need to stretch your savings. If you try to guess, and start spending part of your savings, you could run out of money if you live longer than you expect. With an annuity, you donøt run that risk ó you get paid no matter how long you live.
- If you donøt have an annuity, the only way you can make sure you donøt run out of money is to avoid dipping into your principal. But living just off the interest means you donøt have nearly as much money to spend ó perhaps not nearly enough. Most people need to spend (õamortizeö) part of their savings every year to maintain anything resembling their desired standard of living. If you convert your savings into an annuity, your principal will be amortized for you, and you will receive considerably more income than you would if you just lived off the interest.

So you get more income, and you get it for life. Whatøs not to like?

Where's the catch?

Sometimes there is no catch. Traditional employer pensions, and Social Security, are forms of annuity that are given to you in return, usually, for prior work. You already

contributed your sweat and your taxes, and so when itøs time to retire, all you have to do is sit back and collect the cash.

But if you have private savings, or if you have a retirement plan such as a 401(k) or 403(b) plan, or if you have life insurance benefits, you are then dealing with a choice between keeping those funds under your own control, or turning them over to a financial company in exchange for a lifetime income (annuity).

Buying an annuity creates two significant problems:

- Those funds are no longer available to you, generally speaking. If you have an emergency, if you want to spend money on something special, if you want to lend or give money to a relative or friend, if you have a sudden increase in medical expenses or need long-term care, or if you have any other need for cash, it isnøt there. You have income for life, but you had to give up assets to get it. Financially, this can be a fair trade, sometimes a more than fair trade, but it does put limits on your future choices.
- If you die early, you lose. The reason the financial company can afford to pay you if you live an extra long life is that the people who die early stop getting paid. So if you die soon after purchasing your annuity, all of the money you put into it could just be gone. Of course, *you* donøt need it any more in that case, but there is nothing to leave behind to your heirs.

Both of these problems can be gotten around. You can buy annuities that provide cash benefits in case you need long-term care, or that give you access to some of your original money, if you need it later. You can also buy annuities that guarantee payments for at least a certain number of years (five, ten, fifteen, or twenty years are common minimums), so that if you die early, your beneficiary will continue receiving payments for that number of years, but if you live long, you will still receive income for your whole lifetime. If there is someone in particular you need to protect (usually a spouse, but it could be someone else), you can buy an annuity that pays for as long as *either* of you is alive. These provisions are not free, however. You pay for them by accepting a lower monthly payment than you would receive otherwise. Weøll look into these trade-offs in a bit more detail later.

Of course, if you do buy an annuity, you donøt have to (and you shouldnøt) put every dime you have into it. You can keep some of your money under your own control, and õannuitizeö some of it ó i.e., use some of it to purchase an annuity. So you can use an annuity to guarantee lifetime income, and your other assets can be used to cover emergencies or other cash needs.

Is an annuity right for you?

There is an easy answer to this if you have very little money or if you have a whole lot of money. Otherwise, itøs a difficult question, and there is no general agreement in the financial industry over how to answer it.

If you have little money, you canøt afford an annuity. Borrowing against your house to buy an annuity, for example, is rarely (if ever) a good idea.

If you have lots of money, you donøt need an annuity, because there is not much danger that you will run out.

But if you are in that vast middle group, there is a good chance that an annuity might help you. How much will it help, though, and how much of your savings should you put into an annuity? These are very difficult questions, which is why good financial software is often needed to answer them.

Everyone agrees, of course, that *you should not "annuitize" any funds that you need to or really want to leave to others when you die*. Putting such funds into an annuity almost always means that they will not be available after your death. So first, set aside any such amounts as unavailable for an annuity.

Beyond that, there are two current approaches to answering this question that are probably not, in fact, very sound:

1. You can use annuities to cover õnecessaryö expenses, while using other (often, more risky) investments to cover õdiscretionaryö expenses. This idea makes superficial sense: using annuities ó starting with Social Security and traditional employer pensions, then adding your own money, as needed ó for õnecessaryö expenses guarantees that you will have the income you need for lifeøs essentials. The problem with the concept is that it is not possible to easily identify what expenses are really õnecessary.ö Usually this is done by category, but that method doesnøt work. You would be right, for example, to suppose that housing is a õnecessaryö expense, since you need to live somewhere, but that doesnøt mean that the amount you currently spend on housing is all necessary. In fact, when most people experience a significant drop in income, cutting their housing expenses is one of the first things they look at, because itøs usually such a big number, and itøs almost always possible to find a cheaper place to live. Likewise, most õdiscretionaryö expenses are discretionary only in their amounts ó you need to spend *something* on yourself and others, if life is to be worth living. So the whole õnecessaryö vs. õdiscretionaryö distinction is largely an illusion. What you would really want to do, if you used this method, is to figure out: what is the minimum you could live on, if you had to? But even then, there is no definite number that can be identified. Itøs really a sliding scale of sacrifice, with no clear point where you cross from OK to not-OK. So this method, though appealing at some level, doesnøt actually work.

2. Another approach is to use highly technical analysis to compare annuities with other ways of investing your money, looking at the risks and likely financial rewards of each. This method makes sense in an abstract way, but it has not been successfully applied to peopleøs real-life needs. How big an annuity you need, should reflect how big a need you have to stretch your income, which can be determined only by a detailed analysis of your financial situation. The investment models currently available donøt take enough detail into account, so they, too, cannot give the best answer.

If you are reading this write-up because a report from RetirementWorks® II software recommended the purchase of an annuity, this recommendation was indeed based on a pretty detailed analysis. It compared the cash flow you might receive from an annuity to the

cash flow you might experience without one, and found that an annuity would give you some more financial breathing room, which it judged that you need. It assumed that you would buy a traditional, plain-vanilla sort of annuity ó but you do not necessarily have to follow that assumption. If, in consultation with your financial advisors, you determine that some other variation has a specific benefit in your case, you should go ahead and make the substitution.

Another concern you might have is health. If you do not expect to live as long as most people your age, then an annuity is probably not right for you. However, some companies sell õimpaired riskö annuities that pay out a *higher* monthly amount, in recognition of your shorter life expectancy. In the right circumstances, this can be a good arrangement ó giving you a higher income in the short-run, but still guaranteeing that your income wonøt end if you beat the odds and recover from your health problems.

Also keep in mind that a few states tax annuity purchases, essentially skimming money off the top, and thereby reducing your benefit. California, Maine, Nevada, South Dakota, West Virginia, and Wyoming all do this, with Nevada being the worst (taking 3.25%).

What kind of annuity is right for you?

In the end, you will probably need to consult someone who sells annuities in order to help you answer this question. We can describe the kinds of choices you may have, and point you to other sources of more detailed information, but in the end, it is a matter of choosing a particular financial product from a particular company. The features and costs vary considerably, and only a specialist can do justice to explaining them.

But here are the *kinds* of choices you most commonly will face:

One life or two? Annuities normally pay an income for one personøs life, but you can buy õjointø annuities that cover two peopleøs lives. This means that the checks keep coming as long as either person is still living. This can be very suitable for married couples, and in some other situations. But it means that the amount of each monthly payment will be a lot less. You can mitigate this problem a bit by getting an annuity that reduces the amount (usually by a quarter, a third, or a half) when the first person dies ó which makes sense, because one person usually can live more cheaply than two. Still, you get the biggest bang for the buck if you can make the purchase on one personøs life instead of two, which you can often do if one person is older or more vulnerable financially than the other.

Guaranteed payments or floating amounts? The most basic annuities are õfixedö annuities: they pay a guaranteed level amount for life. If you are worried about inflation and are willing to start off at a lower amount, you can also get annuities that pay amounts guaranteed to increase by a certain amount or percentage every year, or that follow the Consumer Price Index. If you are more adventurous, you can also get annuities where the value fluctuates with the financial markets, or where you can get increases if the markets go up enough but you are protected if the markets go down. Some annuities of this kind are called õvariable annuitiesö, while others are called õequity-indexed annuitiesö (these two kinds actually have significant differences, but these differences are too technical to get into here). If you choose something other than a level guaranteed payment, however, keep in mind that every benefit you get with a different kind of annuity has a

price in terms of the risk you take, the benefit you receive, or both. Nothing is free. So when you decide, you should consider how comfortable you are with investment risk, how concerned you feel you need to be about inflation, how much risk (or lack of it) your other assets and income sources already include, and what the impact is on the payments you will start receiving right away.

Protection against dying early? As previously mentioned, if you want an annuity for one personøs lifetime, you can buy ones that guarantee a minimum number of payments ó usually 5 years, 10 years, 15 years, or 20 years. These are called õcertain and continuousö annuities, because a given number of payments are õcertain,ö but additional lifetime payments are õcontinuousö if you live beyond the guarantee period. These guarantees assure you that if you are unfortunate enough to die soon after buying an annuity, someone else will still receive something from it, and you havenøt just lost the money you put into it. Such a guarantee may make you feel better about the purchase, but the longer the guarantee the more it reduces your monthly income. Unless it is really important that someone else receive income when you are gone, a õcertain and continuousö annuity is not a good idea, because you will pay for it (via a reduced monthly benefit) for the rest of your life. For most people, if they die they donøt need the money anyway ó so you are probably better off if you make the best deal assuming you live, which means not paying for the extra guarantee ó unless someone else specifically needs it.

Access to your money? Insurance companies now offer annuities that do allow you access to at least some portion of your money if you need it later. Some offer riders that pay off in case you need long-term care. Others are more open-ended about why you want to get some of your money back. But again, you need to understand that if you need financial flexibility in an annuity, there will be a cost. There is usually a cost in terms of lower monthly payments just to have the right to get some of your money back later. There may also be a further reduction if you actually exercise the right. So you need to understand these costs, and consider whether they are worth it, whether you should just put less cash into an annuity in the first place, or whether you might have enough other sources of cash (home equity, for example) if you have a large expense later. If you are purchasing an annuity to stretch your income, you should not reduce it again by getting withdrawal rights unless you really need them.

Get paid now or later? Our focus here is really on õimmediateö annuities ó that is, annuities that start paying you a monthly income right away. But if you are still working, or still have income from another source so that you donøt need the extra income right away, you can either wait to purchase an immediate annuity, or you can put your money into a õdeferredö annuity now. Deferred annuities, unlike most other forms of saving, allow your money to grow without your paying taxes on that growth until you start receiving a monthly income, and even then the taxes are spread out over many years. This tax deferral may be especially helpful if you indeed are still receiving other income, because you may well be in a lower tax bracket later than you are now. This tax-deferred growth will be reflected in higher monthly payments to you when are ready to start receiving them. Your payments will also be higher if you wait, because annuities pay higher amounts the higher your age when you start (because you arenøt expected to live as long). On the other hand, there may be restrictions, fees, and taxes if you change your mind and want to take your money out again before monthly payments start.

A newer option is a õdelayedö annuity, in which you put money in now, or over a period of years, specifying an older age to start collecting monthly payments (maybe age 80 or 85, for instance). Typically, you can take your money out before that future date if you change your mind, but you might not get any interest on it, or not much. A delayed annuity is more of a pure bet on how long you will live, and for most people does not meet their most important needs ó unless they buy it young, and start receiving payouts when they retire (like a pension). Sometimes these are sold on the basis of their apparent high rate of return, but when you take into account that that return includes gradual repayment of the money you put in, the returns are seldom all that attractive.

When is the right time to buy an annuity?

Deferred annuities can be bought any time as a nice tax-sheltered savings vehicle. But most people who buy immediate annuities, or who convert deferred annuities or pension money or life insurance values to an annuity, do it when they retire, or at some point during their retirement. Letøs assume thatøs the case with you.

Is there a perfect age to buy an annuity? In fact, there is, but the bad news is that you cannot determine it in advance. Only when you die can someone say, based on your date of death and on the history of interest rates and annuity payment rates, when you *should* have bought your annuity.

Here are basic facts you should know:

- The longer you wait to buy an annuity, generally the higher the income you will receive because, as mentioned just above, you are not expected to live as long. But of course, you will not receive as many payments as you would if you started earlier. So there is a trade-off.
- The monthly amounts you will receive on many annuities will be higher if you buy an annuity when interest rates are high, and lower if you buy when rates are low. So when you know that rates are significantly lower than normal, hold off for a while, even if that means dipping a bit into the amount you intend to annuitize. (For variable or equity-indexed annuities, however, you are probably better off buying when the *stock market* is low. For pension or life insurance money being converted to a lifetime income, rates may be set in advance and not determined by the financial markets, in which case, if the markets are favorable, you might be better off withdrawing the money and buying an annuity privately.)
- Since annuity payments increase the older you are when you start, if you are near to a change in age, wait a little bit. Depending on where you get your annuity, your official age may change on your birthday, or on your õhalf-birthdayö if the annuity issuer goes by your age at your *nearest* birthday.

Here is another suggestion that makes sense for most people:

Spread out your purchase over a number of years. If you are in your sixties, for example, take the total amount you plan to use to purchase an annuity, divide it into, say, four pieces, and only use one piece to buy an immediate annuity. Invest the other three pieces in a conservative fashion. In about four years, use the second piece to purchase a second annuity. Then repeat the cycle with the other two pieces. If you are older, though, donøt

spread it out as much (divide it into three pieces, perhaps, and purchase at 2- or 3-year intervals).

This strategy has several advantages:

- Since you donøt know what the best time to purchase an annuity is, based on age and interest rates, it makes sense to spread out the purchase, rather than putting all your eggs into one basket.
- You do not commit yourself all at once. If you do have the misfortune to die young, or if there is some radical change to your financial circumstances, you have made only a modest commitment up front.
- Because you are holding money in reserve, you do not need to lower your benefits by using a õcertain and continuousö form of annuity, and there is at least somewhat less need to consider an annuity with withdrawal privileges that also would reduce your income amount.
- On the contrary, by waiting you increase your monthly income over the long run, because a majority of your purchase will be made at ages older than you are now, which means you will get more and more favorable rates with each purchase. And if you do live a long time, you will receive a higher income than if you had made your purchase all at once.
- If you have any doubts about the wisdom of purchasing an annuity, making a small commitment is easier than a big one. Chances are, you will like getting those checks every month when they start coming in, and then you will feel even more comfortable about making the second and later purchases.

Note, however, that if you have a õvariable annuity,ö which ties the payments you receive to the performance of the financial markets, there may be no financial benefit to spreading out your purchases (or conversion of existing variable annuity balances into a lifetime income). Thatøs because these products recalculate the payments every year, taking your current age into account. So you automatically get much of the same advantage, and you actually get less advantage if you donøt annuitize the whole amount at once. Still, you might feel psychologically more comfortable doing it in smaller doses.

Where should you get an annuity?

Annuities are actually an inverted form of life insurance, so only life insurance companies can manufacture them, but many securities firms, banks, or sometimes other organizations have insurance company subsidiaries, or arrangements with established insurance companies, so you actually can get annuities through many financial outlets. Itøs a good idea to know which insurance company is actually backing any annuity that you buy ó make sure it is a name you trust, because with any luck you will be depending on them for many years. Annuities are guaranteed at the state, not the federal, level, and limits on the guarantees range from $100,000 to $500,000 depending on the state ó though the insurance industry itself usually makes up the difference, because the security of these products is crucial to them.

In addition, as we have mentioned, certain financial assets you may already own often contain built-in options to convert part or all of your balance to a lifetime income. Employer-sponsored 401(k), 403(b), 457, and other kinds of plans often offer this benefit. So do many life insurance policies. And of course, deferred annuities you may own can always be converted to a lifetime income. The advantage to using these sources is that there normally will be fewer or no fees or taxes imposed on the transaction. Buying an annuity from scratch often does have some such expenses attached.

But using pension, insurance, or existing annuity assets to purchase a lifetime income also means that you are probably more limited in your choices about what kind of annuity you get, and what you have to pay for it. And, as mentioned a little while back, you should compare the rates being offered inside such plans to the rates you can get on the outside. If you are not satisfied with the annuity types and rates available inside these plans, there are usually ways to transfer the money out of the plan into a new annuity that you own, without generating any immediate income tax problems ó your annuity seller will be delighted to help you with the details.

If you have one or more financial advisors, you should consult with them about what kind of annuity you want and where you can get it at the best price. It can pay to take time and care with this decision, because it will affect you for the rest of your life.

For More Information

- ***General info:***
  - Annuities For Dummies by Kerry H. Pechter
  - http://www.annuityadvantage.com/immediate.htm provides more detailed information on many annuity varieties not explored in the pages above.
  - The Insurance Information Institute offers some general information about annuities at: http://www.insurance.info/individuals/annuities/
- ***Current annuity rates:***

  Monthly payments you could receive for an annuity change fairly often, depending on how interest rates change, so you should always make your decision based on current rates. The services listed below do not necessarily provide the best available rates, or the best available products ó but they will give a basis for comparison.

  - http://www.immediateannuities.com/ can quote average current rates for immediate annuities from several companies, but you have to submit more personal information to get detail about rates from individual companies.
  - http://www.annuityadvantage.com/immediatequote.htm provides personalized quotes if you submit personal information via the website, or by phone.