

Understanding Annuities

It may bring you peace of mind to have a regular source of income during retirement. And that is what an annuity can offer. But annuities come in many shapes and sizes. Before you determine whether a specific annuity meets your needs, you'll want to take time to understand some of the basics.

How They Work

An annuity is a contract between you and an insurance company. The company promises to make periodic payments to you in return for the premium or premiums you agree to pay. The annuity payments may last for a set period, such as 25 years, or for an indefinite period, such as your lifetime or the lifetimes of you and your beneficiary.

With an *immediate annuity*, you start receiving payments right away. With a *deferred annuity*, you will begin to receive payments at some point in the future.

Types of Annuities

There are two basic types of annuities:

- Fixed annuities, which provide payments of a fixed dollar amount, generally set when the payments start. A fixed deferred annuity accumulates interest at a current rate, commonly adjusted annually. A minimum interest rate is guaranteed.
- Variable annuities offer a variable rate of return based on the overall return of the investment options you choose. Variable annuities offer potentially higher returns than fixed annuities, but they also carry a greater risk of loss.

An equity-indexed annuity has characteristics of both fixed and variable annuities. It offers a minimum guaranteed interest rate combined with an interest rate linked to the performance of a specified equity market-based index, such as the S&P 500, an unmanaged index of stocks of 500 major corporations. (You cannot invest in an index.)

Annuity Premiums

Annuities are purchased with either a single premium or multiple premiums. With a multiple (installment) premium contract, you may have a choice between:

- Scheduled premiums — you know the exact amount of your premiums and the timing of your payments.

- Flexible premiums — you pay as large or small a premium as you want, when you want, within certain limits.

Receiving Payments

When you are choosing an annuity, you'll need to decide how and when you want to receive payments. You may be able to choose from a number of options. Keep in mind that once you begin receiving payments, you generally will not be able to change the method of payment. Some common payment options include:

Fixed amount. The value of the annuity is paid in fixed amounts for a specified period. If you should die before the full amount is paid, payments may continue to your estate or heirs — or the payments may end.

Life only. The annuity is paid for as long as the recipient ("the annuitant") is alive. The payment amount is generally determined by the recipient's life expectancy. The recipient is guaranteed the payment for the remainder of his or her lifetime, but there is no guarantee that the full amount invested will be returned.

Joint and survivor life. The annuity is paid for as long as either the recipient or the named beneficiary is alive. Payments typically are lower than with the life-only option.

Fixed period. The annuity is paid for a specified number of years or for as long as the recipient lives, whichever is longer. If the recipient dies before the end of the specified period, payments may be made to a named beneficiary.

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Life with period certain. The annuity payments end when the recipient dies. However, if the payments haven't exceeded a stated amount, the remaining balance is paid in a lump sum to a designated beneficiary.

Advantages of an Annuity

Annuities provide several benefits that may make them a good fit for your particular situation.

Income during retirement. An annuity can provide you and/or a loved one with income that you can't outlive. If you're looking for a reliable source of income for a retirement that's still a long way off, you may want to consider a deferred annuity. If you're close to retiring or have already retired, an immediate annuity may be a more suitable alternative for providing a retirement income stream.

Another way to save for retirement. Retirement plans usually limit the amount you can contribute each year. If you want to contribute more, an annuity is another tax-deferred way to save for retirement.

Tax-deferred investment earnings. The annual earnings on an annuity's investments are tax deferred. So you won't have to pay federal income taxes on any growth in your annuity's investments until you start receiving payouts at retirement. As with most other tax-deferred savings plans, you will have to pay income tax (at ordinary rates) on any earnings you withdraw from the annuity at retirement — or earlier — and withdrawals before age 59½ may be subject to a 10% early withdrawal penalty. In addition, surrender charges may apply if funds are withdrawn in the early years of the annuity.

Before You Buy

If you think that an annuity may be a good fit for your financial portfolio, here are a few issues to consider before you buy.

What is your time frame? If retirement is right around the corner, some annuity products may not be right for you. It can take many years for them to become profitable. However, others are designed for individuals seeking to convert a lump sum into an immediate income in retirement.

How much annuity income will you need? Take a look at your other sources of retirement income — Social Security, company pensions, individually owned retirement plans, personal savings, and other investments — to determine how much income you think you will need to receive from an annuity.

How comfortable are you with risk? Your comfort level may determine the type of annuity that is appropriate for you. For example, if you primarily want a predictable income source that you can count on, you may want to consider a fixed annuity. In contrast, if you're willing to accept a certain degree of risk to increase the possibility of greater investment earnings, you may want to look at a variable annuity. A variable annuity's underlying investment options, however, are subject to market risk and could lose value.

Is the issuing insurance company financially stable? Annuity payments and guarantees are dependent on the claims-paying ability of the issuer, so it's important to consider a company's financial condition before you purchase an annuity.

What charges are associated with the annuity? An annuity may impose charges, including, but not limited to, surrender charges, mortality and expense risk charges, administrative fees, underlying fund expenses, and feature charges, that can reduce the value of your account and the return on your investment. You'll want to understand these charges before you invest.

An annuity can help you build wealth and provide a reliable source of income. Your professional advisors can discuss annuities with you in more detail and help you determine whether an annuity is right for your situation.

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