Income Annuity Basics: What to Know Before You Buy

It's no secret that annuities can be complicated, so before you consider one, acquaint yourself with the fundamentals.

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Annuities are growing in popularity among older investors, and there's a good reason for that.

Year after year, retirees tell researchers that running out of money is among their top worries. And the right type of annuity can help ease that concern by providing a dependable income stream when retirees are no longer receiving a steady paycheck.

A recent study conducted by Michael Finke and Wade Pfau, researchers with The American College of Financial Services, found that adding an income annuity can boost the chances of a retiree's portfolio lasting until age 95. The study, funded by Principal, a financial management and insurance company, concluded that using both annuities and investments can enhance the legacy value of assets over the long term.

The idea behind an income annuity is pretty straightforward: Investors put money into an insurance contract that guarantees how and when they'll get their money back.

But the simplicity of the investment often ends there. There are different types of annuities, and they can come with complicated rules, restrictions, riders and fees. And any guarantee on the contract is only as good as the claims-paying ability of the insurance company.

A little healthy skepticism is a good thing when you're looking at any investment — including annuities. They aren't necessarily a fit for every retirement plan. But an annuity can be a good choice for those who do their research, understand the product's purpose in their portfolio and make the purchase through someone they trust.

If you're interested in the possibilities, here are a few annuity basics:

The Five Main Types of Annuities

Variable annuities: A variable annuity's returns are tied to the stock market or other investments the owner chooses, and gains and losses are based on the performance of those underlying subaccounts. If the fund performs well, the value of the annuity will grow, and the owner may receive a larger total payout. But even if the fund's performance declines, the contract's guaranteed rate may provide a reliable long-term income.

Fixed annuities: When investors purchase a fixed annuity, they receive a fixed interest rate for a designated period of time (similar to a certificate of deposit). The rate won't go up when the market is good, as it does with a variable annuity, but the investor will always earn the stated interest rate, and the

investment can't lose money through market losses or decrease in actual dollar value.

Fixed indexed annuities: A fixed indexed annuity combines features of variable and fixed annuities. It offers a guaranteed minimum rate of return, much like a fixed annuity, so investors can protect their principal. But it's also tied to an underlying index (usually the S&P 500), so if the stock market rises, there's the potential for higher gains. The upside is subject to caps, spreads and participation rates, so it's important to read the fine print.

Immediate annuities: With an immediate annuity, the investor makes a lump-sum payment to the insurance company and starts receiving income payments right away — typically within 30 days. An immediate annuity can be structured to pay out for a lifetime or for a fixed period of time. Payouts are usually interest-rate sensitive, which could affect the income the annuity provides.

Deferred annuities: With a deferred income annuity, the investor makes an upfront payment, but the insurance company doesn't start paying out income until the investor reaches the age specified in the contract. The payouts can be higher than with immediate annuities (especially if the starting date is far in the future), but the trade-off is that the investor may not reach that age.

Terms to Know

Cap: A cap is the maximum an investor can earn in a given year. There are usually different cap choices available on each contract.

Spread: The spread is the amount the insurance company deducts before crediting an annuity with any gains. For example, if the S&P 500 goes up 6% and the investor has a 2% spread, the investor would be credited with a 4% gain.

Participation rate: This is the percentage of index gains the investor is credited with. If the investor has a 50% participation rate and the S&P 500 goes up 10%, the investor is credited with a 5% gain (50% of 10%).

Surrender charges: If the investor takes out more than the predetermined free withdrawal amount, he or she will be charged an early withdrawal penalty. Surrender charges typically apply for the first five to 10 years of the contract. This allows the insurance company to give more guarantees on its product because it knows investors won't be taking out a lot of money early on.

Income rider: Some annuities have an income rider that will use a second, separate account value to determine a future income stream. It has no lump-sum value and can't be passed on to a non-spouse beneficiary. Most income riders will grow at a fixed rate every year and aren't subject to market gains or losses. Some income riders have a fee, but most companies offer fee-free income riders.

Other riders: Some annuities have riders such as long-term care or terminal illness waivers, which allow access to the invested money if it's needed to cover qualifying expenses. These riders are sometimes added at no cost, but they can be structured in various ways, so be sure you know what you're getting.

Possible Fees

It's also important to be aware of any fees that could add to the cost of an annuity (and, therefore, take away from your nest egg).

- Variable annuities usually have the highest fees. These can include mortality and expense charges, policy administration fees, subaccount fees and rider charges.
- A fixed rate annuity typically doesn't have any fees.
- A fixed indexed annuity can have a fee for an income rider, but investors can choose whether they want the rider included or not. Most fixed indexed annuities without an income rider have no fees.

An annuity can be a great tool if used properly, but it probably isn't the best DIY buy. Working with a financial professional — preferably a fiduciary, who is bound to do what's in the client's best interest — who can discuss the pros and cons of various investment options, including annuities, can help you make the right decisions based on your objectives and risk tolerance.

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