ARE ANNUITIES A SOLUTION FOR BABY BOOMERS IN RETIREMENT?

May 31, 2018 by Carlos Dias Jr.

Retirement is posing a lot of challenges for Baby Boomers as many feel their money won't last over 30 years. Lower interest rates and market fluctuations are making them pursue other options that will provide a safety net for the remainder of their lives.

One potential solution for Baby Boomers is to purchase an annuity offering guaranteed income. With this, you can receive payments immediately or defer them, allowing the earnings to accrue tax-deferred with future payments taxed as ordinary income. There is no limitation on how much you can contribute to an annuity.

HOW DO ANNUITIES WORK?

Annuities are contractual guarantees between you and an insurance company, either as a single deposit or multiple payments. In exchange, the insurance company follows through on the terms of the contract. Annuities grow tax-deferred until the interest is withdrawn, and payments can be taken as a lump-sum (which, although I've seen it, is not what I'd recommend) or through periodic distributions.

There are **four** basic types of annuities:

- **IMMEDIATE ANNUITIES** offer a guaranteed fixed payment and are typically used to fund pension plans (e.g., for the rest of your life or, depending on your annuity terms, the rest of your spouse's life).
- **FIXED ANNUITIES** are similar to CDs, which promise a fixed interest rate over a set period of time through an insurance company instead of a bank. Rates for fixed annuities are typically higher than those offered by CDs.
- **VARIABLE ANNUITIES** allow you to directly invest in the stock market, usually through mutual funds although with less risk because your principal is guaranteed — but you'd have to pass away in order for your heirs to receive it. Payments will be based on the performance of your investments. The account usually carries some sort of guaranteed interest rate (although you would have to start receiving the payments in order to get the guarantee). On a side note, I'm not a fan of variable annuities. Most of the retirees I've met who had variable annuities with high fees had to surrender and receive less then what they put in to get out of them.
- **FIXED INDEXED ANNUITIES** tie the interest rate they pay to an index, such as the S&P 500. The minimum a fixed indexed annuity will pay typically is 0% (meaning it is guaranteed not to lose money when the market falls), but it can significantly increase in comparison to a fixed annuity (although the top range is typically capped depending on the insurance company you purchase from, so it is imperative to find which ones have higher participation rates in the index chosen). You can also structure payments like immediate annuities.

Beyond the basic promise of receiving payments from the insurer, you can customize your contract to leave money to your spouse or your estate and can work in guarantees that you'll at least be able to get your initial deposit back should the performance be less than satisfactory. Be wary, however, that guarantees and other riders in your contract may come with added fees and costs. It's important to be as informed as possible before making a decision.

ADVANTAGES ANNUITIES OFFER

1. Lifetime Income with Less Risk

The timing of withdrawals from a stock-based investment portfolio in retirement is always crucial and can be subject to "sequence of returns risk." That means that if the market falls substantially when you are retiring or newly retired — just as you start taking withdrawals from your portfolio — your retirement savings could take a hit from which you can't recover.

Understanding, and planning for, this risk will be the difference between running out of your retirement savings and never having to worry about retirement ever again. Market conditions can sway based on random occurrences, so timing can be extremely unfortunate. A portfolio can yield big returns for 20 years and then in one year set back all prior gains.

You can minimize this risk either by withdrawing a constant, non-inflation-adjusted, amount every year, or you could take an approach that incorporates guarantees with annuities.

2. Alternatives to Bonds

Bond interest rates move inversely with their prices, meaning that today's bond holdings will drop in value in the future because interest rates have been predicted to rise in the coming years. Many retirees and investors have tried to combat this with dividend stock investments, but these can be volatile and risky, sometimes offering more problems than bonds.

One strategy that has worked to assist retirees from bond and stock market conditions while allowing them to retain income like a bond investment has been annuities. Besides this, other advantages include removal of bond default risk, and simplification of your investment management, which includes not having to pay management fees.

3. Principal Protection

Finally, annuities can be wonderful tools because of the principal protection they offer. Some annuities come with a guarantee that you will get all your initial deposit back from the insurance company at some point in time, generally to help make up for losses you may experience (in the case of variable annuities). The cost for this service is the only downfall to consider, usually in the form of an extra expense.

DOWNSIDES OF ANNUITIES

While annuities do offer a lot of positives, there are, of course, some negatives to consider. Variable annuities can come with a bevy of fees (such as a mortality and expense fee, administrative fees and the costs for riders), and they can be complicated and confusing to buy. In addition, they are guaranteed by the company that issues them, so it pays to check the company's rating with a credit-rating firm such as Moody's.

Another potential downfall is the amount of time you need to wait to have access the principal and interest, which is called the surrender period. Most companies make investors wait five to 10 years. So, you'd better be confident that you won't have to withdraw your entire balance before that period is up, otherwise you'll be looking at paying a surrender charge.

Also, if you take payments while you're under age 59½, you may be faced with an additional 10% penalty from the IRS.

WHO SHOULD (AND SHOULDN'T) CONSIDER ANNUITIES

For investors who don't need to secure a guaranteed stream of income for the rest of their lives or who aren't worried about potential stock market fluctuations, annuities are most likely not the right fit.

However, for investors who would like higher interest rates than a CD, want to create a "personal pension" to last them through the rest of their lives or who want out of the stock market altogether, an annuity can be a considerable alternative.

In conclusion, annuities are not for everyone, but they can be a viable solution to Baby Boomers approaching retirement.

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