

The Unvarnished Truth About Annuities: Income, Expectations, and Realities

Few financial products provoke as much fierce debate as annuities. Mention the word to a group of retirees or investors, and you are bound to hear two polar opposite views: either that annuities are the ultimate bedrock of a secure retirement, or that they are overly complex, fee-laden traps designed to enrich financial salesmen.

The truth, as is usually the case, lies somewhere in between.

To evaluate annuities fairly, we have to strip away decades of aggressive marketing, clear out the noise on both sides, and examine what these products actually do and what they were never meant to do.

The Core Function: A Private Pension Engine

At its fundamental level, one of the most important functions of an income annuity is to transfer longevity risk from you to an insurance company. It is a contractual mechanism designed to turn a pool of capital into a predictable stream of income that can last for the rest of your life.

Think about Social Security. Although Social Security is a government-administered social insurance program rather than a private annuity contract, it illustrates a similar principle: providing income for as long as you live. Traditional defined-benefit pensions can serve a comparable purpose.

For decades, modern retirement rested on a three-legged stool:

1. Social Security
2. Company Pensions
3. Personal Savings

As traditional private-sector pensions have become less common, retirees face a daunting challenge: managing their personal savings to ensure they do not run out of money before they run out of breath. Outliving capital, known as longevity risk, is one of the greatest psychological and financial stressors facing retirees today.

Properly structured lifetime income annuities offer something that traditional investment portfolios cannot guarantee on their own: a contractual promise of income for life, even if the funds supporting those payments would otherwise have been exhausted.

That promise is backed by the claims-paying ability of the issuing insurance company, making the financial strength of the insurer and the specific contract provisions important considerations.

Where the Industry Went Wrong: The Hard Sell and Market Myths

If annuities solve such a critical problem, why do so many people treat them with suspicion? The skepticism is not unfounded.

For years, annuities have frequently been oversold by aggressive agents lured by high upfront commissions. In some cases, products were recommended to individuals who didn't need them or whose liquidity needs were

incompatible with the surrender charges attached to these contracts.

Worse still, marketing pitches have sometimes blurred the lines regarding market returns:

- **The Market Competition Trap:** Certain annuities have been pitched as a way to "get all of the market upside with none of the downside." In reality, fixed-indexed annuities typically limit the interest credited from positive index performance through contractual features such as caps, participation rates, or spreads.
- **Changing Terms:** Buyers may be drawn in by eye-catching upfront bonuses or attractive participation rates, only to discover later that certain contractual features, including cap rates, spreads, and renewal participation rates, may be adjusted by the insurance company within the limits established by the contract.

When annuities are sold as wealth-creation vehicles meant to outperform or match equity markets, buyers can be set up for disappointment.

An annuity is fundamentally an insurance contract. Its value should be evaluated in terms of the specific financial problem it is designed to solve, rather than whether it can compete with the stock market.

The Case for Reasoned Expectations: What Is Guaranteed

To approach annuities objectively, expectations must align with reality.

Annuities are not all structured alike. Fixed annuities, fixed-indexed annuities, variable annuities, and immediate income annuities can offer significantly different features, risks, and guarantees.

In certain fixed and fixed-indexed annuities with optional lifetime income benefits, contractual provisions may establish guarantees such as:

- Specified minimum growth or roll-up rates used to calculate an income benefit base during the deferral period.
- Guaranteed payout percentages or factors used to determine lifetime income.
- Contractually defined lifetime income payments once the applicable requirements have been satisfied.

These guarantees must be understood in the context of the actual contract.

For example, an income benefit base used to calculate future payments is not necessarily the same as the contract's cash value or the amount available for withdrawal.

Likewise, some annuity features, including certain interest-crediting terms, may change over time, while other guarantees are established when the contract is issued.

All contractual guarantees are subject to the issuing insurance company's claims-paying ability. Withdrawals, surrender charges, rider fees, and other provisions can also affect the benefits available.

When framed correctly, an annuity's purpose may be less about maximizing accumulated wealth and more about establishing a dependable, contractual income floor.

Two Primary Reasons to Consider an Annuity

When you eliminate the hype, there are two particularly compelling reasons for a retiree to consider allocating a portion of their wealth to an appropriately selected annuity.

1. Generating a Guaranteed "Paycheck" Floor

Using a portion of a portfolio to help cover essential living expenses, such as food, healthcare, housing, and taxes, can create meaningful psychological and financial flexibility.

Knowing that a portion of basic living costs is covered by contractually guaranteed lifetime income may allow the remaining portfolio to be managed with a longer-term perspective.

Rather than depending entirely on withdrawals from market-based investments to meet everyday expenses, retirees may be able to reduce the need to sell investments during unfavorable market conditions.

This does not eliminate investment risk from the remaining portfolio, but it can help separate the responsibility of generating essential income from the responsibility of pursuing long-term growth.

2. Protecting De-Risked Capital

For the portion of a portfolio that an individual cannot afford to expose to direct market losses, certain fixed and fixed-indexed annuities may serve as conservative allocation tools.

These contracts can provide protection against negative market performance while offering interest-crediting opportunities or other contractual benefits.

However, principal protection does not necessarily mean unrestricted access to every dollar at all times.

Surrender charges, withdrawal limitations, rider costs, and other contract provisions may affect the amount available if funds are accessed early. In addition, protection against market losses does not eliminate inflation risk or the risk associated with the issuing insurer.

The objective is not to suggest that annuities are risk-free, but to understand which risks they may help manage and which risks remain.

Striking the Right Balance

Annuities are neither financial miracles nor financial poisons. They are specialized tools.

Committing an entire nest egg to an annuity without considering liquidity, flexibility, and other financial needs can create serious limitations. Expecting an annuity to rival the long-term growth potential of a diversified equity portfolio can also lead to unrealistic expectations.

On the other hand, rejecting guaranteed lifetime income outright while relying entirely on market-based withdrawals for essential retirement expenses introduces risks of its own.

The important question is not whether annuities are universally good or bad.

It is whether a particular annuity, with its specific benefits, limitations, costs, and guarantees, solves a meaningful problem within an individual's overall retirement plan.

By viewing annuities for what they truly are, contractual financial tools that may provide lifetime income and help protect certain assets from market losses, retirees can set reasonable expectations, avoid sales hype, and make more informed decisions.

The goal isn't to own an annuity. The goal is to build a retirement plan that works.

Stephen C. Smith, CTBA

Symphony Financial Group

Important Considerations

Annuities are insurance products, and guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company. Product features, income benefits, surrender charges, fees, withdrawal provisions, and limitations vary by contract. Annuities are not FDIC-insured or guaranteed by any government agency. This article is provided for educational purposes and should not be considered an individualized recommendation. Suitability depends on personal financial circumstances, objectives, and liquidity needs.

Educational References

National Association of Insurance Commissioners (NAIC), Annuities Overview: <https://content.naic.org/insurance-topics/annuities>

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U.S. Securities and Exchange Commission, Investor.gov, Annuities:

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