

The Truth About Annuities: Benefits, Risks and Who Needs Them

Annuities can be powerful tools for generating retirement income, but they're often misunderstood. At their core, annuities are contracts with insurance companies that can provide guaranteed income, either immediately or in the future. While they're not right for everyone, they can serve specific financial needs.

Why is an Annuity?

An annuity is a contract between an individual and an insurance company. In exchange for a lump sum or a series of premium payments, the insurer agrees to make periodic income payments to the individual, either starting immediately or at a future date. Annuities are commonly used as part of a retirement income strategy because they can provide guaranteed income for life or for a set number of years.



The key idea behind an annuity is that it helps convert savings into a reliable income stream. This is especially useful for people who are no longer earning a paycheck and need to supplement Social Security or other retirement income sources.

Main Types of Annuities and Their Benefits

There are several different types of annuities, each with its own unique structure, benefits, and trade-offs. Understanding the distinctions between them is important when deciding whether an annuity is a good fit for your retirement plan.

1. Fixed Annuities

A fixed annuity offers a guaranteed interest rate for a certain period of time. Once the contract is annuitized or converted to an income stream, you receive regular payments based on the terms of the contract. These payments do not change and are not affected by market performance.

Benefits:

- Provides stability and predictability.
- Guarantees principal and interest.
- Offers tax-deferred growth until withdrawals begin.

Things to Watch Out For:

- Returns may be lower than other investment options, especially during periods of low interest rates.

- Early withdrawals may result in surrender charges and tax penalties.
- Payments may not keep pace with inflation.

Fixed annuities are best suited for conservative investors who prioritize safety and predictable income over market growth.

2. Variable Annuities

Variable annuities are more investment-oriented. The money you contribute is allocated to investment subaccounts (similar to mutual funds), and your future income payments are based on the performance of those investments. Some contracts offer riders or guarantees that can protect a portion of your income.

Benefits:

- Offers the potential for higher growth through market exposure.
- Allows tax-deferred growth.
- Optional riders can provide income or principal guarantees.

Things to Watch Out For:

- Investment risk—if the market performs poorly, your account value and income could decline.
- Often involves high fees, including mortality and expense charges, administrative fees, and fund management fees.
- Contracts can be complex and difficult to understand without guidance.

Variable annuities may be appropriate for individuals who want market exposure but also value the option of lifetime income guarantees.

3. Indexed Annuities

Indexed annuities are designed to provide returns based on the performance of a stock market index, such as the S&P 500, while also protecting your principal. You won't lose money if the index performs poorly, but your gains are usually capped.

Benefits:

- Offers principal protection with some potential for growth.
- Returns are based on a market index but do not involve direct investment in the stock market.
- Provides tax-deferred growth and optional income riders.

Things to Watch Out For:

- Caps, spreads, and participation rates limit the amount of interest you can earn.
- Complex terms and crediting methods can be hard to interpret.
- Lower upside potential compared to direct market investments.

Indexed annuities are often used by people who want a blend of safety and moderate growth without full exposure to market risks.

4. Immediate Annuities

With an immediate annuity, income payments begin almost right away—typically within 30 days of making a lump-sum payment. These products are ideal for retirees who need a steady and guaranteed income stream starting now.

Benefits:

- Provides a predictable stream of income.
- Can be structured to pay income for life or for a set number of years.
- Simplifies budgeting by eliminating investment decisions.

Things to Watch Out For:

- Once annuitized, you generally cannot access the lump sum again.
- Payments may not adjust for inflation unless specifically included in the contract.
- No flexibility—this is a long-term commitment.

Immediate annuities are best for individuals who are retired or very close to retirement and need income right away.

5. Deferred Income Annuities

Deferred income annuities work similarly to immediate annuities, but payments begin at a future date (often several years later). This allows for potentially higher income payments due to the deferral period.

Benefits:

- Provides predictable income starting at a later age, such as age 70 or 75.
- Can be used to guard against longevity risk—outliving your savings.
- Typically offers higher monthly income than starting right away.

Things to Watch Out For:

- Ties up funds for an extended period without flexibility.
- May not provide a return if you don't live long enough to receive significant payments.
- Inflation can erode the purchasing power of future income if not accounted for.

This type of annuity is often used as a longevity insurance strategy and may be a good fit for individuals in good health who want to plan ahead for late-stage retirement income.

Who Might Benefit from an Annuity?

Annuities are not the right choice for everyone, but there are several scenarios where they can be especially valuable:

- **Retirees without a pension:** An annuity can act as a personal pension, providing lifetime income to cover basic living expenses.
- **Individuals worried about outliving their money:** Lifetime annuities protect against longevity risk by ensuring income continues as long as you live.
- **High-income earners looking for more tax-deferred growth:** For those who have maxed out other retirement savings options, annuities can offer an additional tax-deferred investment vehicle.
- **People who are risk-averse:** Fixed or indexed annuities may appeal to those who want stable returns without exposure to market losses.
- **Those approaching retirement with large lump sums:** Rolling part of a 401(k) or IRA into an annuity can provide guaranteed income while still allowing for growth and flexibility elsewhere in the portfolio.

Key Points to Consider

Before purchasing any type of annuity, it's important to understand both the benefits and the limitations. Here are some key questions to consider:

- What are the fees and charges involved?
- Is the annuity inflation-adjusted or fixed?
- How long is the surrender period, and what are the penalties?
- Are there riders that add value or protection, and what do they cost?
- How does this annuity fit into your broader retirement plan?

Annuities can be valuable tools for creating reliable income, protecting against longevity risk, and preserving capital in retirement. However, they should be evaluated carefully and purchased with a clear understanding of how they work and what they cost. Not all annuities are created equal, and some are far more complex than others.

Before making a decision, consider speaking with a trusted financial advisor who can help you assess whether an annuity fits into your long-term goals and financial strategy. When used properly, annuities can offer peace of mind and financial stability during one of life's most important transitions—retirement.

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