Annuities: Why You Need To Know How They Work

It is important to know how annuities work because many financial planners recommend them to their clients for retirement planning purposes. Does that mean you need one? Learning more about annuities can help you decide.

We all know we should be building retirement assets, but how do you make sure that you don't outlive them? Before the growth of 401(k) plans, many employers paid a pension that lasted a lifetime. The employer paid the benefit no matter what happened to the stock market. Today, pension plans have largely been replaced with 401(k)-type plans whereby people must make their own key decisions, decide how to manage their own funds and decide how to cope with the three big *what ifs* of retirement: *What if* I live for a very long time, *what if* my investments lose money, and *what if* inflation hurts my investments? There is no perfect answer, but the goal is to make the best informed decision you can.

What Choices Will You Have?

For example, let's say you have built up a retirement fund of $250,000 by the time you are age 65. Few of us realize that we have to make that money last for perhaps 20 or 30 years after we stop working. There are two ways to make your fund last for the rest of your life:

- Make withdrawals that you estimate will last for the rest of your life—and keep whatever money you haven't spent in an investment. Or…
- Take some of your money and buy an immediate annuity—which will provide you with guaranteed income payments for the rest of your life.

You may decide that the best way is to use a combination of both of these by managing your own retirement fund until the time seems right to convert some of your fund into an annuity.

Here are some general guidelines to help in your decision about an annuity:

Immediate Annuities: They May Be Right For You If…

- **You have retirement expenses not covered by monthly pension and Social Security benefits.** An annuity can guarantee a regular monthly payment for the rest of your life. If you have a large income to pay all your expenses, you may not need an annuity.
- **You have every expectation of living a long life**. Most of us don't know and can only make our plans based on reasonable expectations. If you know (not think) that you won't live for many years, you may want to spend the lump sum instead.

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- **You want the certainty of knowing you won't outlive your means**. An annuity is the best way to be certain you will get payments for the rest of your life, no matter how long you live. Some people worry they will die early. An alternative is to get an annuity that is guaranteed to pay benefits for at least 5 or 10 years, even if you die before then. You may be able to make more money in the stock market, but you may not. If you can live with the uncertainty, you can time the withdrawals from your investments.
- **The money you would use to buy an annuity is for retirement, not for your heirs**. The more money you leave in the pension plan or use to buy an annuity, the less you have to pass on to your children. Annuities generally don't pay death benefits. However, if you kept your money in a lump sum and made periodic withdrawals, and then live for a very long time, your heirs wouldn't get anything anyhow.
- **You have money set aside or figured in your annual expenses for other items**. Long-term care insurance, Medigap insurance, prescription drugs or other unexpected costs. Some people worry about having a lot of money tied up in an annuity.
- **As you get older, you want to take fewer risks with your money.** Some financial advisors and insurance agents may say they can do better for you than an immediate annuity. Make sure you understand the risks involved and how they are paid. A financial advisor should provide you with a plan, and you should be comfortable with the risks and the costs.

Why Should I Buy An Annuity?

Some people suggest that you wait until you are between ages 70 and 80 to buy your annuity, because you get a better deal from the insurance company. Just make sure you don't take out too much money before then. Financial advisors suggest if you are in your 60's, you can withdraw around 5% of your assets, and in your 70's, about 6%.

What Should I Consider When Choosing An Annuity?

The two main criteria for comparing the companies are price and safety. You will want the best price among the safest companies. To find out which companies are safe, ask them for their credit rating. You should use companies with a top rating. Check the Annuity Shopper, available for free on their website **www.annuityshopper.com**. If an insurance company goes under, state insurance guarantee funds may continue to pay your annuity up to the state's maximum amount. Second, ask them how much the annuity you need will cost and choose the cheapest annuity price.

How Much Annuity Do I Need?

1. Estimate your annual expenses in retirement.

   Remember that some of your expenses will go down. You won't have to pay Social Security taxes, you won't need to pay work-related expenses and you probably won't need to save. However, be prepared for some expenses to go up—especially your health care expenses.

2. Subtract your annual Social Security benefit from your estimated annual expenses.
3. Subtract your pension benefits.
4. If you decide to buy an annuity, it should cover your expenses NOT covered by Social Security and pension benefits.

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Annuity Glossary:

Immediate: This is a straight-life annuity that pays a fixed amount for as long as you live. Another option is to get guaranteed payments for a certain number of years, for example, "life or 10 years certain," and if you die sooner, your beneficiary receives the payments.

Deferred: This is an investment product that accumulates money until a future payment. Most annuity articles and advertisements seem to be talking about deferred annuities. There are several types, including:

Fixed- based on interest rate that is initially fixed and then may vary.

Equity-indexed- based on the stock market, with a guaranteed minimum rate.

Variable- based on accounts invested in stocks and bonds

An Annuity Story:

"Mom, Take Care Of Yourself, Don't Leave Me Any Money"

by Ron Gebhardtsbauer

Senior Pension Fellow of the American Academy of Actuaries

My mom is 77 and she had all of her money in an Individual Retirement Account. Once she turned 70½, she had to start taking a minimum monthly amount required by law. (Basically, she has to take out enough so that she would empty the account over her lifetime. This amount changes each year as her life expectancy changes, and the amount of money is less.)

I told her she could get an annuity from an insurance company, which will always pay more. She asked, "How can an insurance company beat the Savings & Loan? Insurers generally have high expenses." I agreed with her, but said that the insurance company can still win—it focuses all of mom's money on her, not on me as her heir, because, fortunately, I don't need it. Under her current payment system, taking out the minimum required amount each year, she was taking out close to $3,000 a year, and this annual amount would soon begin to decrease. If she lived to 95, she would get only about $1,500 a year, and about $500 a year at 100.

However, if the insurance company had the money, about $33,000, they would pay her about $4,000 each year. They would pay her that amount each year, even if she lived to 100 or beyond. It took a while, but my mom finally bought the annuity, and she's glad she did. Her income is higher now, and she doesn't have to worry about it running out, even if she lives a long time.