SPECIAL MIDYEAR DOUBLE ISSUE

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Create a Retirement Paycheck With an Annuity

Predictable income can provide stability and peace of mind. Here's how to decide whether an annuity is right for you—and sort through the options.

BY DAVID RODECK

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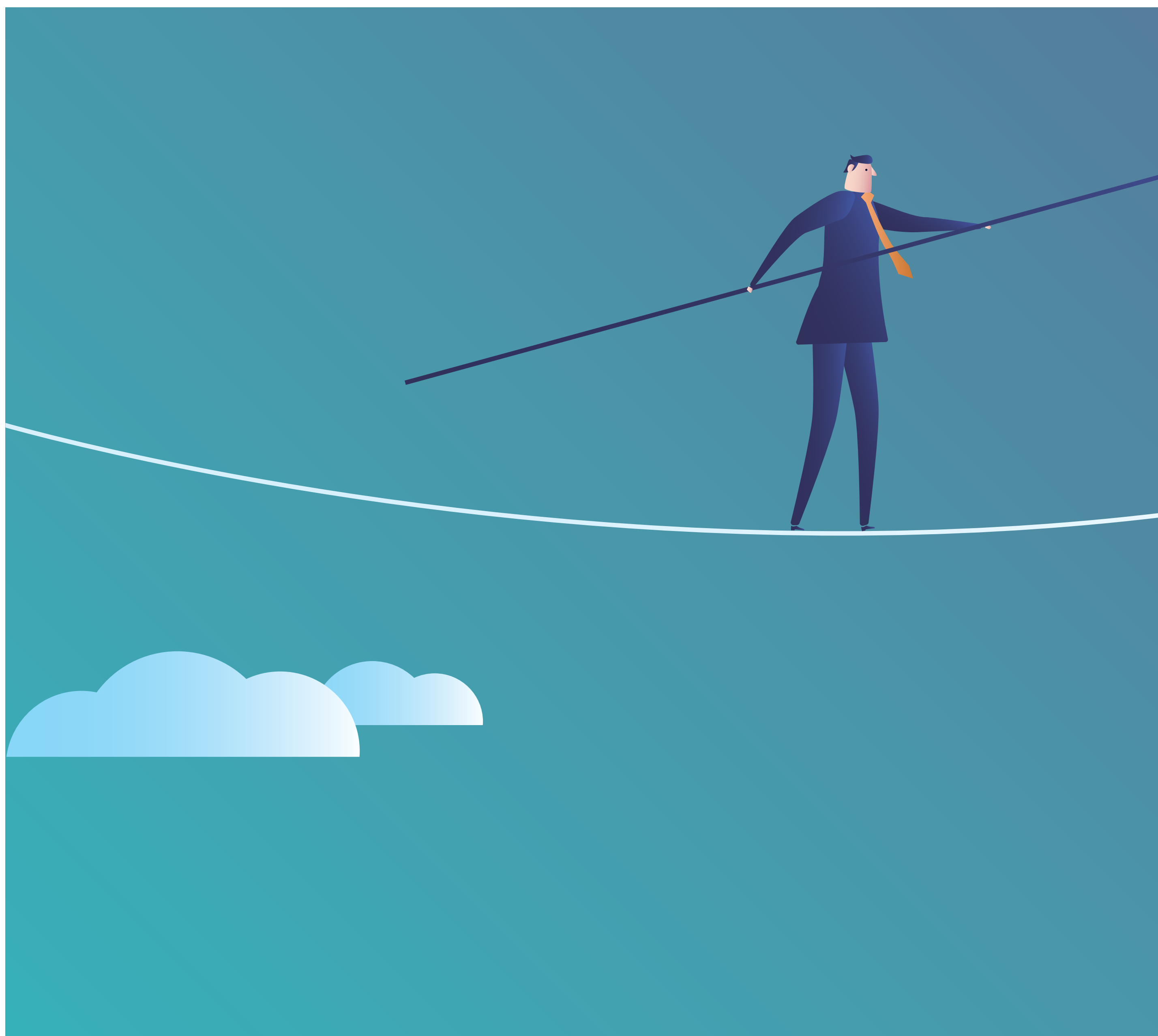
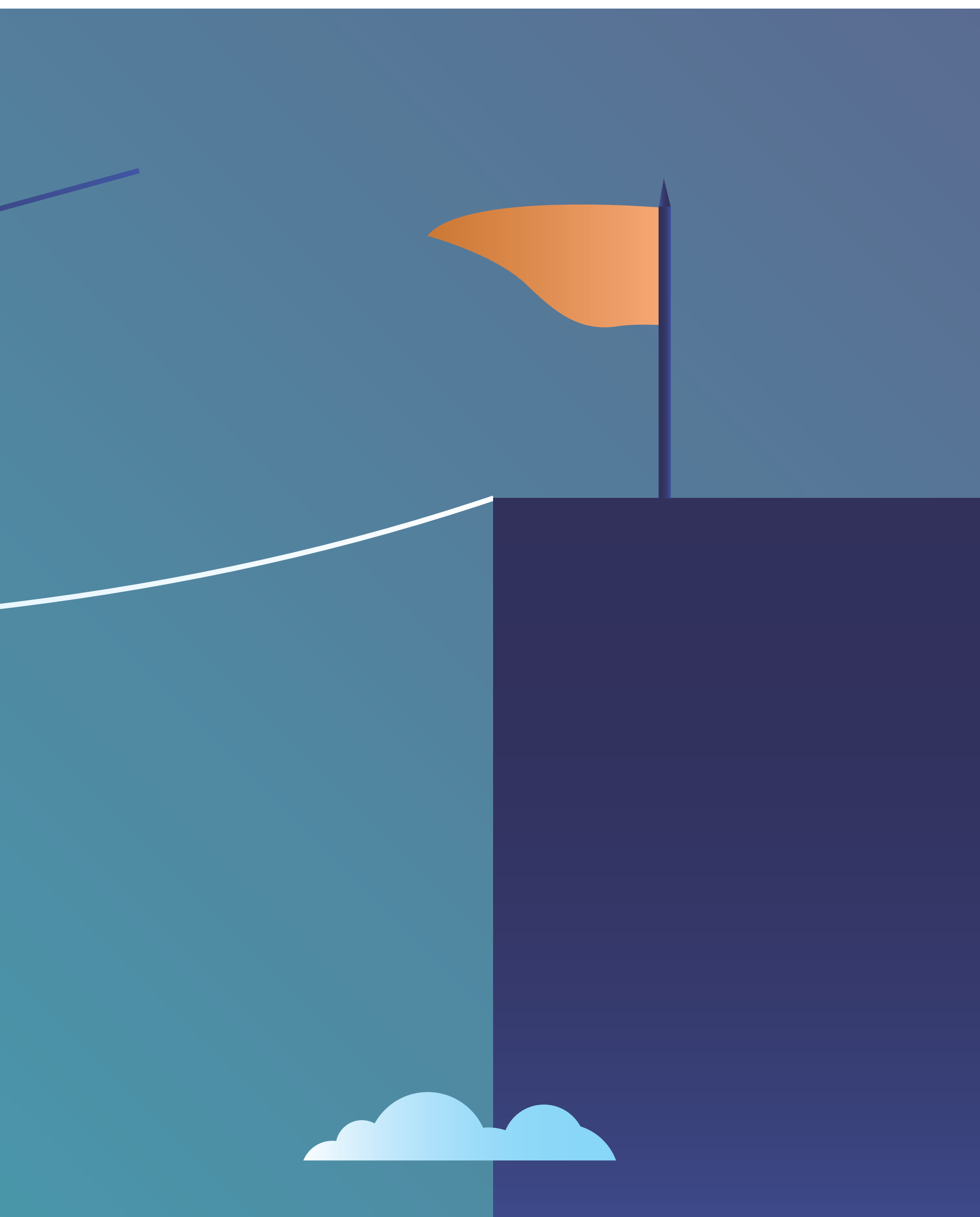


IF you're feeling left out after reading the previous article because you don't have a pension, you're far from alone. Only 22% of workers are covered by a pension these days, according to the Federal Reserve. But if you want to have an additional stream of steady income in retirement to supplement your Social Security benefits, you could create one using an insurance contract known as an annuity.

"An annuity is like a personal pension," says David Blanchett, head of retirement research for PGIM DC Solutions, the investment management division of Prudential. You transfer part of your savings to an insurance company, which then turns that money into future income payments. You can set up an annuity that provides guaranteed income for the rest of your life, like a pension. "No matter how long you live or what happens in the market, you'll get some benefit."



Having a paycheck you cannot outlive makes retirement a lot less stressful. Studies show that retirees with at least some annuitized income are happier, more satisfied and less likely to be depressed than those without. Creating this extra paycheck for life also takes out some of the work of budgeting and investing your money, especially later in retirement, when you may begin to experience cognitive decline. "It's like an easy button for turning wealth into income," says Blanchett.

That said, it's essential to research annuities carefully before using one. They are long-term investments. If you buy an annuity, getting your money back is costly and sometimes impossible. There are also many types to choose from. If you are considering an annuity, here's what to know about when these contracts make sense and their pros and cons.

OPTIONS FOR GROWTH AND INCOME

Annuities can both increase your savings and provide future retirement income. If you aren't ready to turn on the income spigot yet, you can use a deferred annuity to earn a return on your money. There are a few types of deferred annuities.

A *fixed annuity* pays a guaranteed interest rate on your savings. "It's like a bank certificate of deposit on steroids," says Mindy Oglesby, a certified financial planner and CEO of Oglesby Wealth Strategies in Watkinsville, Ga. For example, you might

find a fixed annuity with a 6% guaranteed interest rate for five years.

A *variable annuity* lets you invest your balance in mutual funds. The money you invest in a *fixed index annuity* increases based on the performance of a market index, such as the S&P 500. However, there are limits on your gains and losses. For example, a fixed index annuity might dictate that you won't lose money during down markets but cap your gains at 8% per year, no matter how high the index goes.

Each type of deferred annuity lasts for a scheduled number of years that you pick. At the end, you can renew to another deferred annuity, cash out your money or convert the balance into income.

Immediate income annuities. If you're ready to get paid from an annuity, you have several ways to do so. An income annuity is the simplest version. You transfer part of your savings and immediately start collecting income based on your deposit.

You can set up payments for a set period, such as 10 years. Payments continue to your named beneficiary if you pass away before the period ends. After that, payments stop. You can also set up payments that last for your entire life. It's possible to choose guaranteed payments for as long as both you and your spouse live.

For example, say a 65-year-old man buys an income annuity for $200,000. He'd receive $1,271 per month guaranteed for his life, according to Charles Schwab's online annuity calculator. If he's married to a 60-year-old spouse, they could get a joint-life annuity paying $1,043 per month for as long as one of them is alive.

You could set up a lifetime income annuity with a minimum number of guaranteed payments in case you pass away early. "If someone gets hit by a bus the day after purchase, their heirs will get the money. It protects against dying early," says David Lau, founder of DPL Financial Partners, an online platform for buying annuities.

Guaranteed income riders. Another option is to set up a minimum guaranteed income rider on a variable or fixed index annuity. With these contracts, your money is invested and grows as usual. Once you're ready to start

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payments, your income is based on your contract value at that point. For example, if you start payments with $200,000 in a variable annuity, the insurer may promise lifetime income of 5% of that balance, or $10,000 per year.

The money you put in stays invested, and ideally your contract balance will increase. But if withdrawals and poor investment performance deplete the entire value, you'll continue to get the lifetime income ($10,000 a year in the previous example). You could take a lump-sum withdrawal from your balance at any point. Doing so would reduce your future guaranteed income, but it gives you liquidity in a pinch. If you pass away with a positive balance, it goes to your heirs.

Adding the guaranteed income rider on an annuity costs extra, and that lowers your long-term return. A common fee is 1% a year off your investment return. The guaranteed income payouts are also lower compared with putting the same amount in an immediate income annuity.

Deferred income annuities. If you aren't ready to retire just yet, you could buy an income annuity that begins payments in the future. The longer you wait, the larger your future payments. A deferred income annuity can also support the final stretch of your retirement.

"You could buy an annuity with a deeply deferred payment date, like age 82 or later," says Jim Szostek, vice president of retirement security at the American Council of Life Insurers (ACLI). "You know you will still have income at the tail end of retirement." Because roughly one-third of 65-year-olds will reach age 90, this later-in-life income could be worth considering.

If you have money in a traditional, tax-deferred 401(k) or IRA, the government requires you to start making withdrawals at age 73. However, you could use funds from those accounts to set up a qualified longevity annuity contract (QLAC), which would allow you to push back withdrawals to age 85 for more tax-deferred growth.

THE BENEFITS

As with any investment, annuities come with pros and cons. Here are some good reasons to use these contracts.

Guaranteed retirement income. The guaranteed income that an annuity creates provides valuable peace of mind in retirement,

WHEN TO BUY

How Interest Rates Affect Annuities

Annuities base their returns on market interest rates. Given that rates were recently at their highest level since 2001, conditions overall are favorable for buying an annuity. But higher rates benefit some products more than others.

Fixed annuities are paying higher guaranteed rates to match current market conditions. Fixed index annuities have also become a better deal. Many now offer higher possible caps for your returns as insurers are earning more. The interest rate environment doesn't matter as much for variable annuities, as the returns depend on the performance of the mutual funds they invest in rather than rates.

Many annuities also pay initial bonuses as a percentage of your deposit that can be worth 10% or more. "If someone bought an annuity years ago when rates were low, it could make sense to break a contract to get the better rates. A bonus would help offset the surrender charge," says Mindy Oglesby, a certified financial planner and CEO of Oglesby Wealth Strategies in Watkinsville, Ga.

High interest rates could help you earn more if you're looking for income, but it depends on your age. "It matters much more the younger you are," says David Blanchett, head of retirement research for PGIM DC Solutions, the investment management division of Prudential. If you're 55, the amount of your payout is based on the insurer investing the money for the long term. High interest rates can help you lock in higher lifetime income. If you're 85, high interest rates don't matter as much. "At this point, payouts are mainly based on life expectancy."

Interest rates could fall later this year, although higher-than-expected inflation in early 2024 may delay rate cuts from the Federal Reserve. The possibility of declining rates provides extra incentive to purchase some types of annuities sooner than later. But before you pull the trigger, make sure an annuity is appropriate for your long-term financial goals. If you cancel an annuity early, surrender charges could wipe out any benefit you gain by purchasing it when interest rates are high.

says Szostek. “It keeps people from running out of money and allows them to spend the rest of their savings more freely. Otherwise, you might be too conservative and deny some of the pleasures you could have had in retirement.”

Stability from risk pooling. Insurance companies can generally afford to pay out higher income than most people could safely draw from their portfolios because of risk pooling and the law of large numbers, says Blanchett from PGIM DC Solutions. “If I plan on my own, I have to be more careful. There's a 50% chance I'll live longer than my life expectancy.”

By combining resources from many people, insurers can wait out market swings and cover the payouts for those who have exceptionally long life spans. People who live a long time also benefit from mortality credits: They get extra money from the annuity pool from people who passed away earlier.

Safe returns. Fixed and fixed index annuities can offer growth while preventing market losses in the final few years before retirement. You can avoid a major loss at this point, when you don't have much time to recover. “The downside protection is useful from a risk-management point of view,” says Lau, the founder of online annuity platform DPL Financial Partners. “If your portfolio is negatively impacted in the last stretch, it will hit your retirement hard.”

Tax-deferred growth. You don't owe taxes on investment gains as long as they stay in the annuity. If you buy an annuity using after-tax money from your savings, it grows tax-deferred, and you get those deposits back tax-free when you withdraw them or receive the money as income payments; you pay income tax on investment earnings. “For someone who maxes out their 401(k) and other retirement plans, an annuity offers another way to get tax-deferred growth,” says Oglesby, the CFP from Georgia.

People who live a long time benefit from mortality credits: They get extra money from the annuity pool from people who passed away earlier.

If you put pretax funds from a retirement plan, such as a traditional IRA, into an annuity, taxes continue to be deferred until you withdraw the money or start income payments. It is also becoming more common for workplace retirement plans, such as 401(k)s, to offer annuities because the SECURE Act of 2019 removed legal barriers for the plans to provide this option. When you cash out or receive income, you pay income tax on the entire amount.

Extra rider benefits. You can buy riders to create other benefits for your annuity. One option is to add a long-term-care rider. If you need long-term care in a nursing home while collecting annuity income, the annuity increases your payment to help cover the costs. You could also buy a rider so that an annuity leaves a larger death benefit to your heirs.

THE DRAWBACKS

Surrender charges and taxes. When you buy a deferred annuity for growth, you agree to a long-term contract of several years. You pick the length when you sign up. If you cancel or take a lump-sum withdrawal before the period expires, the annuity company will likely deduct a surrender charge.

For example, the company might deduct 7% from the amount you take out. Surrender charges gradually decrease the longer you own the annuity—the charge may, for instance, fall by one percentage point per year before disappearing after seven years. Some annuities allow limited withdrawals without the surrender charge, such as taking out 10% of your balance per year.

Early-withdrawal tax penalty. As retirement products, annuities lock up your money until you turn 59½, warns Lau. If you cancel an annuity or take a lump-sum withdrawal before you reach that age, the IRS charges income tax plus a 10% early-withdrawal penalty on your gains. And if you made pretax contributions, you'll pay tax and the 10% penalty on withdrawals of the contributions, too.

If you take lump-sum withdrawals, annuities require you to take out the taxable portion first before any after-tax deposits. The 10% penalty doesn't apply if you convert your annuity into future income payments with the insurance company. You can start that at any age.

Limited liquidity. Buying an income annuity takes money out of your portfolio. “Removing liquidity is dangerous. You could run into a health problem, or your kids might have an emergency,” says Randy Kurtz, a CFP

with Upper Left Wealth Management in Tampa.

As noted, there are ways to create guaranteed lifetime annuity income while keeping some access to your money. Still, you don't have the same flexible access to your cash that you would by keeping it all in your investment portfolio.

High fees. Generally, the more complex an annuity is, the more it costs. Basic fixed and income annuities have few or no fees. Variable annuities with many riders can be expensive. "I once saw a variable annuity deducting more than 4% a year from the investment return," says Kurtz. Make sure you understand exactly what's being taken out of your earnings each year for the contract.

Inflation. Most income annuities pay out the same monthly amount the entire time, and inflation can chip away at your spending power. You could set up your annuity with a rider for cost-of-living adjustments. Your payments then increase over time—by 2% annually, for instance. In exchange, your starting income is lower. Another option is to use variable payments that depend on the market. You get more income in good years and less in bad, with a higher expected return.

IS AN ANNUITY A GOOD CHOICE FOR YOU?

As you weigh whether an annuity makes sense, think through these factors.

Other guaranteed retirement income. Start by looking at your expected, fixed monthly retirement expenses, recommends Szostek from the ACLI. Think of bills for your rent or mortgage, utilities, insurance, food, car, and other costs that will come up month after month.

Ideally, you should have enough guaranteed income to cover these ongoing expenses so that you don't have to worry about them. If you expect $4,000 a month in fixed expenses and get $2,000 a month from Social Security, you could use an annuity to cover the remaining $2,000. You would then invest the rest of your savings to cover variable expenses that you can skip during a market downturn, such as travel and home renovations.

However, if all of your fixed costs are covered by Social Security and/or a pension, you might not need an annuity. Although you can start Social Security at age 62, each year you wait until age 70 increases your benefit. If you need income while delaying your application for Social Security benefits until age 70, you

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could use an annuity to get through that stretch.

Once you start Social Security, you get cost-of-living adjustments to help keep pace with inflation. This makes Social Security an even better deal than an annuity, says Blanchett. "Many Americans can get all the guaranteed income they need just by delaying Social Security until age 70."

Life expectancy. You should also consider your health and life expectancy based on family history. If you're in excellent health and have a good chance of living longer than average, an annuity with guaranteed lifetime income could be a good deal. On the other hand, someone with preexisting conditions who may have a shorter retirement might prefer to keep access to all their cash and spend it while they can.

Investment risk tolerance. Annuities are often most suitable for risk-averse people, "I recommend them to clients who don't want to deal with the stock market ups and downs," says Oglesby.

On the other hand, if you're comfortable investing and managing risk, you might get a better long-term return and generate more income on your own, especially at a time when you can lock in 30-year Treasury bonds paying more than 4.5% a year in guaranteed interest, says Kurtz. "I recommend putting two to five years of spending needs in bonds, with the rest invested for market returns." That way, you don't have to sell off your stocks during a downturn.

If you think an annuity is a good fit for you, avoid putting all of your savings in one. Contribute only up to about 20% to 40% of your portfolio so you still have money that's easily accessible and that you can invest in the stock market for growth. "An annuity is insurance," says Blanchett. "You don't buy insurance to make money but to mitigate a risk. In this case, the risks are longevity and outliving your savings." K

For questions or comments, e-mail feedback@kiplinger.com.

DECISION TIME

Where to Get Advice

Annuities have different rates, features and fees, so you should compare several options to find the right fit. You have a few ways to do so.

First, you could contact life insurance companies directly for quotes. Allianz Life, MassMutual, Pacific Life and Prudential are some common options. You can meet with one of their agents to discuss the annuity products.

There's no up-front cost to meet an agent or collect quotes. Instead, insurance agents earn a commission for selling products. As a result, they are motivated to get you to sign up for something—and historically, that has caused issues for the annuity industry from overzealous agents. State regulators warn of annuity salespeople using high-pressure techniques such as claiming "limited time offers" to close deals quickly or running seminars on a different topic, such as estate planning, to disguise the fact that they are selling annuities.

However, in most states, insurance agents must follow what's known as a best-interest standard. "They need to understand your needs and goals and compare them against what products are available to you. The rules are designed to make sure the annuity fits," says Jim Szostek, vice president of retirement security at the American Council of Life Insurers. An agent following this standard could not put their financial interest ahead of yours when recommending products, meaning they'd need to recommend the annuity that makes the most sense, even if another might pay a higher commission.

If you want assistance from someone who isn't in the insurance business, consider hiring a financial planner to help you compare products. You can search for an adviser who does not accept commissions and charges on an hourly basis at *www.garrettplanningnetwork.com*.

If you're comfortable doing research independently, you can collect annuity quotes from websites such as BlueprintIncome.com, ImmediateAnnuities.com and IncomeSolutions.com. While online annuity marketplaces historically focused on more-straightforward products, such as fixed annuities and income annuities, technology is evolving to compare other products.

DPL Financial Partners' platform, at *www.dplfp.com*, allows users to compare more-advanced products, such as variable and fixed index annuities. Users answer questions about their financial goals, and the platform then recommends a product. Because you're buying them on your own, the cost of an agent commission isn't built into the annuity.