THE Wealth REPORT

Knowing you have a regular and consistent source of income waiting for you in retirement can help create confidence and make it easier to make the jump from employee to retiree.

LIFE BEYOND THE PAYCHECK

Overview

What happens when the paychecks stop coming? That's the question for many people approaching retirement age. Most of us will rely on a combination of financial sources to cover our expenses in our later years, but how do we know if they will be enough to cover our everyday expenses?

Let's take Social Security, for example. In December 2023, more than 50 million retirees in the U.S. received Social Security benefits averaging $1,905 per month.[1] These benefits are based on an individual's lifetime earnings, so they fluctuate from person to person and may only cover a portion of your expected expenses in retirement.

Other income sources may make up the difference, including an employer retirement plan (such as a 401(k) or 403(b)) or IRA. You might also have access to a pension, although fewer employers are offering pensions to their employees.

Some retirees will need to use their own non-retirement savings and investments to create additional streams of income. However, these funds may be subject to external factors — such as a market drop or changing investment rates — and may not provide as much income as planned for as long as you need.

How, then, can retirees make sure they have enough to live on in retirement? One option is to add an annuity to your portfolio, which can be a source of guaranteed lifetime income for retirees when set up properly.

Annuity Basics

An annuity is a contract between you and an insurance company, where the purchaser pays a premium in exchange for a variety of guaranteed payout options for a set period of time or for the remainder of the individual's life. (It could also be for the remainder of a surviving spouse's life, if the annuity is jointly owned by a couple.)

The two phases of an annuity are the accumulation phase, where the contract value accumulates interest, and the distribution phase, where income is paid out from the annuity to the account owner. Annuities are the only financial product that can provide guaranteed income for life. One caveat, however: The guarantees of an annuity are backed by the financial strength and claims-paying ability of the issuing insurance company.

Types of Annuities

There are two main categories of annuities: fixed and variable. A fixed annuity earns a guaranteed rate of interest and, once income payments are started, can provide a guaranteed income amount for a certain period or life, depending on the options selected.[2]

A variable annuity provides income subject to underlying investment performance, so even though the interest credits may not be guaranteed during the accumulation phase, it does offer the potential for higher payouts over time. Like the fixed annuity, payments are guaranteed for either the time period or life, depending on the options selected.[3]

Some annuities offer both fixed and indexed interest crediting. For example, depending on the interest crediting options chosen, an indexed annuity provides a guaranteed interest crediting rate with the opportunity to enhance accumulation and income payouts based on the performance of the market index, such as the S&P 500. If the S&P 500 has a good year, the annuity owner will receive higher interest credits, up to a predetermined limit, based on a proportionate calculation of index earnings. If the S&P performs poorly, there will be no additional interest credit, but the annuity owner will continue to receive the guaranteed minimum benefit. Unlike variable annuities, fixed index annuities do not actually participate in the market; they only track the index as a means of determining interest credits.

Dispelling Annuity Myths and Misperceptions

Annuities have gotten a bad rap over the years, and some misperceptions still exist despite changes over time. However, insurance companies have made many positive changes to annuities, and today's annuities often provide benefits investors don't know about. Here are just a few:

- Some policies offer a "lifetime income payout" rider. This optional add-on allows you to select a guaranteed lifetime income payout option without "annuitizing" or giving up control of your account to the insurance company. (The rider may be offered for an additional fee.)

- You may be able to leave money to your heirs. Some policies offer a guaranteed death benefit, transferring funds to your beneficiaries upon your death. (This option is typically available through a rider and also may be offered for an additional fee.)

- You can have access to a portion of your funds. Some people believe that once you pay the premium for the annuity, you can no longer access any portion of your funds, but most insurance companies allow account owners to withdraw funds up to a certain cap, such as 10% per year. However, most annuities have surrender charges if you withdraw funds exceeding the cap during a certain time period, typically in the early years of an annuity's life. And keep in mind that withdrawals will impact how much money is in the annuity for your retirement.

Annuity Realities

One perception that is grounded in reality: Annuities can be difficult to understand. This is in large part because there are so many types of annuities and optional riders available. Plus, annuities aren't one-size-fits-all, and deciding which one works for you and your situation is a difficult task. Because of this, it's important to work with an experienced insurance professional to help you understand whether an annuity is a good fit for your portfolio and identify the right annuity (and add-ons) for you.

Another reality is that despite an annuity's guarantee, it is possible to miss out on lifetime income. This feature is determined by actuarial calculations based on the amount of money initially used to purchase the contract. If the annuity owner violates any of the withdrawal limits or other contract rules, it could result in a reduction of benefits or even void the guarantee altogether. This is another reason to work with a qualified advisor and read the policy literature to understand the features, risks, charges and expenses related to the account. And it bears repeating: All annuity guarantees are subject to the claims-paying ability of the issuing company.

Final Thoughts

While guaranteed lifetime income is the goal for many people as they plan for retirement, it's not always easy to generate. In recent years, concerns about Social Security funding and the decline of pensions have made it especially difficult for retirees to know where income will come from in their later years. It's becoming more and more important for individuals to proactively develop their own income streams using a portion of their savings and invested assets.

Annuities can offer important benefits such as the opportunity for tax-deferred growth, potential guaranteed income and a possible death benefit for your beneficiaries. If you're worried your income may not be enough to live on in retirement, an annuity can help shore up your financial situation. We encourage you to reach out to your financial advisor to find out if an annuity is right for you and pinpoint annuity options that fit your situation.

[1] Social Security. "Fact Sheet: Social Security." https://www.ssa.gov/news/press/factsheets/basicfact-alt.pdf. Accessed May 30, 2024.
[2] Amy Bell. Investopedia. June 1, 2024. "How a Fixed Annuity Works After Retirement." https://www.investopedia.com/articles/personal-finance/121415/how-fixed-annuity-works-after-retirement.asp. Accessed June 2, 2024.
[3] Akhilesh Ganti. Investopedia. June 7, 2023. "Variable Annuity: Definition, How It Works, and vs. Fixed Annuity." https://www.investopedia.com/terms/v/variableannuity.asp. Accessed June 3, 2024.

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