Financial Planning: What Are The Different Types of Annuities?

With all the retirement options out there, it can be confusing when building your retirement portfolio, especially when you are considering purchasing an annuity. There are different types of annuities and some are better suited for your lifestyle than others. When considering which retirement annuity is best for you, it's important to research. In this article, we answer your basic annuity questions to help determine if they are the right choice for you and your retirement plan.

First of All, What Are Annuities?

Annuities are financial products that can ensure a steady stream of retirement income. The other main purpose of annuities is to minimize the risk of outliving your income or savings. They are insurance contracts that legally bind you and your insurance company to provide lifelong income and funding for your retirement.

How Do Annuities Work?

Most annuities work in three phases - the accumulation phase, the annuitization period, and the payout phase. During the accumulation phase, the person who purchased an annuity places an initial investment into the annuity, pays a monthly premium, or pays lump-sum installments towards the annuity. This initial investment is evaluated by a formula specifically formulated to determine the future value of the annuity investment. During this stage, the income is accumulated until the annuitization or payout stage.

Not all annuities have an annuitization phase. However, for those that do, the issuing institution will begin paying the annuitant, which is the individual to whom the annuity is registered. In sum, annuitization is the process of converting your payments into accumulation units. After, they are be paid in regular installments during the payout phase. Annuitizing your annuity is a permanent choice that cannot be reversed.

During the payout phase, the annuitant begins receiving their steady stream of income. The annuity contract outlines when the issuing financial institution will begin dispersing the fixed stream of income to the annuitant. The length of the payout period is predetermined when you initially sign the annuity contract and also depends on the type of annuity you purchased and the total amount that has been invested. Despite entering the last phase of the annuity, interest gains will continue to accrue until the entire payout has depleted.

Are Annuities a Good Investment?

Annuities are technically not an investment, but rather an insurance product. Whether they are good financial products is based on several factors relating to age, lifestyle, and your financial portfolio. They are considered to be low-risk under the right circumstances. One important thing to note is that you will face penalty fees for cashing out your annuity before the payout period. Some people will argue that annuities do not generate enough interest to keep up with the risk of inflation.

Are Annuities Safe?

In terms of safety from market crashes, yes, annuities are considered to be generally safe financial instruments, as they are strictly regulated by the insurance industry. They are not market products and they are designed to give you guaranteed life-long income. When it comes to annuities, some areas of concern include:

- Premature death and the consequent forfeiting the remaining payments
- Withdrawal before the payout period in *some* contracts results in “surrender charges”
- Issuing insurance company failing to make payments toward your annuity
- The growth of annuity value is slower than the rate of inflation

The Different Types of Annuities

There are multiple types of annuities categorized by various factors. These factors depend on the value you invest into your annuity product, how the annuity is paid out, and how the interest gain is accrued. The main classification between immediate and deferred annuities is when the annuity can be paid out. For example, after purchasing an immediate annuity, you can cash it out anytime within a year of its purchase date. Deferred annuities can be paid out only after a specified period of time in predetermined amounts. Annuities can be broken into two types, fixed and variable, but knowing that there are multiple options available to you will help make sure you choose the right one for you.

- Fixed Indexed Annuity

  Fixed indexed annuities guarantee a set amount of payments to the annuitant until the annuity contract is depleted. This the most secure annuity to choose , as it is not tied to anymarket index. However, the interest that accrues is sometimes not enough to keep up with the rate of inflation.

- Variable Annuity

  Variable annuities, whether immediate or deferred, are considered to be higher risk than fixed annuities. This is because your payment is invested in a portfolio that can potentially produce bigger returns, but the amount of your payment can fluctuate each month.

Immediate Annuity

Immediate annuities, whether fixed or variable, are great for individuals who want to receive payouts as soon as possible. Immediate annuities allow you to start receiving payments as soon as you make the initial lump-sum payment. The issuing company guarantees the annuitant payment at a future date, which is ensured by investing the annuitant's lump-sum payment into safe vehicles such as U.S Treasury securities and bonds.

Deferred Annuity

Deferred and immediate annuities differ based on when the money begins being distributed. Deferred annuity payments begin at the time of retirement or at another time specified by the annuitant in the annuity contract. This can be beneficial in the sense that income has more time to accumulate interest, which may produce bigger returns. Deferred annuities can also be fixed or variable, with the possibility of greater returns each month.

The Bottom Line

Annuities can be a great choice for individuals who want guaranteed steady retirement income. They can reduce the risk of outliving your pension, 401K, or Roth IRA plans - if you exhaust the funds from these sources, annuities can continue to provide monthly payments until the contract is depleted. However, they may not be the best source of retirement income for you. Make sure to do your research and evaluate the pros and cons before purchasing an annuity.