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Annuities: a retirement income solution?

By Jay MacDonald • Bankrate.com

No pension? No problem. With a little research, you can build your own pension with an annuity, a multifaceted insurance product that's been on the upswing since the economic downturn.

A decade ago when the stock market was booming, annuities were shunned as "granny insurance" because they limit or avoid market exposure in order to protect principal. But when the market tanked in 2008, many a 401(k) holder wished they'd listened to granny.

For those at or nearing retirement, annuities offer a flexible solution to a range of back-nine challenges, from income and estate planning to long-term care insurance. That said, you'll need to become comfortable with annuities in order to make them work for you.

"They're very complex products, and every one I've come across is different," says David Batchelder, a CFP with Mackensen & Company, a fee-only financial planning firm based in Hampton, N.H. "They definitely require an owner to do their homework before they sign on the dotted line."

Annuity Features

Annuities come in three basic flavors: fixed, variable and indexed (see Bankrate feature "Different types of annuities" for details), each with its advantages and disadvantages. But the one appealing factor that sells more annuities than any other is that, with proper planning, you won't outlive your money.

Jean Dorrell, an estate planner and founder of Senior Financial Security in Ocala, Fla., sells only fixed and indexed annuities. The reason? Unlike variable annuities, fixed annuities are state-regulated and require insurers to maintain a state-supervised guaranty fund to back up every annuity they sell. Fund guarantees vary by state from $100,000 to $500,000 per policy.

"Variable annuities are not insured by anybody, so the strength of your insurer is going to be the only guarantee you have," says Dorrell. "If you buy a variable annuity from a B-rated company in this day and age, big trouble -- you could be wiped out."

To help avoid that worst-case scenario, the Securities and Exchange Commission, which oversees variable (not fixed) annuities, and the Financial Industry Regulatory Authority, or FINRA, which oversees VA sales agents, issue frequent alerts to combat abuses by overaggressive sales people.

"There were certainly issues that FINRA saw, and we've issued enforcement actions on unsuitable sale of variable annuities," says FINRA spokesman George Smaragdis.

Batchelder says buyers should beware of variable annuities. "They're only as good as the underwriter," he says. "Take AIG, for example. I don't know if all of their annuity contracts were honored, but if I were an annuity owner of AIG at the time (in 2008, when it suffered a liquidity crisis), I would be questioning what that leaves me with."

Dorrell advises most retirees to stick with fixed annuities, which typically feature a guaranteed annual return of 4 percent to 8 percent over five to 10 years, depending on the type of fixed annuity purchased.

"If people are properly informed, they flock to (fixed) annuities," she says. "Elderly people do not want stock market risk; they want something safe."

If you don't plan to need the income, Dorrell says a fixed annuity can come in handy to pass along an inheritance over a number of years to avoid leaving your heirs with a "tax bomb" from your IRA or 401(k). It can also protect against windfall squandering by a child with a history of substance abuse, or preserve an inheritance in the event of divorce or bankruptcy.

Bells and whistles

If you need the money now, Dorrell says to get what she calls a split annuity. "You have a growing side that grows to replace what you take out and a paying side that gives you mostly tax-free income," she says. "There are also some really neat inflation-guarantee annuities now, too."

Fixed annuities with a long-term care rider effectively address three main objections to long-term care insurance: its cost, the use-it-or-lose-it catch and the possibility of rate increases.

"When you put $100,000 in the annuity, that's yours to spend, but by adding the LTC rider on for an extra 1.5 (percent) to 3 percent, you may have double that amount to use for long-term care," she says. "Although the coverage does decrease as income is paid out, you generally can receive twice the amount of income available to be used for the facility or home care, plus the annuity company can never raise your rates."

In the newest annuity wrinkle, some fixed annuities now offer income riders that guarantee to grow your income payment by a set percentage every year, so long as you draw it as an annuity and not a lump sum. Some companies combine the guarantee with inflation protection on the annuity itself; others do not.

"The companies realized that the longer their customers leave the money in, the more profitable it is for the company," Dorrell says.

Still, fixed annuities also have their downside: They don't typically fare well against inflation, and the surrender fees can be exorbitant. Buying an immediate fixed annuity at today's historically low interest rates could prove costly, with interest and inflation expected to rise in the coming years.

Bottom line:

Don't write off annuities; instead, learn more about them. Used correctly, they may provide the income stream that's been missing from your retirement plan.