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Annuities for Lifetime Income

While today's annuity designs can accomplish many different retirment planning goals, annuities were originally designed with one goal in mind—generating an income for life. Today, annuities remain uniquely positioned to deliver on this goal.

There are many ways to generate steady income. Bonds pay interest, stocks pay dividends, and retirement plans can be a source for spendable withdrawals. But bonds eventually mature, stock dividends can get cut, and retirement plans get depleted. There are three ways to generate lifetime income—social security, pensions, and annuities. Unfortunately, pensions for retirees have become less common, and few can live on social security. As of January 2022, the average social security benefit was $1,657 per month.[1] And, as of 2019, only 16% of private-industry workers had access to a defined benefit plan such as a pension.[2]

Why guaranteed income for life is so important

Every retirement income plan has three assumptions:

1. **Age: How long will you live?** Estimating length of life is subject to significant error. Sure, it is easy to go online and look up a life expectancy. Based on an investor's current age, sex, and the answer to a few health-related questions, many online tools will give an estimate of life expectancy. However, this is just an average and actual results can vary widely.

2. **Expenses: What will expenses be in retirement?** How will they change? As people get older, they spend less on things like travel and entertainment. However, they spend more on health care—sometimes significantly more. In life, the unexpected happens. Often times, the unexpected can be very expensive.

3. **Growth potential: How much will retirement assets grow each year? Will stocks go up or down? What about interest rates?** A huge factor in the success—or lack thereof—of any retirement income plan is *timing*. Anyone who retired in 2009, just as stocks were beginning their 12-year climb,[3] has likely benefited from equity performance. Whereas anyone who retired in 2007, just before stocks fell by roughly 50%,[5] may have had to cut back on expenses for several years to get back on track.

By creating a guaranteed income for life, an investor will be less impacted by inaccuracies in these three assumptions. Whether the investor lives longer than expected or there is an unanticipated drop in stock prices, an annuity that offers lifetime income allows for comfort in knowing there will be a stream of periodic income, regardless of age, expenses, or current portfolio.

Generating income with annuitization

The most traditional way to receive lifetime income from an annuity is through a process called "annuitization." When an investor annuitizes an annuity contract, some or all of the value of the contract is turned over to the insurance company in exchange for a monthly, quarterly, or annual check depending on the time period the investor selects. Typically, these payments will last as long as the investor lives, or as long as the investor and their spouse live.

As an example, a couple, both age 65, may be able to secure income of up to $10,000 per year upon annuitizing their contract with an account value of $200,000. This annual payment would continue as long as one of them is living. In addition, the couple could elect to add a refund option to make sure they receive the full account value of their annuity even if they both experience an unexpected or early death. This option allows for either continued income payments to their beneficiaries, or a lump sum payment of the $200,000 annuitized amount reduced by the amount of income payments already paid. Including this option would reduce the amount of the annual income payments, but it is an option that can provide peace of mind that the insurance company will, at a minimum, pay back the entire amount that was annuitized.

Generating income with an income benefit

In fact, a small percentage of the annuities that are purchased in the United States are ever annuitized. As attractive as getting periodic income for life may be, most people have a hard time turning over a significant percentage of their retirement savings to an insurance company. If the goal is to generate an additional $50,000 in annual retirement income, it could take an annuity contract with an account value as much as $1 million to accomplish this, depending on the investor's age and interest rates. It can be hard for some investors to lock up that amount of capital in exchange for a future stream of income.

Understanding the difficulty of such a choice, insurance companies now make it possible to add an income benefit to most annuities. For an extra fee of typically 0.75%–1.5% per year, the insurance company guarantees an income payment for as long as the investor lives, in the form of a withdrawal amount from the account value. When an income benefit is added, an investor doesn't have to annuitize the contract in order to get the income guarantee in the future. Instead, the money in the annuity continues to earn interest, and the income taken out each year is withdrawn from that account value. Should the withdrawals cause the investor to liquidate the account value before he or she dies, the insurance company will continue to send the agreed upon income amount out of its own reserves. One way to think of it is as income insurance – the fee the investor pays each year for this benefit is essentially the premium they pay to ensure they will receive income payments for as long as they live.

Who should consider an annuity for retirement income?

Investors seeking future income, regardless of how long they live or what happens in the financial markets, should explore annuities. There's something very reassuring to know that when the headlines read "stocks plunge again," there is a source of guaranteed income.

Key considerations

Retirement income is not cheap: It takes a lot of money to generate meaningful lifetime income, especially in an environment of low interest rates. If investors think of their retirement accounts as a safety net and/or a source of funds to pass directly to heirs, it will likely be difficult for them to annuitize and turn a significant amount over to an insurance company. However, if they think of their retirement account as a means to generate retirement income, then they can consider the annuity purchase as a repositioning of assets to achieve that goal.

Annuities are long-term investment vehicles: Investors should be prepared and able to hold an annuity through the full length of the surrender charge period, which is typically between 3–10 years. Early withdrawals that exceed the free annual withdrawal amount during the surrender charge period may trigger surrender charges, fees, and/or tax penalties, and may be subject to negative adjustments, which could be substantial. Withdrawals and distributions of taxable amounts are subject to ordinary income tax and, if made prior to age 59½, may be subject to an additional 10% federal income tax penalty.

Receive quotes from several highly rated insurance companies: An insurance company's appetite to provide for guaranteed income changes over time. A company with competitive rates today might not offer as appealing rates a few months down the road. Also, investors should always keep in mind that all references to guarantees arising under the annuity contract, including optional benefits, are subject to the claims-paying ability of the carrier.

Get informed: Every annuity comes with numerous income options and features, therefore it is important for investors to understand and explain the various trade-offs of each option to find a good fit for their retirement income plans. Investors should review the annuity's offering document, disclosure document, and buyer's guide for important contract details, including fees and charges.

1. How Much You Will Get From Social Security, U.S. News, 2021
2. Employee Benefits Survey, U.S. Bureau of Labor Statistics, 2020
3. Note: See S&P 500 index performance from January 2009 to December 2021, available at CNBC
4. "Stock Prices in Financial Crisis", Federal Reserve Bank of Atlanta, 2009

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