Annuities: The Basics

An annuity is a contract between an investor and an insurance company. The investor buys an annuity with a lump sum of money and the insurance company promises regular disbursements for a specific period of time in return. These payments begin when the investor, also called the annuitant, chooses to annuitize their investment. The annuitant chooses the amount paid and how frequently they receive the payments. They also decide if they want a lump sum payout or regular disbursements. However, it all depends on the type of annuity.

Annuities may also earn interest, but the amount depends on the type of annuity and market conditions. These financial instruments also enjoy tax-free growth, which can be another attractive aspect for investors. Keep in mind though that you will pay income tax on all or part of the annuity disbursements. There's also typically a 10% tax penalty on the interest earned if you withdraw money before age 59 1/2.

Many see these contracts as a great way to supplement retirement income; some even view annuities as a guarantee against running out of money during retirement. That, of course, depends on the type of annuity you invest in and the duration of your annuitization payments.

Fixed Annuities

As the name suggests, a fixed annuity provides an investor with a guaranteed interest rate for a set number of years. Fixed annuities are one of the most common forms of annuities and are fairly straightforward. Fixed annuities can be Multi-Year Guaranteed Annuities (MYGA) or have the rate guaranteed for less years than the surrender charge.

Basically, the purchaser invests a sum of money with an insurance company. The company then agrees to pay a set amount of interest for a predetermined amount of time, plus principal protection, as a return on the investment.

If you invest in a fixed annuity, how you receive your earnings varies between a set number of years or for life. The latter makes this type of annuity popular with those in retirement. You can also opt to receive your funds via a lump sum payout. Keep in mind that this type of annuity is not linked to market performance.

Indexed Annuities

An indexed annuity is an annuity contract that guarantees a minimum rate of return, with the potential for higher returns based on market performance. This type of annuity is commonly based on indexes such as the S&P 500, but can also follow other indexes as well, depending on investor preference. It's often known as a fixed indexed annuity since it combines features of both a fixed annuity and a variable annuity.

Indexed annuities can earn larger returns for investors. However, overall income can be limited by rate caps, which limit the returns an annuity holder can claim over a certain timeframe. This type of annuity also has a minimum rate of return, often about 2%. Even though these indexed annuities contracts can be more volatile, the principal is still guaranteed – unless you make a withdrawal, of course.

Immediate Annuities

Immediate annuities may be ideal for those who have a large amount of money on hand. An investor buys an immediate annuity with a large lump sum payment and then receives regular payments over a set period of time or as long as they live. Payments begin immediately (hence the name) and the investor can earn a fixed or variable interest rate.

So why would you tie up a large amount of cash in an annuity? There are a few reasons. An annuity grows tax-deferred. It also provides a steady stream of income for a set period of time and takes away the worry and anxiety around managing a large sum of money.

Deferred Annuities

With deferred annuities, an investor receives payments in the future only after the initial amount used to buy the annuity has accrued interest. Basically, it’s the opposite of an immediate annuity.

Deferred annuities have an investment phase and an income phase. The first phase begins when an investor buys the annuity and ends when the last contribution is made. You can contribute one lump sum or pay into the annuity over time. You start the income phase once you’re done making your contributions. This is when you receive payment, either in one lump sum or through disbursements over time.

Fixed, variable and indexed annuities can also be deferred annuities.