What is an annuity?

An **annuity** is a financial product, usually issued by an insurance company, designed to help you **save for retirement and/or provide a steady stream of income**, often for life.

How annuities work at a high-level

1. **You invest money** into the annuity.
2. The money **grows tax-deferred** (you don't pay taxes on gains until you withdraw).
3. At a chosen time, the annuity can **pay out income**, often monthly.

Common reasons people use annuities

- To create **guaranteed retirement income**
- To protect against **outliving their savings**
- To supplement Social Security or pension income
- To achieve **tax-deferred growth**

In one sentence

An annuity is a tool that converts savings into **predictable, guaranteed income**, often for retirement, backed by an insurance company.

What are the main types of annuities?

1. Timing: When does the income start?

The first way to distinguish annuities is by the "payout phase."

- **Immediate Annuities:** You pay a lump sum upfront, and the insurance company begins sending you payments right away (usually within 30 days to one year). This is like "buying a pension."
- **Deferred Annuities:** You invest money (either as a lump sum or through periodic payments) and let it grow for years before you start taking income. This "accumulation phase" allows your money to grow tax-deferred.

2. Growth Strategy: How does the value increase?

This is where the risk and return levels vary significantly.

Type	How it Grows	Risk Level	Best For...
Fixed	Pays a guaranteed, set interest rate (like a CD).	Low	Conservative savers wanting predictable growth.
Variable	Invested in "sub-accounts" (similar to mutual funds). Value fluctuates with the market.	High	Investors seeking higher growth who can handle market losses.
Fixed Index (FIA)	Interest is tied to a market index (like the S&P 500), but with a "floor" to prevent losses.	Medium	People who want some market upside without the risk of losing principal.

3. Key Differences at a Glance

Principal Protection

- **Fixed & Indexed:** Your initial investment (principal) is generally protected by the insurance company. Even if the stock market crashes, you won't lose your original deposit.
- **Variable:** Your principal is not protected. If the underlying investments perform poorly, your account value can drop.

Earning Potential

- **Fixed:** Predictable but usually the lowest potential return.
- **Variable:** Highest potential for growth because you are directly in the market.
- **Indexed:** A "middle ground." You can earn more than a fixed annuity when the market is up, but your gains are often "capped" at a certain percentage (10% return for example).

Fees and Complexity

- **Fixed:** Generally the simplest and have the lowest fees.
- **Indexed:** More complex due to "participation rates" and "caps" on earnings.
- **Variable:** Often the most expensive, with management fees, administrative fees, and "mortality" charges that can eat into returns.

<u>How does an Annuity compare to a 401(k)?</u>

1. Purpose: What they're designed to do

Annuity

- Designed to provide **guaranteed income**, often for life
- Best for turning savings into a **retirement paycheck**

401(k)

- Designed to help you **save and invest** for retirement through work
- Best for **accumulating money**, not guaranteeing income

2. Taxes: How and when you pay

Annuity

- Grows **tax-deferred**
- Withdrawals are taxed as **ordinary income**

401(k)

- Traditional: tax-deferred, taxed at withdrawal
- Roth: taxed now, tax-free later

3. Investment risk & guarantees

Annuity

- Can offer **guarantees** (principal protection, lifetime income)
- Less market risk (especially fixed and indexed annuities)

401(k)

- Fully market-dependent
- No guarantees you won't outlive the money

4. Income in retirement

Annuity

- Can pay income **for life**, no matter how long you live
- Acts like a **personal pension**

401(k)

- You decide withdrawals
- Risk of running out if withdrawals are too high