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For More Certainty in Your Retirement Portfolio, Consider Annuities

Higher interest rates made annuities more attractive in 2022.

By Tara Siegel Bernard
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In a kinder universe, retirees wouldn't need to worry about market volatility or outliving their money. But 2022 was a nail-biter: Bonds plunged alongside stocks, and many people in or nearing retirement wanted investments that would guarantee a smoother ride.

Many of them turned to annuities, whose sales surged 22 percent to an estimated $310 billion in 2022 — topping the previous record set in 2008, according to LIMRA, an insurance industry trade group. People primarily use annuities in a few ways — to accumulate savings in investments on a tax-deferred basis, to turn the money they've accumulated into a guaranteed lifelong income stream or both.

With interest rates on the rise, many annuities have become even more attractive. Consumers poured money into both simple annuities that work much like bank certificates of deposit, as well as more complicated products that offer a cushion against stock market losses. Paycheck annuities — which provide a guaranteed stream of income for life — also made something of a comeback.

Even though annuities come in a variety of flavors, the entire category is often cast in a harsh light because of their less reputable cousins, including high-cost products often peddled to public schoolteachers or to older consumers at free steak dinners. The prospects come for the meal, but they may also have to digest an aggressive sales pitch on annuities with opaque terms and hefty commissions that give brokers incentives to sell annuities that pay them the most.

For consumers, the tricky part is knowing the difference between more efficient products — and whether they're the right choice for their situation — and the steak dinner variety. It's also been difficult getting truly independent professional help to figure it all out.

The good news? More commission-free annuities are becoming available, both through direct platforms and the types of financial advisers who are required to put their customers' interests ahead of their own. That's because insurers have made a business decision to rework certain annuity products, stripping them of commissions, so that more investment advisers can (and are willing) to recommend them.

"Many of these products have been simplified and re-priced so investors can understand the costs and benefits of the products they are buying," said David Lau, founder and chief executive of DPL Financial Partners. His company has worked with insurers on reformulating annuities, which it provides to consumers and financial advisers. "Importantly, they do not include sales bells and whistles that have made traditional commission-driven annuities unnecessarily complex and expensive."

Plenty of products still are — so as always, consumers need to proceed with caution. Here's a close look at some popular annuities, how they work and where they potentially fit in a retirement portfolio.

Bond Alternatives

One of the most common products is a fixed-rate annuity, which has skyrocketed in sales, rising to nearly $112 billion in 2022, more than double the amount in 2021, according to preliminary research from LIMRA.

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They're pretty straightforward: You pay an insurer a lump sum, and it promises a guaranteed interest rate on that money that grows tax deferred. The rate may change annually, or over some other set period.

One popular flavor — known as multiyear guaranteed annuities, or MYGAs — are typically compared to certificates of deposit. They'll pay a guaranteed fixed interest rate for a set period, often three to seven years. And they may pay more than a C.D.: The top three-year MYGA carries a rate of 5.5 percent on Blueprint Income, an online annuity marketplace, compared with 4.4 percent, the highest rate for a three-year C.D. on Bankrate.com.

They're typically a better fit for older investors who are looking for a safe, guaranteed return as they're approaching (or in) retirement.

But there's some more fine print: These generally have restrictions on withdrawals, which are subject to so-called surrender charges. You may be permitted to withdraw up to 10 percent of your account balance each year without penalty, but there's almost always a fee for a certain term — sometimes as high as 10 percent of the amount withdrawn — or other adjustment if you exceed the allowed limit. (Beware of MYGAs with a surrender term that extends beyond the period for its guaranteed interest rate.) And if you're under age 59½, there may be tax consequences and penalties as well.

Unlike C.D.s, which are guaranteed by the Federal Deposit Insurance Corporation, MYGAs and annuities overall are backed by the insurer. If an insurer cannot meet its obligations, state insurance regulators will first try to find another insurer to take over its contracts. If that fails, annuity holders will receive coverage through their state's guaranty association, up to certain limits.

Another popular product is a fixed indexed annuity, which appeals to people who want their savings to grow, but don't want to risk big losses. The insurer credits your account with interest, which comes from two places: a guaranteed minimum interest rate, and then a rate that's linked to the performance of an underlying index like the S&P 500-stock index, or perhaps an index the insurer has devised itself.

You're also guaranteed to get your principal back, and you won't lose any money even if the markets tank. In return, however, you won't capture all of the gains if stocks skyrocket, just up to a certain portion.

But the method for calculating and explaining the rate of return — and the way annuities have typically been marketed by some providers (think steak dinners) — has given these products a bad reputation.
Image

David Lau, founder and chief executive of DPL Financial Partners, which has worked with insurers on reformulating annuities.Credit...Jon Cherry for The New York Times

Mr. Lau, of DPL, argues that they can be especially useful in what he called the "fragile decade," or the five years before and after retirement, when market downturns can more meaningfully affect retirees' chances of running out of money because their portfolios may not have enough time to recover.

Still, these aren't simple. You'll need to become conversant with terms such as participation rates (the percentage of the index returns that are credited to the account) and cap rates (if the index rises 10 percent, you may be capped at, say, 8 percent.) It's worth noting that cap rates have more than doubled in the past year or so to roughly 10 percent, which is why some experts think they're worth considering again.

On top of that, some contract terms are subject to change year to year. Experts suggest asking the insurer for its renewal rate history — that is, a historical list of the cap rates on the indexes it has offered in the past. The rates for previously issued policies should be compared with new policies, to ensure the insurer isn't using teaser rates that drop after the sale.

Another consideration: Most of your principal will be locked up and subject to surrender charges, often for up to seven years (along with potential tax consequences). So you shouldn't invest money you may need to retrieve during that surrender term.

Shannon Stone, a wealth adviser at Griffin Black, in Redwood City, Calif., calls herself a former "annuity hater." But with the rise of lower-cost and commission-free annuities, she has increasingly turned to them for certain clients to further diversify a portfolio, swapping out a portion of bonds and replacing it with, say, a fixed indexed annuity, or an annuity that immediately provides a guaranteed income stream. (We'll get to those later.)

"It's a great way, I have found — for people who are open to them — to bring a piece of certainty that they can point to and say, 'This will be there if I need it.," she said.

Alternatives to Stocks

First, you have to get past their names: Registered index-linked annuities (also known as RILAs), buffered annuities or structured annuities are all variations on the same concept, which is to provide a cushion against stock market losses. But they're far more risky — you can lose money.

Structurally, they're similar to fixed indexed annuities: They track an index, usually the S&P 500, but holders aren't investing in the underlying stocks. RILAs will let you capture gains up to a certain point (the cap rate), while typically providing a buffer and sometimes a floor against your losses.

For example, if the stock market drops 15 percent, it may offset the first 10 percentage points of that. The strategies can vary widely, however, and investors need to fully understand the risks — surrender charges usually apply here, too.

Build-a-Pension

More people are trying to recreate personal pensions with paycheck annuities, or single-premium immediate annuities (or SPIA). Sales rose 44 percent to $9.1 billion in 2022 compared with the year prior, according to LIMRA.

These annuities are the simplest: You hand a pile of money to an insurer, which soon begins paying a guaranteed paycheck for life. Alternatively, you can buy the paycheck for a set period, say, 10 years.

The size of the paycheck depends on the amount you put into the annuity, as well as your age, gender, whether you're including a spouse and the prevailing interest rate. Some people are reluctant to use these — they account for less than 3 percent of overall annuity sales — because they're irrevocable and tie up a lump sum.

Investors may worry they'll die unexpectedly after relinquishing that pile of cash to an insurer, leaving their heirs with nothing. But most people buy features that guarantee heirs will get something — at least for a certain period — even if the annuity holder dies earlier than expected. Payouts will be slightly lower as a result.

Financial experts don't suggest putting all your retirement money into a paycheck annuity anyway — usually just enough to cover your basic expenses that aren't already covered by Social Security and pensions.

This can alleviate some of the stress retirees experience with market swings and don't want to worry as much about adjusting their spending if and when that happens.

And higher interest rates have helped generate more attractive payouts: A 65-year-old male who puts $100,000 in a SPIA would receive $7,000 in annual income, which is about 20 percent higher than $5,790 in March 2021, according to Blueprint Income.

The reason insurers can offer payout rates that exceed what you may earn, say, in the bond market is because of a simple but morbid fact: Some people die earlier than expected. Put simply, a paycheck annuity is returning a portion of your principal, interest (now helped by higher rates) and that little something extra called mortality credits — or money that was never paid out to people who died earlier than expected, which is distributed to those who live longer.

Another variation on these products is the deferred income annuity, sometimes called longevity insurance. This operates the same way, except instead of receiving the paycheck immediately, you get it later, sometimes much later in life, say 80 or 85. That's why they tend to be lower cost — given the odds, not everyone collects. That's also why fewer people are willing to buy them.

David Blanchett, head of retirement research at PGIM, the asset management firm part of Prudential Financial, said he believed that every American should have enough guaranteed lifetime income to cover their essential expenses. "It's hard to know what

you can spend — you don't know how long you are going to live or what your expenses will be."

But with at least a portion of your necessities covered, "it changes the way you will perceive the remainder of your wealth."

Tara Siegel Bernard covers personal finance. Before joining The Times in 2008, she was deputy managing editor at FiLife, a personal finance website, and an editor at CNBC. She also worked at Dow Jones and contributed regularly to The Wall Street Journal. @tarasbernard