Annuities Vs. Bonds: Which One Is Better For You?

By Greg DePersio | October 12, 2015AAA |

Annuities and bonds, both popular vehicles for retirement savings, offer vastly different benefit profiles. An annuity provides a retiree with a guaranteed paycheck for life that functions like a salary, while a bond offers guaranteed regular interest payments for a fixed duration and then a return of principal at the end. While annuities are purchased from life insurance companies, bonds are purchased from corporations, municipalities and governments. An annuity represents a contract between an investor and an insurance company in which the investor offers a fixed amount of principal to purchase a fixed incremental payout; a bond is a loan an investor makes to a business or government body and receives the interest in fixed payments throughout the life of the loan.

Both investment products can be highly polarizing. Some financial advisors are stridently anti-annuity, cautioning that the high commissions received by the insurance agent and company eat into an investor's gains. Other advisors point out the numerous disadvantages of bonds, such as interest rate risk, the possible callability feature and the risk of not receiving back principal if the company goes bankrupt. However, both products also have their cheerleaders. Advisors who push annuities stress that an investor can never outlive the payments. Bonds are touted for their lower fees and commissions and the fact that their yields are frequently higher than what an investor receives from an annuity.

ANNUITY ADVANTAGES

Annuities offer several distinct advantages, including guaranteed income for life and tax-deferred growth. Investors who purchase annuities years before retirement not only earn interest during the intervening years but they can contribute additional principal to the annuity at any time.

GUARANTEED INCOME FOR LIFE

By far, the most popular feature of an annuity is it provides a fixed-income stream a retiree can never outlive. When a retiree begins taking distributions from his annuity, the insurance company amortizes the balance in a series of fixed monthly payments to the retiree over the expected remaining years of his life. In other words, if the retiree begins receiving payments at 60, and the insurance company calculates his life expectancy to be 80, the annuity pays out 5% per year so the balance is completely amortized in 20 years. However, this does not mean the retiree stops receiving payments if he happens to outlive his life expectancy. Even if he blithely sails past 100 years old, the checks keep coming, and at the same amount as always. While traditional life insurance provides protection from dying sooner than expected, an annuity protects a person who lives much longer than expected.

Moreover, a retiree with an annuity can elect a joint life option that, once he dies, continues to pay out to a surviving spouse. Or, he can add a lump sum death benefit to protect a surviving spouse. Such features, however, lower the retiree's monthly benefit amount; he effectively uses a portion of his benefit to pay for them.

TAX DEFERMENT

An annuity enables an investor to grow his money for a period of time before taking distributions, and even better, that growth is not taxed until money is withdrawn from the annuity. The period of time between when the annuity is purchased and when distributions are taken is called the accumulation phase. Any growth in the annuity during this phase is tax-deferred. When the investor begins taking distributions, only the portion of the annuity balance that represents interest income, not the initial or any additional capital contributions by the investor, is taxed.

When it comes to the tax treatment of annuities, two downsides exist. The first is the schedule under which annuities are taxed. Instead of being taxed as long-term capital gains, like most investment income earned over a long period, annuities are taxed as ordinary income. For investors in low tax brackets, the difference might not mean much, but for wealthy investors, this represents a huge consideration. The top tax bracket for ordinary income is 39.6%; long-term capital gains, by contrast, are taxed at 20%.

The other thing to keep in mind is that while the IRS only taxes the interest portion of an annuity distribution, it considers the first money withdrawn as interest. In other words, a retiree whose annuity earned $10,000 in interest during the accumulation phase is taxed on the first $10,000 he receives in distributions.

BOND ADVANTAGES

Reasons to consider bonds over annuities for retirement income include purchasing a bond usually costs less in fees and commissions, and bonds are known to earn higher yields than annuities.

LOWER FEES AND COMMISSIONS

Annuities are known for being highly lucrative—for the insurance agent who sells them. In the life insurance business, annuities are considered the goose that lays the golden egg because the commissions from an annuity sale are massive. Unfortunately, because there is no such thing as a free lunch, this commission, rather than appearing out of nowhere, eats into what the investor could be earning. Worse, most annuities feature nasty surrender charges that punish investors for withdrawing from an annuity the first few years after buying it. This is another feature that, while not advantageous to the investor, helps keep commissions high for the agent. Bonds, on the other hand, can be purchased with minimal fees or commissions, and the payout structure is much more straightforward.

HIGHER YIELDS

Bonds, on average, pay higher yields than annuities. That said, it can be difficult to make an apples-to-apples comparison between the two. Bond yields vary, and the primary factor that determines yield is the risky nature of the bond. Corporations and government entities with lower credit ratings have to offer higher bond yields to entice people to invest in them; investors, therefore, must weigh risks against rewards when bond shopping.

Additionally, while a given annuity may have a lower stated yield than a given bond, keep in mind the annuity pays out indefinitely, while the bond pays only for a fixed period. Thus, a person with a lifetime income annuity who lives to be 100 or more almost invariably earns a higher effective yield than if he had purchased a comparable bond.

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