How Fixed Index Annuities Yield Retirement Income

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Many Americans are nearing retirement with less money in savings than they anticipated and no guaranteed pension other than Social Security. A growing number of them are becoming increasingly concerned about the prospect of outliving their money, and in many cases, this fear is well-founded. Fortunately, there is a type of financial product that can guarantee that the investor will continue to receive a monthly check as long as they live. Fixed indexed annuities are unique vehicles that can provide retirees with guaranteed lifetime income, even if they collect more than the entire value of the contract before they die.

How They Work

There are three types of annuity contracts offered by life insurance carriers today. Fixed annuities are the simplest kind. They merely pay a fixed rate of interest over the term of the contract. Variable annuities are more complex. They invest the contract owner's money in mutual fund subaccounts that may go up or down in price. Indexed annuities represent the third category of these instruments. They resemble fixed annuities in that they offer guarantee of principal, but instead of paying a set, fixed rate, they will credit the investor with interest into the contract based upon the performance of an underlying financial benchmark index such as the Standard & Poor's 500. When that index rises in value, the investor is credited with interest according to a formula or calculation used by the carrier.

Different carriers use different formulas, indexes and crediting periods, and often they will place various types of limits upon the amount of profit that the investor may earn. For example, one carrier may stipulate that investors can only earn a certain percentage of all gains in the benchmark, while another will allow the investor to keep all of the benchmark gains, but only up to a point. But regardless of the crediting method, investors cannot lose money in these products. When the underlying benchmark declines during a credit period, then the contract value will simply remain the same. When the benchmark starts to rise once more, then the contract value will again be credited accordingly. As with any other type of annuity, investors cannot withdraw funds from an indexed contract before age 59 ½ without paying a 10% early withdrawal penalty.

How They Can Help Retirees

As mentioned previously, many retirees today are facing a growing gap between their incomes and their expenses over the long term. But annuities are uniquely designed to help address this issue. Contact owners who elect to annuitize their contract can then receive a guaranteed period payment from their annuities that will last them for the rest of their lives. They have several payout options from which to choose, such as straight life, joint life (either first or second-to-die) or a straight or joint life option with a period certain payout, such as 10 or 20 years.

As with any other type of guaranteed pension payout, the greater the guarantee, the lower the payout. But it is important for clients to understand that once they annuitize, they effectively forfeit all future control of their contracts and have locked themselves into an irrevocable stream of income. And while that may be the right decision for them, clients fail to grasp this tradeoff in many instances. In some cases, it may be better for the client to simply opt for a systematic withdrawal, so that control over the contract can be maintained.

Another major advantage that indexed annuities can offer clients is a superior return to what can be earned in other guaranteed instruments such as fixed annuities or certificates of deposit (CDs). Most of the new indexed products on the market today offer an array of attractive features, including initial bonuses of up to 10% for new money, waiver of surrender charges for medical or long-term care expenses and total long-term returns over time that can be somewhere in the 5-7% range. Many of them also offer income riders that will guarantee the investor a payout at retirement that is based upon an initial set rate of growth, so that the investor can count on at least that amount per month in retirement if the contract value does not grow large enough to pay more than that when it is annuitized.

The Bottom Line

Fixed indexed annuities can provide an additional measure of guaranteed safety for retirement investors who are worried about outliving their income. Investors need to be sure that they understand all of the rules and features of these contracts before purchasing them, as they often contain several different types of fees and surrender charges. But they can also provide superior returns and a monthly income check that will last for the rest of the investor's life as long as they meet the required guidelines.

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