Equity-Indexed Annuities as a Retirement Strategy

My Comments: We know for a fact that very little in life is free. And that's certainly the case with annuities. Add to that they're hard to understand and are often sold for reasons that are not always in the best interest of the buyer.

None of that, however, means you shouldn't consider annuities when it comes to investing money for retirement. The challenge is to find one where the advantages to you justify the costs.

A critical element when planning for an eventual retirement is an understanding of risk. From a financial perspective, it's knowing when to transfer the risk of something bad happening to a third party. That typically involves an insurance company and the payment of a premium to allow said company to compensate you if and when something bad happens.

When your day to retire arrives, some of the money you plan to use to pay your bills needs to be insured against market losses. That's what annuity contracts do and there are some very good equity-indexed annuities to choose from. And there are some bad ones that someone may try to sell you.

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If you're an investor looking to comprehensively protect your retirement nest egg against the next major market downturn, you're certainly not alone. The tech crash in the early 2000s and the total market crash of the late 2000s are two recent examples of market-wide meltdowns that wiped out retirement savings for tens of millions of Americans. The retirement landscape of today is still changing, so retirees need to protect their financial futures by reevaluating and repositioning their portfolios to reflect the current economic environment.

In addition to the risk associated with capital accumulation, there is also reinvestment risk, purchasing power risk, and the risk every investor fears - capital preservation. Many investors who have already retired or are nearing retirement can't afford the years it takes to rebuild their portfolios after a major downturn. For these retirees, a large market correction could have a devastating effect on their income, drawing down their assets. As their portfolio value decreases, it could force them to take a greater percentage away from their principal balance, which could eventually jeopardize the type of retirement they worked hard to set up

In today's low-rate environment, retirees are finding it hard to generate adequate income to live on. This is especially the case if they are relying solely on their fixed-income investments. The average 10-year Treasury yield is around 2.38%. And according to FINRA TRACE, on average, the 10 most actively traded investment grade bonds are yielding approximately 3.5%. This means you would need a 10-year Treasury portfolio value of over $2.1 million to generate only $50,000 in income, and you would need over $1.4 million to do the same with investment grade bonds. So, with that outlook in mind, what can someone do to build up their retirement savings without putting their existing nest egg at risk?

Ensuring a Guaranteed Retirement Income

For investors most concerned with protecting their principal while also participating in market gains that will grow their account, the equity-indexed annuity could be the best answer. An equity-indexed annuity is an annuity contract that allows investors to participate in a certain level of market gains as the market rises, while guaranteeing a minimum rate of return if the markets have a down year. The rate of return is based on the success of the stock market and the designated participation rate, which measures what portion of the index's return you could expect to receive.

In addition to setting the participation rate that is attached to the market index, the underlying insurance company guarantees the minimum rate of return even if the market drops. Equity-indexed annuities are among the very few savings vehicles that have a guarantee attached with their sale (see the chart below).

While there are various types of annuities, other options don't offer the same benefits of equity indexed annuities. For a retiree whose number one concern is capital preservation, the answer has traditionally been to settle on a fixed-rate annuity, which is a safe option, but one without much potential for high returns. Conversely, variable annuities can promise high returns along with high risk, making them unfavorable amongst anyone fearful of losing their retirement savings.

Equity-indexed annuities, on the other hand, couple the guaranteed safety of a fixed annuity with the upside potential of market gains of a variable annuity. Additionally, investors of the equity index annuity still benefit from the tax-deferred treatment that other annuities are accustomed to - a tax benefit that an investor with a standard retail brokerage account does not receive.

The Best Option for Your Retirement?

The equity-indexed annuity can be a great vehicle for investors who are highly cautious of broad market risk, but also feel that current interest rates are too low and want a shot at higher gains. However, the product's complexity can lead to a few drawbacks.

Oftentimes, the participation rate on gains can vary from contract to contract. Some participation rates will include dividends of the index, and some won't, so make sure you know what you should receive relative to your participation rate and the market index.

Withdrawing money from your annuity can come at a costly price - another drawback of the equity-indexed annuity is its surrender fees or surrender charges, which are fees investors must pay if they withdraw some or all of their principal before the annuity's surrender period (usually 6-8 years) has expired. However, most annuities will allow the participant to withdraw up to 10% a year without being penalized, so be sure to read the fine print.

Insurance companies will often attach surrender charges to the product, with some lasting as long as 10 years. So, if you make withdrawals over 10% within the first five to ten years that you own the annuity, you will probably owe the insurance company a surrender charge, which can be as high as 10%.

If there is a possibility that you will need that money before the contract is up, this product might not be the best option for you. However, if you are most concerned with preserving your principal, but would like to see the value of your account increase when the market goes up and be guaranteed to never lose money when the market goes down, then talk to your financial advisor about how an equity-indexed annuity account can complement your retirement plan.