LESSON · RETIREMENT RISK

Annuities: What They Actually Do (and Don't)

Annuities aren't a scam and they aren't a miracle — they're a specific trade of a lump sum for guaranteed income, and whether that trade is worth it depends on what you're actually trying to solve.

Read time: 8 minutes **Level:** Intermediate **Includes:** Knowledge check

Few products in retirement planning generate stronger opinions than annuities — sold hard by some as the solution to every retirement worry, dismissed entirely by others as expensive and unnecessary. The truth is narrower than either camp suggests: an annuity is a contract that trades a lump sum (or a series of payments) for guaranteed income, and whether that trade makes sense depends entirely on what you're trying to solve for.

The basic trade, stripped of the sales pitch

At its core, an annuity is an insurance contract, not an investment in the usual sense. You give an insurance company money; in exchange, they guarantee you a stream of payments, often for the rest of your life, backed by that insurer's claims-paying ability. That's it. Every variation — fixed, variable, indexed, immediate, deferred — is a different way of structuring that same basic trade.

The four main types, in plain terms

TYPE 1

Immediate annuities

You hand over a lump sum and payments start right away (or within a year), typically for life. This is the closest thing to a private pension you can buy, and it's the most straightforward version of "trading a lump sum for guaranteed income."

TYPE 2

Deferred fixed annuities

Money grows at a guaranteed interest rate for a period before payments begin later. Functionally similar to a CD with tax-deferred growth, though usually with surrender penalties for early withdrawal.

TYPE 3

Variable annuities

Money is invested in sub-accounts similar to mutual funds, so the value can rise or fall with the market. Often sold with optional guaranteed-income riders, which add meaningful annual fees on top of already higher base costs.

TYPE 4

Indexed annuities

Returns are tied to a market index (like the S&P 500) with a cap on the upside and a floor (often 0%) on the downside. Marketed as "market gains without market losses," but the caps, participation rates, and fees involved are complex and vary enormously by contract.

What annuities actually solve for

Worked example

Someone retiring with a paid-off house, modest Social Security, and a $400,000 portfolio is nervous about outliving their money — the exact fear behind sequence-of-returns risk (see that lesson). Putting a portion of that portfolio, say $150,000, into an immediate annuity converts it into a guaranteed monthly check for life, covering essential expenses regardless of what the market does with the rest of the portfolio. That's the legitimate use case: converting a slice of savings into a income floor that can't run out, in exchange for giving up control of that principal.

Where the criticism is fair

Fees, complexity, and liquidity are the real trade-offs

Variable and indexed annuities in particular can carry layered fees — mortality and expense charges, rider fees, fund management fees — that are hard to compare across products and can meaningfully drag on returns. Most annuities also come with surrender periods (often 6–10 years) during which withdrawing more than a small percentage triggers a penalty, and once annuitized, the decision is frequently irreversible. These aren't reasons to avoid annuities altogether, but they are reasons to read the contract closely and understand exactly what's being given up.

The question that actually matters

The right question isn't "are annuities good or bad" — it's "does converting some of my savings into guaranteed income solve a problem I actually have?" For someone with substantial guaranteed income already (a pension, strong Social Security) an annuity may add little. For someone whose essential expenses exceed their guaranteed income and who's uncomfortable relying entirely on portfolio withdrawals, it can fill a real gap — provided the specific contract, its fees, and its surrender terms are understood before signing.

Evaluating an annuity

- [ ] Identify what specific problem the annuity is meant to solve (income floor, longevity protection, tax deferral) — not just "guaranteed returns."
- [ ] Add up all layered fees, including any optional riders, and compare the total cost across products.
- [ ] Check the surrender period and penalty schedule before committing any funds.
- [ ] Confirm the insurer's financial strength rating, since guarantees are only as good as the company backing them.
- [ ] Only commit a portion of savings you're genuinely comfortable locking up — not the entire portfolio.

KNOWLEDGE CHECK

Test what you just learned

Answer four quick questions to test what you just learned.

1. At its core, what is an annuity?

A. A type of mutual fund with guaranteed returns

B. An insurance contract that trades a lump sum (or payments) for a guaranteed stream of income

C. A government retirement benefit

2. Which type of annuity begins paying out almost immediately after a lump sum is paid in?

A. A deferred fixed annuity

B. An immediate annuity

C. A variable annuity

3. What is a fair criticism of variable and indexed annuities specifically?

A. They never provide any guarantees at all

B. They can carry layered, hard-to-compare fees and often have long surrender periods with penalties

C. They are illegal in most states

4. What's the better way to decide whether an annuity makes sense, according to the lesson?

A. Whether the salesperson recommends it

B. Whether converting some savings into guaranteed income solves a specific problem you actually have

C. Whether interest rates are currently high

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