How Do Annuities Work?

For many, they can be a secure stream of retirement income

Annuities all work the same way at their core: You pay premiums to an insurance company. In return, the insurance company distributes ongoing payments to an individual for retirement income.

But "annuities really are a whole breadth of options that you can use for accumulation [of value] or for income, and a lot of people buy them for that income purpose," says Andrea Piepho, who manages risk assessment for annuities and income solutions at Thrivent. "It's a way for individuals to create guaranteed income in retirement for themselves."

How is income from an annuity guaranteed?

The annuity is a contract between you and the insurer. You can set up the contract so the insurer pays you for a certain period of time, say 10 or 20 years, or pays you for your lifetime.

When do payments start?

There are immediate annuities, where you start to get payments right away, and deferred annuities, where you wait to begin payments. Waiting gives the earnings on your money more time to compound and grow.

"If you are a younger age or don't necessarily need the income right now, you can buy an annuity just for accumulation, and know that you have guarantees built into your contract to turn it into payments at a future date," Piepho says.

What are the other main types of annuities?

There are fixed annuities and variable annuities. A fixed annuity earns interest at a fixed rate, and the payments to you are a consistent amount. In a variable annuity, your money is invested in subaccounts. The annuity's investments are dependent on market risk and performance and could lose principal. When you begin payments, they will be a consistent amount and based on the value in the variable annuity. The value of the fixed annuity may not keep pace with inflation, given the set interest rates.

An indexed annuity falls somewhere in between. Its interest, if any, is tied to the performance of a specific market index—for instance, the Standard & Poor's 500 Index. Your interest can potentially go up based on the performance of that market index.

Can annuities be risky?

The main risk is choosing an annuity that is misaligned with your needs, Piepho says. As with other financial decisions, it's important to get good advice and ask questions until you're sure you understand the choice you're making.

One consideration is liquidity. You'll pay a surrender charge if you need to withdraw the money early. There are also other fees and income taxes to consider. Money in an annuity grows tax deferred, but when you do receive payments, they'll be taxable at your normal income tax rate.

The S&P 500® Index is a market-cap weighted index that represents the average performance of a group of 500 large-capitalization stocks.

An investment cannot be made directly in an unmanaged index.

Guarantees based on the financial strength and claims-paying ability of the insuer.

Annuities are intended to be long term, particularly for retirement. Product availability and features may vary by state.

Withdrawals and surrenders will decrease the value of your annuity and, subsequently, the income you receive. Any withdrawals in excess of 10% may be subject to a surrender charge. The taxable portion of each annuity distribution is subject to income taxation. Withdrawals made prior to the age of 59½ may be subject to a 10% federal tax penalty.

Thrivent and its financial professionals do not provide legal, accounting or tax advice. Consult your attorney or tax professional.

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