IS AN ANNUITY AN INVESTMENT OR INSURANCE?

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When it comes to talking about protected income, an informed buying decision requires that we understand the different features of annuities.

by John L. Olsen, CLU, ChFC

A common point of confusion many people have about annuities is whether an annuity contract is an investment or insurance.

It's an important issue because the characteristics that make an *investment* a proper choice to meet someone's needs are entirely different from those that determine the value of an insurance product.

What does that mean for people considering options for protected income in retirement? Well, let's start with definitions. Merriam-Webster says an investment is "an asset intended to produce income or capital gains." *Insurance*, is defined as "coverage by contract whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril."

In a nutshell, *investment is about pursuing profit, while insurance is about avoiding loss.*

INSURED PERIL

We don't buy insurance and expect to profit from it. No pure insurance will be profitable for the average buyer; if it were, the insurer would go broke. Instead, insurance will "pay off" if the "insured peril" actually happens. In life insurance policies, that's the death of the insured. In fire insurance policies, it's a fire. What's the "insured peril" in an annuity? It's not having enough income when you need it.

Annuities are fundamentally contracts for *income*. Some, such as *immediate* annuities, provide a protected income stream for a specific period. Others, such as deferred annuities, provide a protected income stream as a feature but also offer the potential of capital growth. They are clearly both insurance and savings instruments. The variable deferred annuity, especially one with a "guaranteed lifetime income" option, is also an example of the "mixed" nature of some annuity contracts.

THE INSURANCE ASPECT OF ANNUITIES

Many types of annuities are also considered *insurance* products because they include *insurance features*, such as the protected minimum "payout factors."

For instance, many annuities sold these days include an optional provision known as a "rider" that is added to the base contract and protects a lifetime income stream. The rider is often described as an investment feature, but it is not because it will "pay off" only when the "insured peril" materializes.

In the case of a guaranteed lifetime income option, that pay off happens when the purchaser's own money (cumulative premiums paid, plus previously credited interest) has been received and the annuitant is still living and entitled to continuing income payments.

Some people persist in thinking of the annuity contract and the "guaranteed income" option only as *investments*. That is misleading. Those are insurance features that manage your risk of not having income when you need it.

In order for you to make an informed buying decision about an annuity, you must understand its insurance nature. Insurance isn't free. Its cost is the price and benefit of transferring your risk of outliving your money to the insurance company.

Annuities are long-term investments designed for retirement purposes. The value of variable annuities is subject to market risk and will fluctuate. Product guarantees are subject to the claims-paying ability of the issuing insurance company.

Earnings, when withdrawn, are subject to federal and/or state income tax, including a 10% tax penalty for withdrawals before age 59½.

Some income guarantees offered with annuities take the form of optional riders and carry charges in addition to the fees and charges associated with annuity products.

There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. Investments in annuity contracts may not be suitable for all investors.

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