

Retirement planning has a quiet obsession with one question: what happens when money outlasts your patience? Many retirees can handle market swings, but what they struggle with is sequence risk, the unpleasant scenario where you retire right before a downturn. Annuities are one of the few products designed specifically for that stress, turning a lump sum into a stream of payments. For some people, that stream becomes a foundation. For others, it becomes an expensive constraint.

The hard part is that “annuities” cover a family of contracts, with different guarantees, fees, tax behavior, and rules. A fixed deferred annuity is not the same thing as a variable annuity, and neither is the same as an immediate income annuity. Even within a single category, terms vary widely. My approach has always been to treat annuities like a tool, not a lifestyle. You want the right tool for the job, used for the right job, and you want to understand what you give up to get what you gain.

What an annuity actually does

At a basic level, an annuity is an insurance contract. You pay money to the insurer. In return, the insurer agrees to make payments to you, either right away or at some future date, for a set period or for the rest of your life. Depending on the product, those payments can be fixed (known amounts), variable (linked to investment options), or blended.

Two features tend to matter most in retirement decisions:

1. **Timing of income.** Some annuities start immediately. Others let you defer payments for years, giving the insurer time to manage funds and, in some products, apply a credited interest rate.
2. **The guarantee.** Guarantees are the “insurance” part. They can cover principal, a minimum income level, or longevity risk (the risk you live longer than expected). The more meaningful the guarantee, the more you should scrutinize the costs and restrictions.

A common misunderstanding is that annuities are always about maximizing returns. In practice, many annuities are about stabilizing outcomes. If your withdrawal plan depends on selling investments in a weak market, that risk can be partially transferred to an insurer, but you usually pay for the transfer.

The benefit retirees most often seek: dependable income

When people ask about annuities, they usually want one of three things: predictable cash flow, longevity protection, or smoothing the emotional burden of market volatility.

Here is what that can look like in real life. Imagine a retiree who plans to fund spending from a mix of Social Security, a pension, and portfolio withdrawals. The portfolio may be solid on paper, but the first five years after retirement are where plans are most fragile. If the market drops early, the retiree may be forced to sell shares at lower prices, locking in a loss. Even if the portfolio later recovers, the damaged withdrawal sequence can take years to repair.

An income annuity can reduce the need to sell during those periods by replacing some portfolio withdrawals with insurer payments. That is the core behavioral advantage: it helps retirees avoid making long-term decisions under short-term fear.

Common reasons annuities are attractive

- **Guaranteed payments** that can cover essentials like housing, utilities, and insurance premiums

- **Longevity protection** through lifetime income options, reducing the risk of outliving assets
- **More predictable withdrawal strategy**, potentially lowering the chances of selling investments during market stress
- **Flexibility in how income starts**, especially with deferred income arrangements

The word “guarantee” should not be treated casually. The guarantees are backed by the insurer, so financial strength matters. It is also important to read what is actually guaranteed, because some contracts guarantee only an income floor, not the investment value you might be expecting.

Costs: where annuities often earn their reputation

People hear “insurance” and assume the cost is reasonable. Then they see surrender charges, spread, and fees. The total cost is not always a single line item; it can appear as a combination of expenses and reduced upside.

There are several cost categories to look for, depending on the annuity type.

1) Surrender charges and liquidity limits

Most deferred annuities come with surrender periods, often measured in years. If you need your money during that window, the insurer can impose surrender charges and sometimes reduce taxable gains withdrawal.

One reason this matters is that retirement is not static. Medical surprises, family needs, home repairs, or a job loss for a spouse can change the plan quickly. A contract that works beautifully in a calm scenario can become painful if life forces a change.

A practical way to think about this: if the annuity is meant to provide lifetime income, you should be comfortable with not treating it like a savings account. If you might need principal for an uncertain event in the next few years, an annuity may not match the need.

2) Fees and charges

Variable annuities often have investment management fees plus additional insurance and administrative fees. Fixed annuities may have less explicit “portfolio” fees, but they still have internal costs, such as the difference between what the insurer earns and what it credits to you.

If you are comparing annuities, you want to understand the structure:

- Are there annual contract charges?
- Are there rider fees for income guarantees?
- Is the account credited at a stated rate, and is that rate guaranteed for a limited time?
- Is there a market value adjustment, and how does it behave when you withdraw early?

A key point: even when a salesperson quotes a “guaranteed return,” the return can be different for different holding periods, and the guaranteed portion may not apply to everything you thought it did.

3) Opportunity cost

Even if an annuity eventually pays well, the question is what you gave up. Money placed in an annuity is often money that cannot easily be used elsewhere. If you have access to lower-cost retirement accounts, such as employer plans, IRAs, and taxable brokerage accounts, you are trading flexibility and potential cost efficiency for income certainty.

Opportunity cost is not just theoretical. It shows up when markets perform strongly and an annuity limits upside, or when you want to rebalance but the contract penalizes you for doing so.

Types of annuities, and how the decision changes

Annuities can be grouped in a few practical ways. Understanding the category helps you avoid comparing apples to oranges.

Immediate annuities: turning assets into income now

An immediate annuity typically converts a lump sum into payments that begin soon after purchase, often within a month or less. The primary appeal is straightforward: you trade principal for income.

This is often most compelling for retirees who:

- want predictable cash flow quickly,
- have enough assets outside the annuity to handle major liquidity needs,
- and can tolerate inflation risk unless the product includes inflation adjustments.

Immediate annuities also vary. Some payments last for a fixed period. Others last for life, sometimes with a survivor option. The survivor option is common, but it reduces the payout compared to a single-life contract.

Deferred fixed annuities: credited interest with time restrictions

Deferred fixed annuities aim to accumulate and then pay later. Some provide a guaranteed interest rate for a period, others provide a guaranteed minimum, and many credit based on current rates or policy rules.

These can be useful when someone wants tax-deferred growth and is comfortable locking up funds during the accumulation phase. They can also be useful in “bucket” strategies, but the liquidity constraints still matter. You should ask what happens if you need access during the surrender window, and what portion is truly guaranteed.

Variable annuities: investment exposure plus insurance wrappers

Variable annuities link account value to investment subaccounts. The upside is that you can participate in market growth. The downside is that the contract can include meaningful fees and, often, riders for income guarantees.

If you are primarily motivated by lifetime income, you should evaluate the guaranteed income rider terms carefully. It is easy to overestimate how much income the guarantee will provide relative to what fees will drain.

For some people, variable annuities are the right solution, especially when they value the combination of tax deferral and guaranteed lifetime income. For others, a lower-cost portfolio plus a simpler income plan is more efficient.

Income riders and “guaranteed” income: read the contract, not the pitch

Income guarantees often come from riders, and riders have fine print. The contract may require a specific election timing, may base calculations on a contract value or a benefit base, and may restrict withdrawals.

One thing I’ve seen repeatedly: retirees focus on the highest guaranteed payout mentioned in marketing materials, then miss that the payout can depend on how long you wait, which investment options you pick, or what you accept for fees and limitations.

Taxes: a common reason people get surprised

Annuities often provide tax deferral on earnings, meaning you typically do not owe annual tax on gains while money accumulates in the contract. When you receive payments, the tax treatment generally follows “earnings first” logic for distributions, with portion treated as taxable income and portion as return of principal, though the exact taxation depends on the type of annuity and contract terms.

Where surprises can occur:

- **Nonqualified annuities** (purchased with after-tax dollars) involve taxable earnings portion at distribution.
- **Withdrawals during the surrender period** can be both taxable and subject to surrender charges.
- **Immediate annuities** may have a different mix of taxable and nontaxable portions depending on expected payments and insurer calculations.

If you are still working or your income fluctuates, the timing of distributions matters. A retiree whose taxable income is higher in the early years may prefer to delay certain distributions, while another retiree with low income early in retirement may benefit from drawing in a different pattern.

Taxes are also relevant for means-tested programs. While Social Security and Medicare interactions are complex, planning around taxable income can affect eligibility for certain assistance. Annuities can help or hurt depending on how payments are classified and how they fit into your overall income picture.

A practical way to evaluate an annuity offer

When a friend or adviser brings an annuity illustration, it is tempting to look for the single “rate” number. The illustration itself is not a lie, but it can be optimistic, depending on assumptions.

Here is the mindset I recommend when evaluating an annuity in a retirement context:

First, identify what problem the annuity is meant to solve. If the goal is stable income for essentials, you should compare the annuity’s payout to what it would cost in other ways, like creating a bond ladder or using a combination of withdrawals and a simpler guaranteed income approach.

Second, verify what costs you are paying, in dollars and in flexibility. Surrender charges, fees, rider costs, and restrictions all translate into an economic trade-off.

Third, stress test the scenario you care about. That might mean: “What if I stop the contract after three years?” or “What if inflation runs higher than expected?” or “What if I need a lump sum for a health event?” Annuities often shine in the scenario they were designed for, but retirement also includes [retirement planning](#) events they cannot predict.

Fourth, consider insurer risk. You do not need to become a credit analyst, but you should at least confirm the insurer’s financial strength ratings and understand how claims are handled. Guarantees are only meaningful if the company can pay.

Alternatives that may fit better, depending on your goals

Annuities are not the only way to buy predictability. Depending on your risk tolerance, income sources, and liquidity needs, alternatives can sometimes deliver similar outcomes with lower complexity.

Alternatives to consider

- **Bond ladders or high-quality fixed income** for predictable payments without surrender charges
- **Systematic withdrawal strategies with guardrails**, adjusted for portfolio health and market conditions
- **Buying a smaller immediate annuity** with only the portion you truly want locked into lifetime income
- **Delaying Social Security** to increase lifetime benefits, if that fits your health and family situation

A bond ladder can be surprisingly effective for covering near-term expenses. It does not protect against longevity risk the way a lifetime annuity can, but it can address sequence risk during the early years when retirement plans often break.

Guardrails can also help. Some retirees use rules such as reducing withdrawals when markets drop, increasing withdrawals when markets recover, and balancing spending with portfolio health. These strategies are not magic, but they can reduce the need for forced selling.

Delaying Social Security is another lever many people underestimate. It is not an annuity, but it can be viewed as a form of longevity insurance. The decision depends on life expectancy, income needs, spousal benefits, and health.

Edge cases where annuities can disappoint

I have seen annuities work well, but I have also seen them become a regret machine. The patterns tend to repeat.

1) Needing liquidity soon

If you might need access to principal within the surrender period, the penalties can turn a long-term plan into a short-term trap. Retirement is full of “just one more thing” expenses, and some are hard to predict.

2) Inflation risk without an inflation feature

Many fixed annuities pay level income. That can be a strong benefit in nominal terms, but inflation can steadily reduce purchasing power. If your annuity does not include inflation adjustments, your “guaranteed” amount can become less meaningful over time.

Some products offer inflation riders, but these often come with additional costs and reduced starting payouts. That trade-off should be evaluated intentionally.

3) Too much concentration in one product

Annuities can be a core income foundation, but they can also become an outsized portion of total retirement assets. If that happens, you lose diversification not only in investments, but also in tax treatment and liquidity.

A diversified income plan is often more resilient. Even if the annuity is great, it should typically play a role, not absorb the entire strategy.

4) Confusing “illustrated” returns with actual outcomes

Illustrations may show assumed returns on account value or hypothetical performance on variable components. If you purchase a product based on those numbers, you risk being disappointed when reality behaves differently.

A disciplined approach separates:

- the guaranteed features,
- the conditional features,
- and the assumptions that are likely to vary.

How to decide if an annuity belongs in your plan

The question is not “Are annuities good?” It is “Do they solve a problem you actually have, at a cost you can justify?”

A few decision prompts often help:

- Are you primarily trying to protect against longevity risk, sequence risk, or both?
- Do you have enough liquid assets outside the annuity to handle unexpected expenses?
- How sensitive is your plan to inflation?
- Are you focused on lifetime income, or on maximizing growth and flexibility?
- Would you still want the contract if markets do very well and you feel less pressure to sell?

If you are confident you want guaranteed lifetime income for a portion of your spending and you can accept the costs and restrictions, an annuity can be a rational choice. If your main goal is flexibility and you have a solid plan for withdrawal timing, you might prefer simpler approaches.

Getting the contract details right

Before anyone signs, I suggest insisting on clarity around a few items. You do not need to become a contract lawyer, but you do need to know what you are committing to.

Ask for:

- the **surrender schedule** and what triggers it,
- the **fee breakdown** (including rider fees if any),
- the **benefit base rules** for income riders in the scenario you care about,
- whether there are **market value adjustments** for fixed annuities,
- and the **options for payments**, including survivor benefits and how income changes over time.

Also ask what is not guaranteed. Many contracts guarantee something, but not everything. A payment might be guaranteed for life, but the account value might not grow in the way the illustration suggests. Or the income might be guaranteed at a floor, but not at the level assumed in marketing materials.

If an adviser cannot explain these items in plain language, that is a red flag. The contract is complex, but your understanding should not be optional.

Final thoughts: think in roles, not in slogans

Annuities earn their place when they play a specific role in retirement: providing dependable income, protecting against the risk of living longer than a portfolio can sustainably support, or reducing the need to sell in a downturn.

They fall short when they are treated as investments designed for maximum growth, or when liquidity needs and inflation realities are ignored. The most successful annuity decisions are grounded in trade-offs, not in optimism.

If you treat the annuity like an income contract with a cost and a set of rules, you can evaluate it like any other financial commitment. If the guarantee fits your life and the restrictions do not break your plan, it may be a strong tool. If not, the best choice might be a smaller annuity, a different product type, or a non-annuity strategy that preserves flexibility while still targeting stability.

Retirement is already a long game. The value of an annuity is not that it makes everything easy, it is that it can make one difficult risk easier to manage.