Annuities, Inflation and Recessions — Oh My!

Annuities are ideal retirement assets. They can be useful in buttressing your retirement portfolio against the twin threats of recession — which is usually accompanied by big declines in stock prices — and inflation, which eats away at the purchasing power of your holdings.

But how do annuities stand up to other investments like your 401(k) plan or stock holdings during stock market volatility, high inflation and a potentially looming recession?

There are many different types of annuities, and some are better at helping you hedge against stock market declines and inflation.

Annuities and bear markets

With annuities, your exposure to a severe stock market decline depends on the type of annuity you choose.

Variable annuities — With these, you choose from a selection of investment options, called subaccounts. These can be tied to a stock market index, bonds or money markets. Their value will vary depending on the performance of the investment options you choose. Stocks tend to be more volatile.

They offer the greatest potential for gains. But they are the most vulnerable to market declines. A money market subaccount is very low risk, but has very little upside. They offer the most protection against stock market declines, but are vulnerable to inflation.

Guaranteed Minimum Income Benefit (GMIB) rider - This is an optional rider you can purchase with your variable annuity that guarantees a certain income in retirement — regardless of what the stock market does. If stocks do well, your income will be higher. But if stocks fall drastically, you'll still get the minimum guaranteed income.

The disadvantage is cost: These riders usually cost from 1% to 1.5% per year. This reduces the growth of the annuity.

Example: You can buy a $200,000 variable annuity, and purchase a guaranteed income benefit rider of, say, $800 per month for as long as you live. (The guarantee amount depends on the size of the annuity and your age at purchase.)

If your subaccounts do very well, your annuity will grow faster — minus the GMIB rider fee of 1% to 1.5%. If your subaccounts fall because of a stock market crash, you'll still get the guaranteed $800 per year.

Fixed annuity — This instrument, which can entirely protect your funds against stock market declines, delivers a low but guaranteed rate of return between now and the time you start taking income, no matter what the market does.

Fixed income annuity — These will typically deliver a lower guaranteed rate of return. But if stocks do well, you have some upside potential.

Deferred income annuity — These provide a guaranteed amount of income starting at some point in the future, regardless of stock market returns. That's another way of hedging against market losses.

Lifetime Income annuity — If you're ready to start taking income now, you can also choose one of these, converting a lump sum into a guaranteed income for the rest of your life.

Annuities and Inflation

Unless you purchase some inflation protection, rising prices are very dangerous for income annuities. In a high inflation environment, a level income benefit buys less and less every year.

A partial answer is a cost of living or inflation rider. This means that your annuity income will go up every year. The downside: You'll start with a lower income in your first year.

Is it worth it? Only if inflation matches or exceeds the annuity company's expectations, and you live long enough to break even.

The longer you live, the more the inflation or cost of living rider will pay off in your favor.

The takeaway

When it comes to annuities, there's no single one-size-fits-all annuity product. Every situation is different, and the best approach is usually a combination of annuities and investments designed to produce a reliable income under any circumstances.

That's why we're here. Our job is to help you make sense of your options and choose the best strategy for your individual situation.

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