

## Fixed Annuities vs Bonds

A fixed annuity is a contract between an insurance company and one or more individuals, in which individuals make premium payments over the course of an accumulation period. The insurance company invests the premiums, then uses the investment proceeds to make distribution payments to the annuity holder. These distribution payments typically span 10-20 years but may also last for the life of the holder. For a close look at other features of fixed annuities, see [Fixed Annuity Features](#).

A bond is a debt security often purchased by older individuals seeking income from its interest payments and the security of principal associated with creditor status. Bonds carry maturities ranging from one year to 30 years. A fixed interest payment (called a coupon payment) is determined at issuance. The effective yield of the bond depends on its price, which is free to fluctuate in accordance with market conditions. Bonds are issued by large companies, state and local governments and the federal government. (Technically, Treasury-bond maturities range from 10 to 30 years; securities with maturities of between two and nine years are called notes.)

Many characteristics of the fixed annuity are similar to those of a bond. This makes it useful to compare and contrast fixed annuities and bonds from the viewpoint of an investor. To get the best picture of which investment is best for your savings goals, compare rates on bonds and annuities through a licensed financial advisor. You can contact an advisor, free of charge, by requesting an annuity rates report below.

## Similarities Between Fixed Annuities and Bonds

### Risk of Default

The risk characteristics of fixed annuities and bonds are quite similar. Corporate bonds carry the risk of default, which can be minimized by choosing only from companies whose bonds are rated at least investment-grade by the bond rating agencies. Fixed-income investors with sufficient resources can also diversify their corporate bonds holdings to reduce the impact of default by a single company. One way of attaining diversification is to invest in a bond fund, which utilizes the mutual fund technique of selling shares in a pool of invested funds created by professional managers who select a portfolio of bonds. This simplifies the process and decreases default risk - at the cost of worsening interest-rate risk.

The default risk of municipal bonds is smaller, since city and state bankruptcies are much rarer than corporate ones. The default risk on federal Treasury securities is lowest of all; these are viewed by financial theorists as the quintessential riskless assets.

Default risk is smaller for insurance companies than for businesses generally, since their product is always in demand and the investments that backstop the company are professionally managed and diversified. Major ratings agencies rate the financial strength of insurance companies, which allows annuity buyers to avoid companies whose finances are shaky. Finally, the existence of state insurance guaranty funds covering life and health policies further decreases the default risk borne by fixed-annuity buyers. Technically, that level of risk is less than for corporate bonds and slightly more than for Treasury securities. Overall, the default risk borne by careful fixed-income investors is quite small – much smaller than that run by purchasers of individual stocks, for example.

### **Security of Principal**

Security of principal is another similarity shared by bonds and fixed annuities. Barring default, a bond investor can assure a specific return by holding the bond until maturity. Thus, market risk becomes a problem only if the investor must sell prior to maturity. Market interest rates may rise, implying that the bond's price must fall to preserve the interest yield of the fixed coupon amount. This fall in price will impose a capital loss on the seller.

Fixed annuities preserve the investor's principal by including minimum guarantees for interest and income credited to the accumulation account, thus insulating the investor against market risk. Once again, an investor who needed to cash in the annuity prematurely would face a penalty; namely, the surrender charges imposed on early withdrawals by the insurance company. (Annuity holders younger than age 59 ½ also face a 10% tax penalty levied by the IRS.) Whereas market fluctuations in interest rates are unpredictable, these charges are known in advance, since the schedule of surrender charges is stated in the annuity contract.

### **Don't Just Shop, Implement a Solid Retirement Strategy**

Purchasing an annuity is a big decision. Online research is a good start, but prudent investors should discuss all their options and risks with an independent financial advisor. Request a free, no-obligation consultation today, along with a report of current rates on brand-name annuities.

## **Cost of Liquidity**

Both bonds and fixed annuities impose a cost for liquidity. The penalty for bondholders is potentially larger in magnitude but lower in probability, which tends to balance out the comparative degree of risk. (Again, the comparison would be modified for annuity-holders younger than age 59 ½, who would face an additional 10% tax penalty levied on withdrawals by the IRS.)

## **Inflation Risk**

Inflation risk is a serious concern for both bond investors and fixed-annuity holders. The purchasing power of fixed coupon payments and principal can be eroded by increases in the general level of prices over the term of the investment. In recent years, the federal government has sought to allay this concern by issuing Treasury Inflation-Protected Securities (TIPS) and I-bonds (savings bonds). Each of these instruments makes adjustments based on fluctuations in the Consumer Price Index. TIPS adjust the principal value of the security on a daily basis, which increases the investor's coupon payments and principal value in accordance with average increases in prices. I-bonds increase the credited interest rate based on changes in the CPI. This protection against unanticipated inflation carries a price tag, since investors will bid up the price of inflation-protected securities, thus decreasing their effective yield compared to non-protected securities.

Recently, insurance companies have begun issuing fixed annuities whose investment accumulations are indexed against inflation. This may be a competitive reaction to the popularity of TIPS and I-bonds. Typically, indexation takes place once per year and is tied to a well-known index such as the CPI.

## **Interest-Rate Risk**

Interest-rate risk refers to the chance that money tied up in illiquid investments may be locked into low-yielding instruments when interest rates rise. This is a problem with bonds of intermediate maturities (say, 5-10 years) as well as with long-term bonds with 10, 20 or 30-year maturities. One strategy for overcoming it is to "ladder" bond purchases by staggering maturities by one year, then rolling each year's maturing funds into a bond of constant maturity. This allows new funds to be available for reinvestment every year, reducing the exposure to interest-rate increases.

Garden-variety fixed annuities may have an initial guaranteed rate that lasts only for a year or two, after which the insurance company is free to specify a lower rate. Ironically, CD annuities arose precisely because they lock in a guaranteed credited interest rate for the investment term of the annuity. Perhaps the surest way to deal with the problem of using annuities is to purchase an annuity

whose investment returns are tied to a bond index rather than an equity index. This is the type of problem that indexation was intended to solve.

### **Effective Interest Yields**

Effective interest yields on bonds and annuities are comparable although not identical. Insurance companies invest in high-grade corporate bonds and blue-chip stocks in order to pay out interest to fixed-annuity accumulation accounts, so we would expect to find the latter yields to be somewhat lower than the former. On the other hand, competition between insurance companies prevents this yield spread from becoming too wide. Treasury securities and municipal bonds have even lower levels of default risk than do annuities, so we would expect the latter's yields to slightly exceed the former's. This range of asset yields nearly covers the spectrum of fixed-income interest rates. High-yield bonds (so-called "junk" bonds) have significantly greater default risk; consequently, their yields are much closer to those of equities.

## **Differences Between Fixed Annuities and Bonds**

### **Income Security**

The biggest difference between fixed annuities and bonds is the security afforded by annuities. The option to annuitize – that is, to distribute the capital sum created by investment in regular payments over the remaining lifetime of the annuity holder – is unique to annuities. The problem of how to allocate consumption over a lifetime is inherent, and annuitization eliminates the possibility of running out of money before running out of life. It does this largely at the cost of surrendering control over the capital sum that finances the annuity payments.

The only fixed-income security analogous to the annuity is a consol – a bond with no maturity date that provides coupon payments in perpetuity to its holder. Consols are familiar to students of financial theory for their useful analytical properties, but unfamiliar to most people because they seldom exist in real life. As a practical matter, an annuity is the only way to assure a stream of income whose duration exactly matches the life span of the recipient.

### **Expenses**

Fixed annuities, like annuities in general, have a well-deserved reputation for incurring high expenses. This is due primarily to the insurance-related, minimum-guarantee features that protect annuity-holder principal. In contrast, bond investments can usually be made inexpensively. Corporate bonds

can be acquired with the help of a discount broker, as can municipal bonds. Treasury securities can be purchased directly at little or no transaction cost. Even bond funds carry lower expenses than annuities.

## **Tax Consequences**

Other significant differences between fixed annuities and bonds exist. Annuity investment gains accumulate tax-deferred, which is another significant investment benefit. Corporate bond interest is taxable in the year of receipt unless the bond is held within a qualified plan such as an IRA – a strategy recommended by some financial authorities. Municipal-bond interest is exempt from federal income taxes but taxable at the state and local level. High-income individuals often hold municipal bonds for this reason. Treasury bond interest is state-and-local tax-exempt but subject to federal income taxes. The value of a state or local tax exemption varies not only with the income status of the recipient but also according to the height of state and local taxation, which itself varies widely by location.

Annuity gains are taxable as ordinary income when distributed or inherited. This does not represent the same relative disadvantage for fixed annuities relative to bonds as it does for, say, variable annuities compared to mutual funds. Bond interest is also taxable as ordinary income and capital gains only become a factor if the bond is sold prior to maturity.

## **Creditor/Liability Shield**

As insurance products, annuity assets are shielded from creditors – such as liability-judgment awardees – in many states. Again, this is a benefit not conferred upon bondholders.

## **Avoiding Probate**

Annuities can pass directly to a beneficiary upon the holder's death, without being tied up in probate. Securities such as bonds ordinarily require re-titling under probate supervision unless their registration includes a transfer-on-death (TOD) stipulation.

## **Summary**

As investment vehicles, fixed annuities and bonds are quite similar. For risk/return analysis and asset-allocation purposes, they can both be viewed as fixed-income instruments. The chief differences between them are created by the specialized features of annuities – both good and bad.