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FIXED ANNUITIES VERSUS BONDS: WHICH IS BETTER FOR RETIREMENT?

Fixed annuities and bonds are designed to help investors fill income gaps in their retirement plan.

By: Rebecca Lake - February 7, 2017

When ranking pre-retirees' biggest investment stressors, running out of retirement income takes the No. 1 spot. Thirty percent of workers in Franklin Templeton's 2016 Retirement Income Strategies and Expectations survey rated it as their top concern.

Fixed annuities and bonds offer two avenues for creating retirement income. Fixed annuities provide a set amount of income for life, while bonds are designed to be held until maturity. Determining whether to include either of these investment vehicles in your retirement portfolio requires a careful assessment of your goals.

Define your expectations. Michael Tove, president and founder of AIN Services in Cary, North Carolina, says it's important for investors to understand what function fixed annuities and bonds serve in a portfolio.

"Financial planners commonly regard total portfolios as consisting of three blocks," Tove says. There are conservative investments, such as cash and cash equivalents. And there are risk investments, such as stocks and mutual funds. In between, Tove says, is a category of low-risk, growth-oriented investments that includes bonds and fixed annuities.

Before investing in a fixed annuity or bond, however, you should be aware of what you stand to gain and how it may impact your overall retirement planning strategy.

Ken Nuss, CEO and founder of AnnuityAdvantage in Medford, Oregon, says investors need to understand how annuities and bonds generate income for retirement. "Annuity contracts may be annuitized for guaranteed lifetime income, which can't be outlived," he says.

Bonds, by comparison, may only pay out interest until maturity. Anthony Pellegrino, co-founder of Goldstone Financial Group in Oakbrook Terrace, Illinois, says that because of those limitations, investors are essentially at the mercy of whatever new bonds are offering once their existing bonds expire.

Pellegrino says annuities may lend another advantage beyond consistent lifetime income.

"There are annuities that offer an inflationary hedge built into them, which will allow your annual income to potentially increase, giving your lifetime income a raise each year," he says.

That's a plus if inflation rises. A 2016 analysis by Limra, a Connecticut-based research group, found that inflation of 2 percent can erode retirees' purchasing power by more than $73,000 over a 20-year period. If inflation jumps to 3 percent, that number climbs to more than $117,000.

Compare the cost. Minimizing fees and tax liability is critical with any investment and fixed annuities and bonds offer different benefits on both counts.

"Fixed annuities provide the tax advantage of tax deferral," says Roger Cowen, owner of Cowen Tax Advisory Group in Hartford, Connecticut, with no 1099s to worry about and no taxes due if you reinvest.

That simplicity may be appealing to investors who prefer to keep their portfolio as streamlined as possible for taxation purposes. The catch is that annuity income is generally taxed at ordinary income rates, rather than the long-term capital gains rate, which may be more favorable for some higher-income earners.

While bond interest is taxed as capital gains, Barry Kozak, a certified pension consultant with Chicago-based October Three Consulting, says factoring bond interest payments into your tax filing can be complicated.

"Whether any particular interest payment from any particular issuer will be included in gross income in any given year depends on the myriad of rules outlined in the Internal Revenue Code," Kozak says.

Beyond taxes, investors also need to consider what they're paying in fees or commissions to invest in annuities versus bonds.

Edward Petersmarck, vice president of business development at M&O Marketing in Southfield, Michigan, cautions investors not to confuse fixed annuities with variable annuities. "Variable annuities can involve both a commission and ongoing fees, whereas fixed indexed annuity options can involve commissions but are designed to avoid additional management costs," he says.

He also advises investors to be aware of how commissions may be built into bond investments.

"A bond portfolio can either involve a commission or ongoing management fees," Petersmarck says, but in some cases, the commission may take a form that investors don't recognize. For example, there may be a markup when the bonds are purchased or a markdown when bonds are sold.

Kozak says investors should look beyond the broader comparison and account for the individual cost of a specific annuity or bond.

In the case of annuities, he recommends weighing a larger upfront commission against the reputation of the insurance company and the value of the advice the agent or broker is conveying. With bonds, the comparison hinges on the smaller commissions which may be paid more frequently against the value the bonds add to their overall investing strategy.

Don't overlook liquidity. Tove advises investors to examine their liquidity needs when comparing bonds and annuities.

"Fixed income annuities permit penalty-free access to money within a stated schedule, most commonly 10 percent each year," Tove says.

The only way to access money from a bond, other than a fixed coupon payment, is to sell some shares. The trade-off is a reduction in future income payments.

"Both bonds and annuities are time deposits, meaning the initial deposit is supposed to remain for a minimum number of years," says Tove, but the biggest difference is maturity.

When a bond matures, the investor must find something else to invest in. With annuities, the time restriction only applies to the number of years until penalty-free access to the account is allowed.

Nuss says if managing liquidity is a priority, annuities may be the better choice.

"Annuities, through riders or product design, may offer free withdrawals during the holding period, including withdrawals of up to 100 percent of the annuity's value for terminal illness or nursing home confinement for medically necessary reason," Nuss says

Bonds, on the other hand, offer none of these additional liquidity features.

Keep risk in your sight line. Adding both bonds and annuities to your portfolio is one way to diversify, but it's important to find the appropriate balance.

"Bonds can play a role for a portion of your portfolio, depending on your goal," Pellegrino says. "Annuities can play a role as well, especially if you're concerned with longevity risk and you want to eliminate the possibility of outliving your income in retirement."

Pellegrino advises not putting too much money into either asset class for diversification's sake. Furthermore, investors should be reviewing the ratings of both bonds and fixed annuities before venturing in.

"There's a big difference between A-rated bonds and junk bonds, and there's also a big difference between investing with an A-rated life insurance annuity company and a D-rated one," he says.

Michael Tove Ph.D., CEP, RFC, president and founder of AIN Services, is an insurance licensed Certified Estate Planner and Registered Financial Consultant. Dr. Tove's philosophy is that every client, regardless of net worth, deserves the best planning possible.

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