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4 Steps When Buying an Annuity

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Assuming you've already determined that putting some of your nest egg into an immediate annuity makes sense, you're absolutely right to want to be sure you're dealing with an insurance company that's financially sound. But while identifying a reliable insurer is a good start when converting savings to guaranteed retirement income, it's only that — a good start.

Which is why if you really want to ensure that the portion of your savings you "annuitize" will be able to generate income you can count on no matter how long you live and regardless of how the financial markets perform, you should consider taking the following four steps:

Step # 1: Look for insurers with high financial strength ratings

When you buy an immediate annuity, you're essentially buying an insurer's promise to provide you with guaranteed income for life. So while you certainly want to choose an annuity that offers a competitive payout, you also want to choose one that's issued by an insurance company that has the financial wherewithal to back up its commitment to deliver that income.

But unless you also happen to be a financial analyst, sussing out which insurers are best positioned to do that is likely more than you can manage on your own. Fortunately there's an easier way: limit yourself to insurance companies that receive high financial strength ratings — I'd generally say A+ or better — from ratings firms like A.M. Best and Standard & Poor's.

To be sure, there's no guarantee that an insurance company's rating won't slip over time. But when it comes to buying income you'll be counting on for decades to come, it's just common sense to go with insurers that ratings firms have judged as having greater resources and flexibility to meet their financial obligations than their lower-rated peers.

You can get an idea of how much immediate annuities are paying in general — as well as get quotes from specific insurers along with their financial strength ratings — by going to this annuity calculator.

Step #2: Spread your annuity stash around

Just as you wouldn't put all of your money in a single stock or bond, so it makes sense to diversify the portion of your nest egg you decide to invest in an immediate annuity.

But you don't have to spread your money among dozens of companies, as you would when investing in stocks and bonds. That would be overkill. Splitting your investment among the annuities of two or more highly rated insurers ought to give you sufficient security. The main idea, though, is that you don't want to have all of your annuity income riding on the fortunes of just one insurance company, even if that insurer has a lofty financial strength rating.

Step #3: Don't invest too much with any single insurer

There's a relatively easy way to gain yet another layer of protection for your retirement income: Limit the amount you invest with any single insurer to the coverage limit offered by your state guaranty association.

Although the state insurance guaranty system operates differently than the FDIC's federal deposit insurance program, it's similar in that it provides a safety net of sorts for owners of insurance policies and annuities in the event an insurer becomes insolvent. The maximum amount of coverage varies by state, but ranges between $100,000 to $500,000 for annuities. (You can get details about how this system works and find the coverage limits for your state by going to the National Organization of Life & Health Insurance Guaranty Associations' site.)

The coverage limits are per insurer, which means most people should be able to fairly easily ensure that their entire annuity investment is simultaneously covered by their state's guaranty system as well as spread among highly rated insurers. For example, even if you plan to annuitize, say, $300,000 of savings and your state guaranty association's coverage limit is $150,000, you could get full protection by splitting your annuity investment among two or more highly rated insurers.

Step 4: Invest gradually rather than all at once

The size of the annuity payment you'll receive depends not just on your age and sex, but also on the level of interest rates when you buy. All else equal, the higher interest rates are, the higher your payment. You can't control interest rates, or predict their path for that matter. But by buying in stages — say, annuitizing $300,000 with separate $100,000 purchases over a few years rather than investing the entire three hundred grand in one shot — you can at least diversify against the risk of putting all your money into annuities when interest rates are at a low.

There's another reason to buy in stages rather than jumping in all at once. It's not always obvious early in retirement how much income you'll require to cover your expenses and how much guaranteed income, if any, you'll want beyond what you'll already be getting from Social Security and any pensions. By investing smaller amounts over a period of a few years, you'll be able to periodically re-assess your spending needs and, in so doing, reduce the risk that you'll end up with more guaranteed income than you actually need .