

Avoid These Annuity Mistakes: A Guide for Retirement Planning

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Annuities can be valuable for retirement income, but pitfalls exist. Discover crucial annuity mistakes to avoid, including choosing the wrong type and ignoring potential costs

By Ken Nuss

Like any other financial vehicle, annuities have their pros and cons. But they vary greatly. Different types work differently and accomplish different goals. Some are quite complex; some are straightforward. Some guarantee income; some offer growth.

Get some good advice and have a basic understanding of how annuities work before you commit. Here are some of the main mistakes people make when buying (or not buying) annuities.

1. Not considering annuities at all, especially when you're in your 50s or older

Annuities aren't right for everyone, certainly. But few if any financial products or services, other than perhaps a basic checking account, are suited for everyone.

Some anti-annuity "experts" go to the opposite extreme and claim that annuities are a poor choice for everybody. That's not true!

Annuities are rarely appropriate for young people. Nonqualified annuities (those not in a qualified retirement plan or IRA) offer tax deferral as long as you keep reinvesting the interest in the annuity. Without the drag of taxes, interest compounds faster. However, interest or gains you receive are taxable, plus you're hit with a 10% IRS penalty if you withdraw them before age 59 1/2, unless you're disabled.

But if you're in your 50s, and especially your 60s and beyond, annuities are worth considering because they're designed to help you secure a successful retirement. Annuities (except variable annuities) help you reduce risk because they guarantee income

and/or principal. Even if an annuity isn't right for you now, it might be sometime in the future.

Avoid these six annuity mistakes:

1. Not understanding the different types of annuities

If you don't understand the basic types available, you might make either a poor choice or at least a less-than-optimal one. You don't need to become an expert, but a basic understanding of what's available is needed.

Income annuities provide a guaranteed stream of income, either now ([immediate annuity](#)) or in the future ([deferred income annuity](#)). You're exchanging your money—the premium you pay the insurer—for a contractual promise. An income annuity, particularly a lifetime annuity, can be a superb tool for retirement planning since you're essentially creating a private pension.

However, income annuities do not build savings. If you need funds you can tap (beyond the scheduled payments) or aren't willing to tie up your funds this way, an income annuity isn't for you.

In contrast, variable, fixed-rate and fixed index annuities are designed to build your assets and may provide current or future income. The main differences are in the level of guarantees that come with them.

Variable annuities are much like a set of mutual funds within an annuity "wrapper" that provides tax deferral. They are investments that come with the fewest guarantees and expose you to market risk and fees, but they do offer the most growth potential.

Indexed annuities are complex vehicles that pay interest that's tied to the annual performance of an index such as the S&P 500. The big advantage is that you're guaranteed to never lose money no matter how much the index falls. That's why they're considered a type of fixed annuity: your principal is guaranteed though the interest rate fluctuates.

A fixed-rate annuity does guarantee the interest rate. The older type, less popular today, typically has a higher guaranteed initial rate but once that short period is over, the rate may decline to the guaranteed minimum.

Most people now choose a **multi-year guarantee annuity**, or MYGA, that guarantees a set interest for a term of two to ten years. They're often called CD-type annuities.

2. Not considering actual and potential costs in light of current and future needs

Choosing the wrong annuity can result in high fees, poor returns and limited liquidity. If you purchase an annuity with excessive fees or a long surrender period, you may lose out if you need to withdraw funds early.

The surrender charge applies if you cancel the annuity within the surrender period or if you withdraw money beyond the allowed amounts. The percentage that is charged for surrenders will usually decline each year until the charge eventually disappears.

A 1035 exchange lets you exchange your annuity for another one tax-free, but you could still face surrender charges if done early.

Many annuities offer penalty-free withdrawals, especially beyond the first year. For instance, some allow you to withdraw up to 10% of the contract value annually; some annuities have lower limits. Unpenalized liquidity can come in handy if your needs change or interest rates change markedly.

Fees are particularly germane in variable annuities because they're explicit and charged annually. Fixed annuities of all types don't normally levy separate fees unless you buy an optional rider for something such as enhanced death benefits or lifetime income guarantees. A rider can be worth the extra money if the fee is reasonable and it helps you attain your goals.

3. Falling for exaggerated claims, such as “earn 8%!”

You may have seen ads promising a guaranteed rate of 8%. Those ads are misleading. Though not completely false, they set unrealistic expectations.

Some fixed index annuities do indeed offer an 8% rate guarantee. But it doesn't guarantee the annuity's actual return. Instead, it guarantees the growth of a separate income account value created by an optional rider.

The income account value is used to calculate the amount of future guaranteed lifetime income payments. Most insurers charge an annual fee of about 1% of the annuity value for this option, and over time, that 1% fee adds up. The income rider can be a worthwhile purchase for some people, but don't confuse it with actual money in your account.

4. Waiting for interest rates to rise

Even top economists and financial gurus can't accurately predict future interest rates. But some people think they can, and they're leery of tying up their money at current annuity rates because they think rates will increase.

The problem is that while you're waiting for rates to rise, you're earning less in a money market fund or bank account. It's hard to catch up later.

Playing the interest-rate waiting game is a kind of passive gambling you're almost guaranteed to lose. But unlike Las Vegas, there's no 'house' taking the money—it's just never earned in the first place. It doesn't make financial sense to avoid longer-term fixed annuities when earnings can be dramatically improved over cash equivalents.

5. Failing to shop around for the best deal

Some annuity agents only represent a few annuity companies or even just one. Even the big financial firms such as Fidelity Investments and Charles Schwab usually have a very limited selection. If your provider offers such a limited choice, it's unlikely you'll find the best deal.

It's fairly easy to compare fixed-rate MYGAs because they're straightforward and rates are readily available on several comparison websites. For instance, if you're shopping for a five-year rate guarantee, available rates range from 3.50% to 6.05%, according to AnnuityAdvantage's [database of annuity rates](#).

It takes more work to compare competing income annuities and index annuities because they're more complex, with more features and wrinkles. Nevertheless, you do need to use a provider that will give you a wide choice.

6. Choosing based only on the rate or payout

This may sound like I'm contradicting my advice above, but it isn't. While performance or rate is the first thing to compare, it isn't the only thing to consider. Policy provisions, such as liquidity, are important, as noted previously.

Choose a financially strong insurer. While annuities are backstopped against insurer insolvency by Guaranty Associations in each state, you don't want to have to rely on that. It's easy to find out the company's financial rating from AM Best. For fixed annuities, I recommend a minimum B++ rating and for lifetime income annuities, look for at least an A- rating.

The insurance industry has a good track record of keeping its promises, and insurers are strictly regulated by the states.

Annuities have a lot of ins and outs. Learn about the basics, compare multiple annuities and get good advice before you buy.

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Ken Nuss is the founder and CEO of [AnnuityAdvantage](https://www.annuityadvantage.com), a leading online provider of fixed-rate, fixed-indexed, and lifetime income annuities. Ken is a nationally recognized annuity expert and widely published author. A free rate comparison service with interest rates from dozens of insurers is available at <https://www.annuityadvantage.com> or by calling (800) 239-0356. There are no fees or charges for the firm's services; 100% of the client's money goes to work for them in their annuity.
