

# ANNUITY OWNER MANUAL

## *The Proper Use of an Annuity in a* **RETIREMENT INCOME PORTFOLIO**





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## Preface

First introduced in America back in 1759, the annuity concept of collecting a pool of money for future payouts is as old as the concept of insurance—only the annuity was developed to insure payouts while a person is still alive. (Source: <http://www.savewealth.com/retirement/annuities/history>)

While the annuity has undergone substantial changes since the 18th century, in recent years it has morphed so significantly that previous critics have turned into some of its greatest advocates.

Take Jane Bryant Quinn for example. A syndicated financial columnist for the Washington Post, Quinn has revised her opinion of annuities. By her own admission, "Praise for these contracts is surprising, coming from me...but for people without pensions, the guarantees themselves are attractive, despite the fees." (Source: <http://janebryantquinn.com/2010/06/set-up-a-future-retirement-income-with-new-style-annuities>; July, 2010)

Today's retiree is learning that there is an important place for annuities in today's retirement planning. However, it's important to choose the correct annuity for your financial situation and ensure that it works in concert with the rest of your portfolio. When utilized correctly, the annuity can be a very effective retirement income vehicle.

**That's why it's time for an Annuity User Manual.** The objective of this resource is to help you understand how to determine the type of annuity best suited for your situation and lifestyle and how it should work within your retirement portfolio.

In many cases, you may wish to fund an annuity contract by trading in one of your current investments. This paper will also address when and how to do this and how to evaluate if that's your best strategy.

Most importantly, this Annuity User Manual is designed to help you assess your need for retirement income down the road and construct a strategy to best help you reach your destination. In doing so, you will learn: The Proper Use of an Annuity in a Retirement Income Portfolio.

***So buckle up, start your engine and take this manual out for a spin.***

*"We need to do more to give families better choices to reach a secure retirement. The Administration is promoting the availability of annuities and other forms of guaranteed lifetime income, which transform savings into guaranteed future income, reducing the risks that retirees will outlive their savings or that their living standards will be eroded by investment losses or inflation."*

The White House Fact Sheet: Supporting Middle Class Families; 2010; [http://www.whitehouse.gov/sites/default/files/Fact\\_Sheet-Middle\\_Class\\_Task\\_Force.pdf](http://www.whitehouse.gov/sites/default/files/Fact_Sheet-Middle_Class_Task_Force.pdf)

# It's Personal: 3 Questions to Ask Yourself

My father used to say, "That's why they make Chevys and Fords," whenever he wanted to explain the differences in people. The fact is, there are at least as many different types of financial vehicles as there are motor vehicles from which to choose.

The annuity is not suitable for everyone: It all comes down to personal choice. Your circumstances, income and financial resources, objectives, tolerance for market risk and investment timeline are all very unique to you. There is no one cookie-cutter investment and/or retirement plan that is a perfect fit for all retirees. That's what makes investing so complex—trying to figure out the best solution to meet your needs.

But it really comes down to what you want to achieve in your lifetime. Your financial portfolio is just a vehicle to help you meet those goals. Establishing your objectives can help shed some light on which vehicle(s) are best suited to help you accomplish them.

For the sake of the Annuity User Manual, we've pared it down to three pretty simple questions.

- What do you need in retirement?
- What do you want in retirement?
- What's currently blocking your progress towards those goals?

## Question #1: What do you need in retirement?

Traditionally, financial advisors have recommended that seniors plan to provide for 70% to 80% of their pre-retirement income throughout retirement. The following are four categories you can use to evaluate and provide a clearer picture of what you may need in retirement: *(Source: 1997 GSU/AON RETIRE Project Report, Center for Risk Management Insurance Research, Georgia State University).*

### Housing & Utilities

Regardless of any loss in home equity you may have experienced in recent years, you should be aware of whether or not your mortgage will be paid off by the time you retire. Also consider whether or not you will be inclined to downsize to a smaller home or move into a retirement community—many of which can be quite expensive.

As you get older and lead a more sedentary lifestyle, you may no longer have the ability to drive anymore. Living in your own home may require you to become dependent on others and their schedules to accomplish small tasks like going to the grocery store or seeing your friends.

### Retiree Spending

- 49% of today's retirees report a lower level of spending during retirement
- 50% say that they spend about the same or higher

Source: 2010 Retirement Confidence Survey, Employee Benefit Research Institute and Mathew Greenwald & Associates.

From a health care perspective, living in your own home may not always be an option if you become injured or infirmed and need assisted living or skilled nursing care. Working with a qualified financial advisor to determine what residential options financially make sense for you may become necessary.

### **Food, Clothing, Travel, Entertainment & Gifts**

You need to eat well and be clothed, but many seniors find they spend less money on these expenses in retirement. Travel is something many seniors choose to do early in retirement years, but for most this level of activity—and expense—tends to taper off in later years. As for entertainment and gifts, these are very subjective expenses, but this type of spending also tends to dwindle as you age. (Source: CPIE Index, March 2010; <http://www.bls.gov/cpi/cpid1003.pdf>)

### **Transportation**

Inevitably, your transportation needs will change as you get older. You may get to the point where driving is no longer comfortable for you and transportation may become more expensive, depending on your options.

### **Health Care**

Health care expenses will be discussed in more depth later in this manual, which you should consider carefully when planning for your retirement expenditures.

## **Question #2: What do you want in retirement?**

What is the purpose of your money—to live out your life comfortably and secure, or to live in luxury, entertain and travel extensively? Do you wish to leave a substantial sum for your loved ones and/or any causes you support, or are you inclined to spend more of your money now and leave less to your loved ones? As for how much to leave as an inheritance, consider Warren Buffet's philosophy:

"The perfect inheritance is enough money so that they feel they can do anything, but not so much that they could do nothing."

Most of us don't have Buffet's wealth challenges, but the sentiment is evident: Don't live your life as if its value is only worth as much as you leave your children. The last thing you want to do is not spend your money on housing, health care, long-term care, and your own quality of life so that you can leave a larger inheritance. If you want both to live comfortably and leave an inheritance, now is most certainly the time to position your assets for this goal.

*"The perfect inheritance is enough money so that they feel they can do anything, but not so much that they could do nothing."*

-Warren Buffet: [http://money.cnn.com/magazines/fortune/fortune\\_archive/1986/09/29/68098/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/1986/09/29/68098/index.htm)

## Question #3: What's currently blocking your progress towards those goals?

### Economic & Job Instability

The past few years have been difficult, and as we slowly turn the corner, we're finding there may be more challenges we need to consider. That's because, with the bailouts and economic stimulus distributions, we anticipate income tax hikes, rising interest rates which will impact our ability to borrow money, a slower than usual economic recovery, a slow housing market recovery and continued market volatility.

### Taxes

For now through 2012, capital gains and dividends are taxed at 15% (0% for individuals in the 10% and 15% income tax brackets). Beyond 2012, taxes are likely to increase as a result of Congress' bipartisan deal to reduce the deficit going forward. The new Medicare Tax contained within Health Care Reform legislation is slated to add an additional 3.8% in payroll taxes starting in 2013 for individuals with over \$200K income and households with over \$250K income.

Taxes are always a wrinkle in retirement planning because regulations can be changed, repealed or back-dated depending on the economy and who is in office. However, one tenet will always remain the same: When it comes to retirement planning, it is advantageous to pursue tax-deferred compounding for the highest long-term return on your money. Whatever current tax-advantaged vehicles are available should be considered for retirement income planning.

### Market Losses

If you're like most retirees, your investments lost money—at least on paper—during the latest market downturn. You may not have even fully recovered yet from the correction in 2001. And yet the closer you are to retirement, the less time you have to recover lost gains. Furthermore, recent volatility may cause you to shy away from riskier—but potentially higher performing—investments at a time when you need to aggressively recoup your losses.

*From May 2008 to October 2009, 34% of seniors age 75+ lost between 25%-49% of their assets."*

-Generations 3, Emerging Trends in Consumer Preferences, SB&A Research, 2009.

*"The future ain't what it used to be."*

-Yogi Berra, The Yogi Book: "I Really Didn't Say Everything I Said" by Yogi Berra.

## Perils of the Road

- Inflation Pressure: Cost of Living
- Maintenance Costs
- High Mileage: Life Expectancy
- Unstable Ride: Market Volatility

### Inflation Pressure: Cost of Living

Retirement planning requires that you take into account the impact of long-term inflation on income over a long lifespan.

Moshe Milevsky, associate professor of finance at Schulich School of Business at York University and Executive Director of the Individual Finance and Insurance Decisions Centre in Toronto, is a recognized expert in the study of retirement income.

Milevsky has been quoted as saying that, "Once you retire and your wealth has been transformed into financial capital, you are completely exposed to inflation risk. Over a 25-year retirement—typical for a married couple—inflation at 4% will cut the value of a \$1,000 pension check to just \$375." (Source: *cnnmoney.com*, September 11, 2008; [http://money.cnn.com/2008/09/05/retirement/minds\\_money.moneymag/index.htm](http://money.cnn.com/2008/09/05/retirement/minds_money.moneymag/index.htm))

To put this scenario into more practical numbers, if you need about \$67,000 a year of income when you retire, your retirement portfolio will need to generate more than \$122,000 a year in 20 years, as illustrated in the chart below.

Retirees face a more unique type of inflation risk than the rest of the population. So much so that since 1987, the U.S. Department of Labor's Bureau of Labor Statistics began tracking a separate consumer price index—one specifically weighted for elderly Americans—called the CPI-E Index.

During the 25-year period from 1987 to 2007, the CPI-E increased an average annual rate of 3.3% as compared to 3.1% for the Consumer Price Index for All Urban Wage Earners and Clerical Workers (CPI-W).

As you can see in the accompanying table, CPI-E data indicates that older Americans devote a substantially larger share of their total budgets to medical care, which is why the medical care category receives a higher weighting in the CPI-E index. Therefore, one might conclude that the goods and services that seniors spend a greater portion of their money on experience a higher inflation rate over time than the things on which the rest of the population spends its money.

#### CPI-W vs. CPI-E

CATEGORY	CPI-W	CPI-E
Food	16.43%	12.35%
Housing	39.75%	47.08%
Apparel	3.79%	2.65%
Transport	18.65%	14.22%
Medical care	5.26%	11.07%
Recreation	6.03%	5.53%
Other	3.92%	3.19%

(Source: CPI-E Index, March 2010; <http://www.bls.gov/cpi/cpid1003.pdf>)

## Housing

Many people think that their expenses will go way down once their house is paid off. However, you may not consider that these savings will be offset by other expenses, such as health care. If you live a particularly long time or develop a chronic illness or Alzheimer's, that may result in you no longer being able to live at home.

For couples, one spouse may be able to live at home while the other has to move into a nursing center—which may affect your financial situation.

## Health Care

Today, health care comprises about 12.9% of seniors' total income expenses, according to the Bureau of Labor's Consumer Expenditure Survey, 2009.

As illustrated in the accompanying table, a couple both age 65 today could need up to \$391,000 to cover premiums for health insurance coverage and out-of-pocket expenses during retirement.

### Savings needed for 90% chance of having enough savings to cover health costs in retirement (premiums and out-of-pocket expenses)

Retirement Age	Employer-based health care benefits & premium subsidy	No Employer-based health care benefits Medicare, Medigap & Part D; ranges based on drug expenses
Man age 65 today	\$125,000	\$124,000-\$187,000
Woman age 65 today	\$143,000	\$152,000-\$213,000
Couple age 65 today	\$262,000	\$271,000-\$391,000
Man age 65 in 2020	\$210,000	\$208,000-\$313,000
Woman age 65 in 2020	\$240,000	\$255,000-\$337,000
<b>Couple age 65 in 2020</b>	<b>\$439,000</b>	<b>\$454,000-\$655,000</b>

Source: EBRI Issue Brief, December 2010

## Maintenance Costs

Much like your car or home, your retirement portfolio requires maintenance fees to keep it running smoothly. However, what many retirees don't realize is that even small differences in fees can translate into large differences in returns over time.

For example, mutual funds have come under fire for earning their money managers exorbitant salaries by not passing through the investment returns through to the investor.

## Average Mutual Fund Return vs. Index Return 20-year Annualized Returns Ending 12/31/2009

To translate fees into a monetary example, say you invested \$100,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%. After 20 years, you would have roughly \$497,254. If the fund had expenses of only 0.5%, then you would end up with \$608,577.

While annuities are often criticized for their administrative and surrender fees, the fact is that all investments charge some form of fee. What is just as important as how much you are charged is what you receive in return.

### Typically, annuity fees are levied for two reasons:

- **Mortality & Expense Fee (M&E)** - this fee pays for the management, sales commissions, administrative expenses and insurance guarantees—including death benefits and income payouts for life. The M&E expense fee may be avoided based on the annuity selected.
- **Surrender Fee** – in order for the insurance company to be able to payout annuity benefits to policyholders, it invests the purchase premium received in exchange for the contract. Just like any investment, this invested money needs time to accumulate earnings. If policyholders withdraw money prematurely, the base investment fluctuates and can reduce the amount of money available to pay out eventual income benefits to remaining policyholders. That's why some annuities charge surrender fees—the shorter the amount of time you give the insurer to invest your money, the more you have to pay in a penalty fee. Over time, surrender charges typically reduce to zero.

Bear in mind that the cost of an annuity may present a good value for the benefits you receive. In the case of guaranteed income benefits, note that because an annuity is not considered an investment, you're not paying a fee for a guaranteed performance return—you're paying for the guaranteed income stream in retirement. Ultimately, it's the insurance company that bears the risk of market volatility.

*Widowhood of 15 years or more is not uncommon. For many women, their husband's death is often accompanied by a decline in standard of living.*

Source: SOA; 2009 Risks and Process of Retirement Survey Report

*Surprise! The returns reported by mutual funds aren't actually earned by mutual fund investors.*

- Little Book of Common Sense Investing (2007) by John C. Bogle, author, founder and retired CEO of The Vanguard Group

## High Mileage: Life Expectancy

The longer you live, the greater your chance of running out of money. If you start withdrawing retirement income too early, withdraw too high a percentage, or don't invest enough for growth potential, you may spend down your principal too soon.

If you're married, your ability to plan adequately may be even more complex. You may need long-term income for two people, for one person, for one spouse with a long expensive illness and one spouse who simply lives to a very old age and any number of other scenarios.

Even more difficult to plan for is the volatility of the market. The longer you live, the more likely you are to experience additional market and economic ups and downs. The accompanying table illustrates just how often dips, corrections and bear markets occur.

### Actual Stock Market Declines Since 1900

DIPS (5% OR MORE)	CORRECTIONS (10% OR MORE)	BEAR MARKETS (20% OR MORE)
358 times	117 times	31 times
3.3 per year	1.1 per year	1 every 3-4 years

*Source: Ibbotson and Associates, 2008 Stocks Bonds and Inflation Yearbook.  
Past performance is no indication of future performance or value.*

The following examples demonstrate how a retirement portfolio may be impacted both before retirement—when you're trying to accumulate assets—and after retirement when you are actually withdrawing assets.

### Value of \$100,000 during a hypothetical 3-year market decline

YEAR	MARKET RETURN	YEAR-END VALUE
2000	-6.17%	\$93,830
2001	-5.35%	\$88,810
2002	-16.76%	\$73,926

If you are withdrawing assets while the market is declining, this may reduce your opportunity to recoup losses when the market recovers.

### Value of \$100,000 with 5% annual withdrawals during a hypothetical 3-year market decline

YEAR	MARKET RETURN	5% WITHDRAWAL AT YEAR START	YEAR-END VALUE
2000	-6.17%	\$5,000	\$89,139
2001	-5.35%	\$4,457	\$80,151
2002	-16.76%	\$4,008	\$63,382

Not only does a market decline during retirement reduce your opportunity to reasonably earn back the depreciated assets, but if you are withdrawing income from your principal instead of receiving insured payouts, the retirement income you receive—and quite possibly the subsequent lifestyle you enjoy—may also decline.

## Unstable Ride: Market Volatility

Historically, stock and bond markets have moved out of tandem, so that whenever one market dropped, the other was typically performing well. This allowed a diversified investment portfolio to always be able to tap growth potential somewhere to some degree, while also offering downside protection through more conservative holdings. Globally, the same was true. When domestic markets faltered, there was always growth somewhere overseas and vice versa.

The markets and economy will recover; they always do. However, given a shorter investment timeframe and the fact that the new global economy has investments moving in tandem—rendering a diversified portfolio less effective—you may wish to consider positioning your retirement portfolio for growth and secure income sources.

One thing to consider is incorporating financial vehicles that offer growth potential to help meet the challenges of a long life and the impact of long-term inflation on cost of living expenses and health care, but also sources of guaranteed income to ensure that daily essential living expenses will always be met.

### Market Recoveries

- 3 years after the October 1987 market crash, the market had a cumulative return of 71.5%.

—Morningstar, Downturns and Recoveries, 2009

## Your Three-Point Turn

As mentioned in the preface, one of the truths of using an annuity in a retirement portfolio is that you should not put all of your nest egg in one annuity basket. That's because annuities are designed to be long-term income accumulation and/or distribution vehicles.

However, you have to live in the here and now, so you need to have income for today, a plan for retirement income for tomorrow and a plan for emergency income at any time. This means that throughout retirement, you should not have all of your assets tied up in an annuity. It is advisable to have a financial resource that you may tap immediately should you need to put your hands on cash in a hurry.

In fact, one way to allocate assets to meet all of your retirement income needs is to place them into the following categories:

**Emergency Assistance | Standard Essentials | Discretionary Options**

### Emergency Assistance

An emergency constitutes an immediate financial need, ranging from out-of-pocket expenses for medical care to losing your job. Many financial experts suggest an emergency fund of three to six months of expenses. One thing to consider is placing your emergency funds in a safe or conservative financial vehicle, such as a savings or money market account or Certificate of Deposit.

### Standard Essentials

Essential expenses tend to be constant from month to month, such as food, clothing, rent or mortgage payment, utilities, basic transportation, medical insurance and health care expenses. These represent more than 86% of income for people age 65 and older, according to the 2009 U.S. Bureau of Labor Statistics Consumer Expenditures Survey.

## Discretionary Options

The amount of discretionary income you have in retirement will depend upon how well you've provided for your essentials. Discretionary income is generally used to pay for a new car, entertainment, vacations and travel, hobbies and recreation.

But remember, no matter the amount of income you plan on having when you retire, you will inevitably need more as time goes on. As a result of long-term inflation, if you had retired back in 1976 on \$30,000 a year, your annual income would be worth only \$8,415 today. (Source: [http://inflationdata.com/Inflation/Consumer\\_Price\\_Index/HistoricalCPI.aspx](http://inflationdata.com/Inflation/Consumer_Price_Index/HistoricalCPI.aspx))

One retirement strategy is to ensure that all of your essential living expenses in retirement will be covered by guaranteed income sources such as Social Security, employer pensions and annuities.

For more discretionary retirement expenses, consider your risk tolerance for allocating a portion of your retirement assets to unsecured investments.

Professor David F. Babbel and Professor Craig B. Merrill of the Wharton Financial Institutions Center are leading academics in the area of retirement income planning. In their paper, *Investing your Lump Sum at Retirement* (2007), they state that:

*"By covering at least basic expenses with lifetime income annuities, retirees are able to focus on discretionary funds as a source for enjoyment. Locking in basic expenses also means that the retiree's discretionary funds can remain invested in equities for a longer period of time, bringing the benefits of historically higher returns that can stretch the useful life of those funds even further. Income annuities may also be a vehicle that enables retirees to delay taking Social Security benefits until they are fully vested, bringing substantially higher payments at that point.*

*The key in all of this is to begin by covering all of the basic living expenses with lifetime income annuities. Then, to provide for additional desirable consumption levels, you will want to annuitize a goodly portion of the remainder of your assets, while making provisions for extra emergency expenses and, if desired, a bequest. These last two items can be accomplished through combinations of insurance and savings."*

In other words, if you cover your basic expenses with money received from guaranteed streams of income:

- You have the freedom to use the rest of your money as you wish
- You no longer have to worry about outliving your money in retirement
- You are able to enjoy your discretionary funds

This strategy also enables you to avoid fluctuations in the stock market or in any other place where your money is invested since you'll be able to move those investments when it is most advantageous for you to do so rather than when it is necessary based on your need for income. This allows you to maximize the use of your resources and do what you want with the rest of your nest egg.

## Performance & Safety

On one hand, the long-term rising cost of living can reduce the buying power of a fixed income, but on the other hand, market volatility can dramatically impact the performance of your retirement portfolio. So what is the best solution to safeguard your retirement assets and invest for growth so your money can last your lifetime?

In today's market, an annuity is the only personal financial vehicle that can offer you both growth potential and the security of guaranteed income payments.

In 2008, MassMutual Financial Group released an updated study showing a portfolio incorporating stocks, bonds and incremental purchases of annuity income benefits over time—a process called retirement annuity laddering—produces more guaranteed lifetime income, develops more liquidity to address other retirement needs and builds more long-term wealth than other commonly adopted retirement income strategies.

The study, which tested four strategies for managing a retirement income account over 181 time periods (referred to as cases) between 1965 and 2006, found that the three strategies involving an income annuity, whether purchased all at once or over time, generally outperformed the stock and bond-only strategy, regardless of market conditions in the periods studied. In fact, the investment-only approach—even during strong equity and bond markets—ran out of money in 25 percent of cases. In contrast, the strategy of laddering into a life annuity matched the income goal in 100 percent of the cases tested.

While the stock- and bond-only strategy preserved the original deposit at the end of each period tested in just 45 percent of the cases, the laddered life annuity strategy preserved the original deposit in 93 percent of the cases.

- For the 45 percent of the cases in which the stock- and bond-only strategy preserved the original deposit, the average liquid value of the laddered life annuity strategy was 66 percent higher.
- In every case, the laddered life annuity strategy matched the income of a life and 20-year certain annuity (which offered no liquidity) utilizing 100 percent of the deposit, and on average, more than tripled the original deposit at the end of the period.
- In contrast to a strategy of living off interest and preserving the original deposit, the laddered life annuity strategy matched the income in every case and, on average, resulted in more than five times the original deposit.

Moreover, the study found that retirement annuity laddering was the most effective strategy of those studied regardless of market conditions, topping the performance of other strategies during both good and bad markets.

*Source: MassMutual Finance Group, Study of Retirement Income Account Allocation Among Equities, Bonds, and Fixed Income Annuities (updated May 2008).*

*Incorporating a fixed income annuity in a retirement income account yielded greater long-term wealth for an investor—along with more income security—than a portfolio of equity and bond investments alone, even in an 'up' market.*

Source: MassMutual Financial Group, Study of Retirement Income Account Allocation Among Equities, Bonds, and Fixed Income Annuities (updated May 2008).

# Annuity Models

In the past, retirees could typically count on three sources of retirement income that divided roughly into thirds:

With this traditional scenario, both the government and employer-sponsored components of the plan were considered “fixed”—guaranteed income sources with adjustments for inflation. Only one-third of the plan, individual savings, was considered variable.

Today, however, the majority of the burden for retirement income has shifted to the individual. That’s because Social Security is continually being re-evaluated and benefits are being scaled back. Employer-sponsored plans have evolved from guaranteed pension payouts to more defined contribution plans—which result in a payout in retirement based upon level of participation and long-term market performance.

You may want to consider a guaranteed fixed income component to your retirement plan. In short, adding an annuity to your retirement portfolio may be an opportunity to help ensure a portion of your retirement income will be guaranteed.

An annuity is a contract you purchase from an insurance company. For the premium you pay, you receive certain fixed and/or variable growth options able to compound tax deferred until withdrawn. When you are ready to receive income distributions, this vehicle offers a variety of guaranteed payout options through a process known as “annuitization.”

Most annuities have provisions that allow you to withdraw a percentage of earnings each year up to a certain limit. However, withdrawals can reduce the value of the death benefit and excess withdrawals above the restricted limit may incur “surrender charges” within the first three to ten years of the contract.

Because they are designed as a long-term retirement income vehicle, annuity withdrawals made before age 59½ are subject to a 10% penalty fee and all withdrawals may be subject to income taxes.

## The Annuity Inventory

- **Deluxe Model: Variable Annuity**
- **Drive Off the Lot: Immediate Annuity**
- **Safety Rated: Fixed Annuity**
- **Hybrid: Fixed Indexed Annuity**

## Deluxe Model: Variable Annuity

A Variable Annuity is comprised of professionally managed portfolios that vary in both investment objectives and representative holdings. You may allocate your purchase payments across any number of these portfolios in whatever percentage you choose, with regard for your financial objectives and tolerance for market risk. Taxes on earnings from these portfolios are not due until distributed, and you may transfer assets between portfolios without having to pay taxes on gains.

However, because these various portfolios are managed by professional money managers, the fees you pay for each portfolio, combined with the overall M&E and administrative fees, have the potential to be quite high.

Many variable annuities also offer optional riders guaranteeing minimum annual income for a specific number of years or even for life, available for an additional fee. Annuities with optional income riders tend to have fees commensurate with the additional risks as underwritten by the issuing insurer.

### Optional Variable Annuity Income Riders:

- **Guaranteed Minimum Income Benefit (GMIB)** - guarantees you a minimum income stream.
- **Guaranteed Minimum Accumulation Benefit (GMAB)** - guarantees that your account value will accumulate to a certain amount at a specific date in the future.
- **Guaranteed Minimum Withdrawal Benefit (GMWB)** - guarantees you a minimum income stream without having to annuitize the contract.

## Drive Off the Lot: Immediate Annuity

With an Immediate Annuity, you use a lump sum of money to purchase a contract from an insurance company in return for a guaranteed series of payouts. This stream of income is guaranteed for a specified period of time or for the rest of your (and even your spouse's) life—no matter how long you live. The amount of the payout is based on several factors:

- How much money you use to buy the contract
- The interest rate environment at the time you purchase the contract
- The payout option you select (typically at issue)
- Your life expectancy—based on current age and gender
- The date you select for your first payment (within one year of issue date)
- Any additional features you choose

Immediate Annuity income payouts may be either level or increasing periodic payments for a fixed term of years or until the end of your life, whichever is longer. While an Immediate Annuity can provide reliable income to help cover fixed living expenses, it does not offer substantial potential for growth.

Your income payouts will be taxed at ordinary income tax rates rather than the lower capital gains rates.

One thing to take into consideration with an Immediate Annuity is because there is no accumulation phase; you must annuitize immediately to receive income distributions. Once you annuitize with the Life Only option, you forfeit access to your assets. When you die, all of your money that could have been left to your heirs is forfeited to the insurance company.

### **Safety Rated: Fixed Annuity**

A fixed annuity provides a guaranteed interest rate for a specific number of years in order to protect you from market fluctuations. Fixed annuities offer fixed interest rate periods over 1, 3, 5, 7 or 10 years, as well as a variety of annuitization payout options—including the option for guaranteed income for life.

The Fixed Annuity can help you conservatively accumulate assets to help cover fixed living expenses in retirement, but it does not offer substantial potential for growth.

### **Hybrid: Fixed Indexed Annuity**

The Fixed Indexed Annuity combines a guaranteed minimum interest rate plus market participation for the opportunity for greater earnings. At the end of each contract year, the insurance company measures the growth of the linked index over the previous 12 months and then credits your contract value with that growth, up to a predetermined cap. It may be an annual cap, a monthly cap or a percentage of the growth of the index.

Because the Fixed Indexed Annuity is linked to an unmanaged index, it tends to have lower administrative fees than a variable annuity.

With a Fixed Indexed Annuity, the contract issuer may credit your account value with a guaranteed minimum rate of return on your premium, plus the potential for additional gains linked to the performance of a specific market index—usually the S&P 500. Some Fixed Indexed Annuities allow you to withdraw earnings without penalty up to a certain amount each year. However, be aware that excess withdrawals may incur surrender fees and may also void the credit from the index-linked return.

Typically, a Fixed Indexed Annuity's index-linked interest rate is computed based on one of three methods:

- **Participation Rate.** If the insurance company sets the participation rate at 80%, your Fixed Indexed Annuity will be credited with 80% of the return rate experienced by the linked index.
- **Spread.** This is the return rate of the linked index minus a percentage. For example, if the index gained 8% and the spread/margin/asset fee is 2%, then the annuity would be credited 6%.
- **Interest Rate Cap.** Some Fixed Indexed Annuities allow you to benefit fully from index gains up to a specific percentage cap. This is the maximum growth percentage the annuity may earn.

A Fixed Indexed Annuity is designed to work in any type of market environment. Whether up, down, or flat, the Fixed Indexed Annuity provides downside protection and the potential for gains linked to the performance of a market index. As long as you abide by the terms of the contract, your principal is guaranteed against market loss from day one, and your interest gains lock in each year on your contract anniversary and cannot be taken away in a future market downturn.

*If you do not want to take any risks but still want to play the stock market, a good index annuity may be right for you.*

- The Road to Wealth Revised (2010) by Suze Orman, financial author & TV host

## Insurance Coverage

### Death Benefits

With a death benefit, should you die before you begin receiving annuity income, your beneficiary(s) will receive the amount of your original purchase payments, less any previous withdrawals. Enhanced death benefit options, available for an additional fee, may pay out the amount of the contract value upon your death or a higher previous contract value (*subject to certain guidelines*).

Should you die after annuity payouts have begun, your named beneficiary will receive any remaining annuity distributions due to you, based on the annuitization option you selected.

### Annuitization

Annuitization is the process of converting the account value of an annuity into a series of guaranteed periodic income payments, such as monthly or annual payments.

### Guarantees

Because an annuity is issued and backed by an insurance company, all guarantees related to fixed account rates, annuitization payouts and death benefits are based on the claims-paying ability of the issuing company.

# Owner's Manual

## Contract Structure

How you structure your annuity will affect its income payouts and death benefits. The following are all the participating entities involved in an annuity contract.

- **Insurance Company** – issues the contract, provides contract information, ensures money is invested as instructed by the owner and is responsible for all payout guarantees.
- **Owner** – purchases the annuity and makes all decisions regarding allocations, income distributions, annuitants and beneficiaries.
- **Annuitant** – typically the same person as the owner; annuity income payouts are based upon the life expectancy of the named annuitant (who generally must be younger than age 85 at the time the contract is issued).
- **Beneficiary** – to avoid probate, you should name a beneficiary (person, charity or trust) to receive benefits upon your death. The owner may change the beneficiary at any time.

## Company Ratings

An important consideration when purchasing an annuity is the strength of the issuing insurance company. Factors such as the size of the company, the length of time it has been in business and its investment profile are all considerations that you should carefully discuss and research with your financial advisor. There are a number of independent agencies that rate the financial strength of insurance companies. The most well-known of these companies is A.M. Best, which rates companies much like a teacher grades students from an A++ down to an F.

# Test Drive The Fixed Indexed Annuity

In 2003 The Advantage Group, a nationally-recognized annuity research group, published a study demonstrating how a Fixed Indexed Annuity would have performed during the very turbulent five-year period from September 30, 1998 to September 30, 2003. The study examined the performance of the mere (14) Fixed Indexed Annuities that were available in 1998 and averaged their credited interest over that time frame.

Fixed Indexed Annuities that reset annually averaged 35.67% in interest credited over the five-year period, resulting in a return of more than 7% per year. This was during a period of time in which many retirees lost large sums of money.

## How to Take Advantage of a “Trade-in”

In recent years, annuities have evolved into more effective retirement planning vehicles than in the past. Therefore, you may currently own an annuity contract that may be less effective for accomplishing your goals than newer annuity contracts on the market today.

If you and your financial advisor determine you would be better suited to “trade in” a current annuity contract for a different one, this is called a “1035 Exchange,” named after Section 1035 of the Internal Revenue Code. The IRS allows you to exchange an insurance contract that you own for a new life insurance or annuity contract without paying tax on the income and investment gains earned on the original contract.

However, you should be aware of the following requirements involved with making a 1035 Exchange:

- The old insurance contract must be directly exchanged for a new contract—you may not receive a check and apply the proceeds to the purchase of a new insurance or annuity contract.
- You may make a tax-free exchange in only the following situations:
  - From a life insurance contract to another life insurance contract
  - From a life insurance contract to an annuity contract
  - From one annuity contract to another annuity contract.
- You may not exchange an annuity contract for a life insurance contract.

### Considerations Regarding a 1035 Exchange:

- While surrender charges eventually expire on an existing contract, be aware that a new surrender charge period may be imposed when you trade in an old contract for new contract, or may increase the period of time for which the surrender charge applies.
- You may have to pay higher annual fees for the new contract.

*The bottom line is that Indexed Annuities went through a baptism by fire during this period and all performed as they were designed to do...Indexed Annuities have proven they offer safety in bad times and extraordinary potential in good.*

- Jack Marrion, CEO of The Advantage Group, <http://www.ain-services.com/articles/eiareturns.pdf>

- Some insurance companies assess a sales charge when a contract is exchanged to repay the company for the commission paid to the person who sold the contract to you. This charge will depend on the language of your contract and may range from 6% to 10%, reduced over the time you kept the original contract. In other words, if 5% remains on the penalty, an account value of \$100,000 would be reduced to \$95,000 upon exchange.

## Conclusion

Brokers or insurance agents recommending an annuity 1035 Exchange are required to inform you of the pros and cons of the exchange. Your financial professional should make a recommendation only if it is in your best interest and only after evaluating your personal and financial situation, needs, tolerance for risk and ability to pay for the new contract.

So how do you know if an income annuity is right for you?

- Are you retired or nearing retirement?
- Do you currently have a retirement income plan in place?
- Do you have guaranteed income streams or are you working with defined contribution plans, such as a 401(K) or IRA?

If you do not currently have guaranteed income streams to cover your basic expenses in retirement, you may want to consider supplementing your portfolio with an income annuity to help offset the risk of outliving your money.

**Now that's the proper way to utilize an annuity in a retirement income portfolio!**



# ANNUITY OWNER MANUAL

