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FINANCIAL

Annuities 101

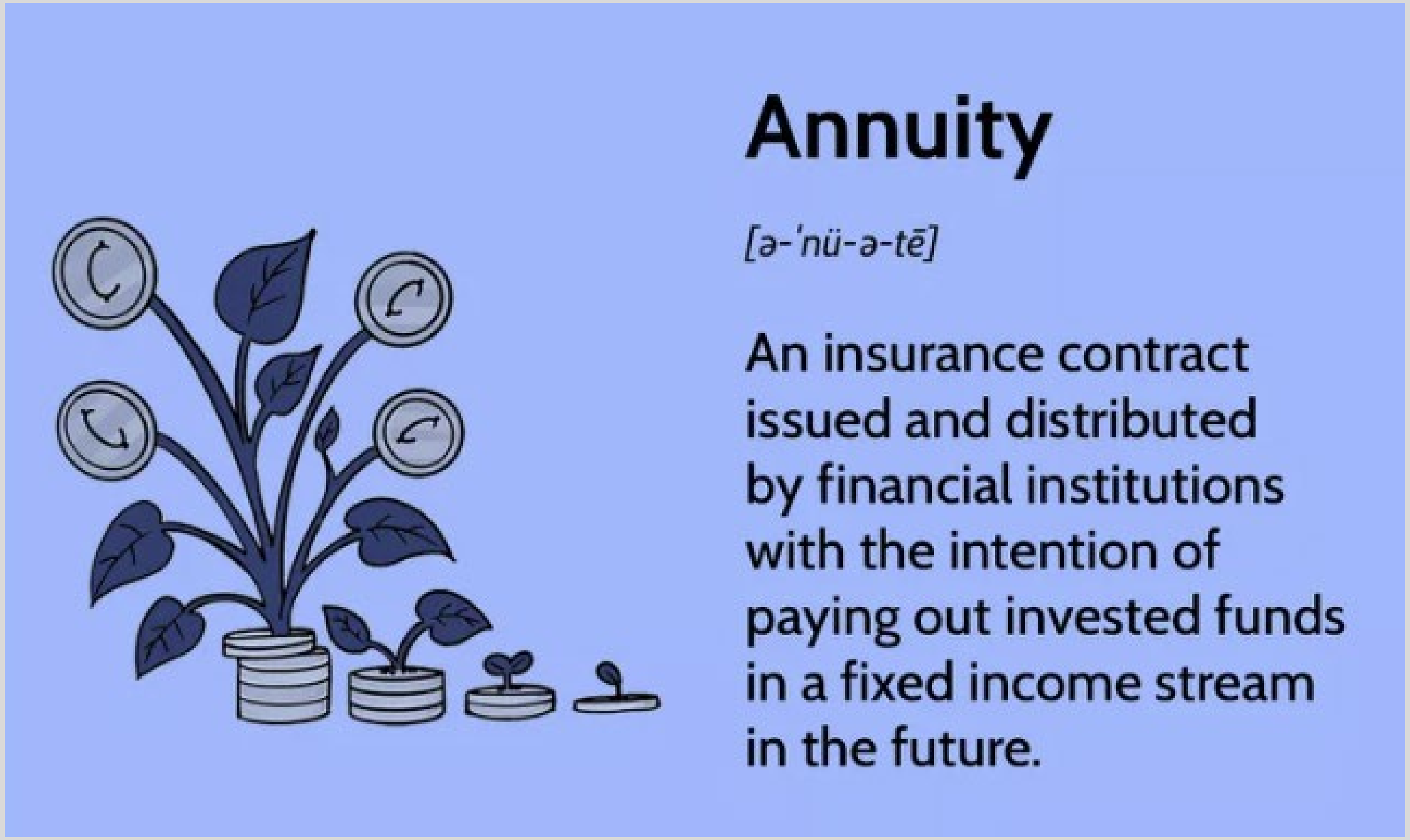
Understanding The Basics of Annuities

The best ideas make a difference

The best people make things happen

The best technology makes you efficient

What is an Annuity?



Key Takeaways

- Annuities are financial products that offer a guaranteed income stream
- Annuities can be structured into various types of instruments, giving investors flexibility.
- An annuity can be categorized as immediate or deferred, and fixed, variable, or indexed.
- The accumulation phase is the first stage of an annuity during which investors fund the product with a lump-sum payment or periodic payments.
- The annuitant begins receiving payments after the annuitization period for a fixed period or the rest of their life.

Purpose of an Annuity

Annuities are designed to provide a steady cash flow for people during their retirement years to alleviate the fear of outliving their assets. These assets may not be enough to sustain their standard of living, however, so some investors may turn to an insurance company or other financial institution to purchase an annuity contract.

These financial products are appropriate for investors, who want stable, guaranteed retirement income. Invested cash is illiquid and subject to withdrawal penalties so it's generally not recommended that those individuals with liquidity needs use this financial product.

Which Clients Might Need an Annuity?

Annuities are most commonly considered alongside a retirement savings strategy, since they may provide guaranteed income for individuals who are preparing to leave work behind for good. If you have clients in one or more of the following situations, an annuity could be a good fit.

- Saving for Retirement
    - If already contributing the maximum to other retirement plans, like an IRA or 401(k), an annuity can be an attractive retirement planning option that grows tax-deferred.
- Don’t need the money soon
    - Client does not anticipate needing money from savings prior to turning 59½.
- Worried they might outlive their savings
    - Annuities can provide guaranteed income for the rest of your client’s life, whether they live to be 100 or even 120.
- Leaving a legacy
    - With an annuity, client’s can provide their loved ones with a death benefit in the event of thier death.

Phases of an Annuity

An annuity has different phases:

- **Accumulation Phase** - period when an annuity is being funded and before payouts begin and the money invested grows on a tax-deferred basis.

- **Annuitization Phase** – Payout phase which kicks in after payments to the investor begin.

Immediate vs. Deferred

Annuities can be immediate or deferred.

- **Immediate annuities** are often purchased by individuals of any age who have a large lump sum of money and prefer to exchange that money for cash flows into the future.

- **Deferred annuities** are structured to grow on a tax-deferred basis and provide annuitants with guaranteed income that begins on a date they specify.

Fixed, Variable, and Indexed Annuities

Annuities can be structured generally as fixed, variable, or indexed:

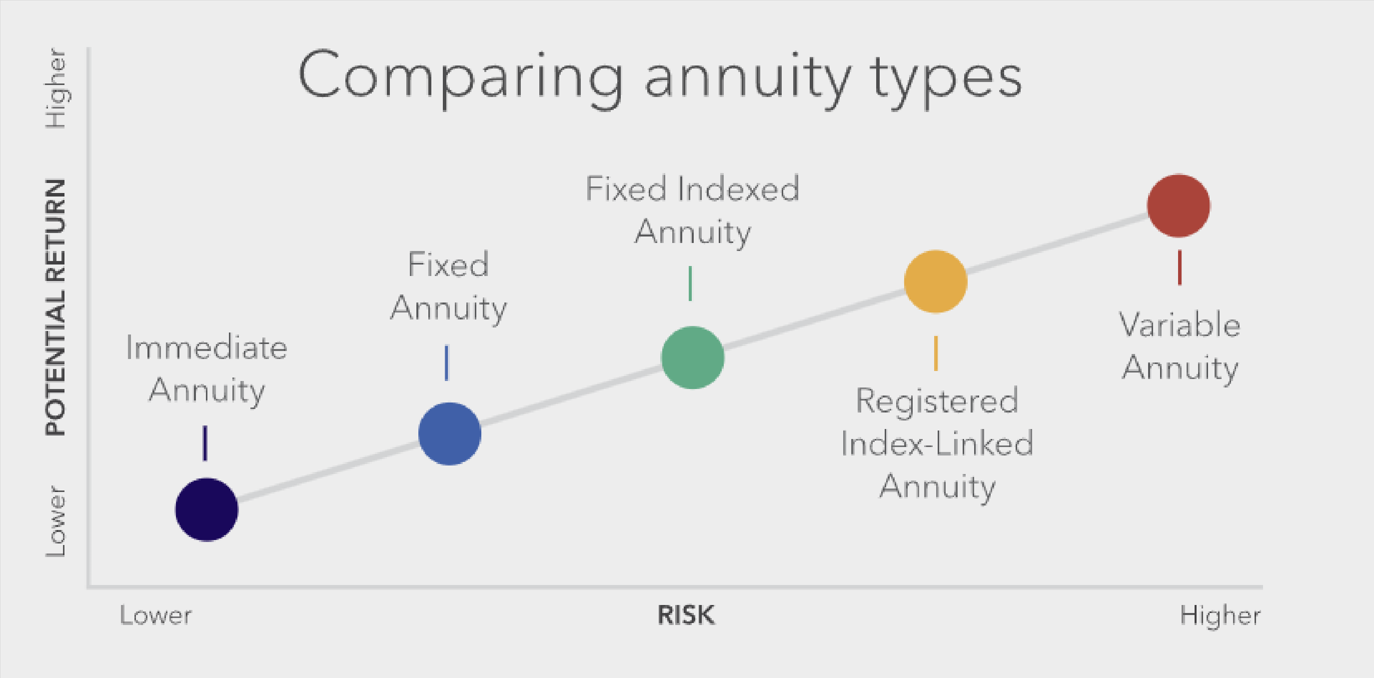
- **Fixed Annuities** - provide a guaranteed minimum rate of interest and fixed periodic payments to the annuitant.

- **Variable Annuities** - allow the owner to receive larger future payments if investments held in the annuity fund do well or smaller payments if its investments do poorly. They provide less stable cash flow than a fixed annuity but they allow the annuitant to reap the benefits of strong returns from their fund's investments.

- **Indexed Annuities -** fixed annuities that provide a return based on the performance of an equity index such as the S&P 500 index.

Different Types of Annuities

Annuities come in different types to help meet different needs. One of the ways they vary is by the amount of potential risk and return. Immediate annuities have less risk and lower return because they simply convert an amount of money into a guaranteed stream of income. The annuities with increasing risk and return are generally used to accumulate money over time. Because they don’t provide immediate income, they are known as deferred annuities.



Surrender Period and Withdrawals

Annuities have a surrender period in which annuitants can’t take withdrawals during this time without paying a surrender charge or fee.

- Investors should consider their financial requirements during this time. It might be a good idea to evaluate whether they can afford to make the requisite annuity deposits if a major upcoming event is going to require significant amounts of cash.

- Many annuity products allow recipients to withdraw up to 10% of their account value without paying a surrender fee but may end up paying a penalty if withdrawing more than that.

- Tax implications can also arise for withdrawals made before age 59½.

Income Riders

Some annuity contracts also have income riders that ensure a fixed income after the annuity kicks in.

You should ask two questions when your clients consider income riders.

1) At what age do they need the income?
    - The payment terms and interest rates may vary depending on the duration of the annuity.

2) What are the fees associated with the income rider?
    - Some products offer them free of charge but most have fees associated with this rider.

- Individuals who invest in annuities can't outlive their income stream and this hedges longevity risk. The product is appropriate provided that the purchaser understands that they're trading a liquid lump sum for a guaranteed series of cash flows.

- Some purchasers hope to cash out an annuity in the future at a profit but this isn't the intended use of the product with an income rider.

- **Qualified vs Non-Qualified Annuity**

Annuities can be purchased with either pre-tax or after-tax dollars.

- A non-qualified annuity is one that's purchased with after-tax dollars.
  - Only the earnings and not the contributions of a non-qualified annuity are taxed at the time of withdrawal because the contributions represent after-tax money.

- A qualified annuity has been purchased with pre-tax dollars. Qualified plans include IRA, 401(k), 403(b) plans.
  - Withdrawals from qualified annuities will be fully taxed at the time of withdrawal since they have never been taxed.
  - Required Minimum Distributions (RMD) have to be taken once the client reaches age 73.

Questions?

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