Fixed and Indexed Annuity Basics

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What role do annuities fill in a portfolio?

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What Role Do Annuities Fill In A Portfolio?

PROTECTION

- Market Risk – Partial or full protection against a significant drop in equities
- Portfolio Decline – Guaranteed income payments v. withdrawals from a volatile portfolio
- Longevity Risk – Income payments for life v. living beyond your retirement savings

TAX EFFICIENCY

Accumulation of assets through tax deferral.

INCOME

Guaranteed, for life.

FIND THE RIGHT ONE

While annuities can meet many financial needs, they work best if you pick the appropriate annuity type for a specific investment objective

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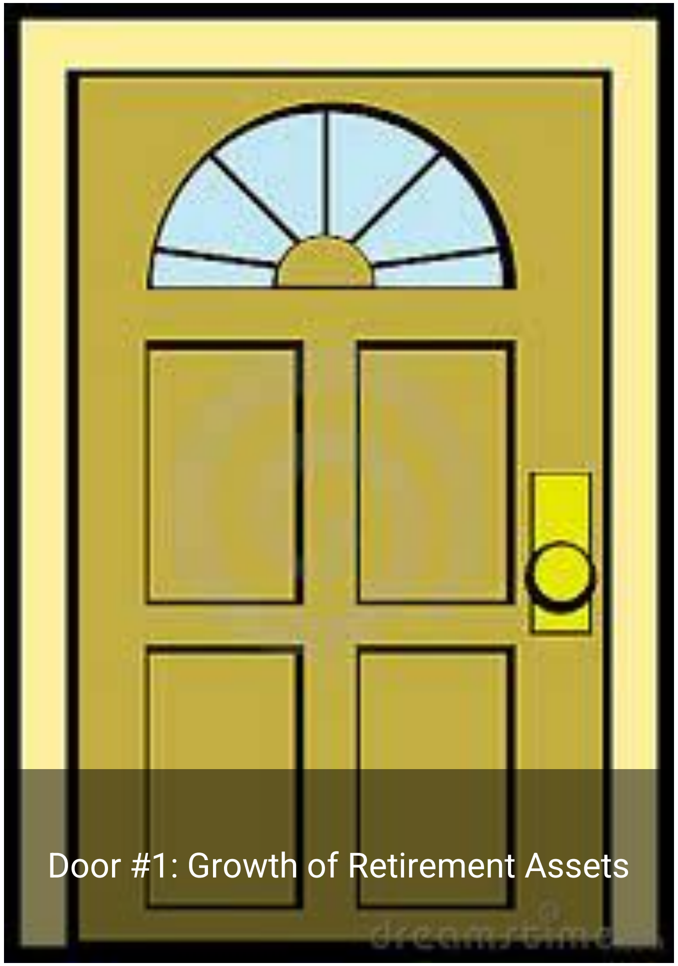
The First Question You Should Ask

First Question: Is My Primary Goal Growth or Income?



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Door #1:
Accumulation of Assets

Second Question: How Much Downside Risk Are You Willing to Take?

- Fixed and indexed annuities provide very limited downside protection and very limited returns
- Structured annuities, also known as RILAs (registered indexed linked annuities) provide some downside protection with partial participation in equity returns
- Variable annuities do not provide downside protection but also fully participate in equity returns

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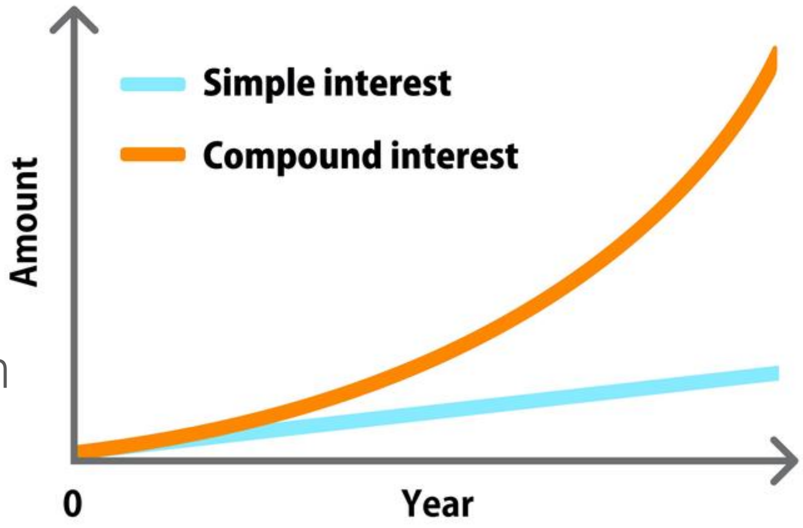
All Deferred Annuities Grow Tax Deferred

- Annuities, like IRAs, are not taxed until money is withdrawn from the contract and received by the policyholder
- Provides 3 types of interest:
  - Interest on original invested amount (principal)
  - Interest on the interest that is credited each year
  - Interest on the money that would have been paid in taxes had it been invested in a taxable investment (such as a CD or mutual fund)



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What is a Fixed Annuity?

- The insurance industry's version of a Certificate of Deposit
  - The insurance company guarantees a specific rate of return—typically for one to five years
- Typical fixed annuity rates today:
  - 2.25% for 3 years
  - 2.75% for 5 years
- Comparable CD rates would be 0.75% for 3 years or 1.0% for 5 years
- It is not uncommon for fixed annuities to pay 1–1.5% more than comparable CDs

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Two Primary Structures of Fixed Annuities

- Traditional fixed annuity that guarantees a rate for 1–3 years, but carries an early withdrawal period (surrender charge) of 7–10 years
  - If interest rates rise, renewal rates can rise with them…or not
  - Make sure you are comfortable with the insurance company's renewal rate history
- Multi-Year Guaranteed Annuities (MYGAs)
  - Will guarantee a rate for 3, 5, or 7 years
  - Early withdrawal period ends at the same time as the interest rate guarantee
  - Provides the certainty of how much money you will have at the end of the guarantee period
  - Like a CD, when the rate ends, you can accept the new interest rate or move to another annuity

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Who is the Typical Fixed Annuity Buyer?

- Does not want to put their money at risk
- Wants to know how much interest they will earn
- 63–65 years old
- Has money that they are confident they won’t need for 3–7 years
- Average purchase size is about $120,000
- Wants to minimize their current tax liability

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Considerations Before Buying a Fixed Annuity

- Should be willing to own the annuity for the entirely of the surrender charge period, which could be 10+ years, in order to avoid early withdrawal charges and get the full benefits of tax deferral
- Penalties for getting out early can be substantial. In addition, withdrawals prior to the age of 59½ will carry an additional 10% tax penalty
- The guarantee of principal and interest is only as good as the underlying insurance company—there is no FDIC insurance

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What is an Indexed Annuity?

- An indexed annuity is just another type of fixed annuity *—it is not an equity substitute*
- Rather than declare a specific rate of interest in advance, the amount of interest credited is linked to the change in the price of a stock index such as the S&P 500
- If the price of the index falls during the selected period of time, the client earns 0% for that period of time
- Because of the downside protection it provides, any positive returns are always capped/limited in some way

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The 3 Decisions of Any Indexed Annuity

The Choice Is Yours…

Pick an Index:

S&P, Russell 2000, etc.

Pick a time period:

1–3 years (typical), 3–5 years, or 5–7 years

Pick a crediting method:

Cap Rate (Point-to-Point), Participation Rate, Performance Trigger

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Cap Rate (Point-to-Point)

Step 1	Compare the price of the selected index from the date the money is invested to the price on the day at the end of the selected time period (from one point to another)
Step 2	If the index price is higher, interest is credited. If it is lower, no interest is earned, but the value of the amount invested does not decline The interest % credited is equal to the % change in the index up to the declared cap

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Indexed Annuity Example–Cap Rate (Point-to-Point)

- **Index Increases:**
  - $100,000 deposited into a 1-year point-to-point on the S&P 500 with a Cap = 4%
  - Index price on purchase date = 4,000
  - Index one year later = 4,400
    - Index up 10%, interest earned = 4% given the Cap
    - New account value = $104,000
- **Index Decreases:**
  - Index price one year later = 3,500
    - Index down 12.5%, interest earned = 0% given the protection
    - Account Value remains at $100,000

Note: Dividends are not included in determining any interest that is due

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Cap Rate (Point-to-Point)

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Participation Rate (Point-to-Point)

- Interest credited equals a specific % of the change in the price of the index
  - There is no cap
- Example:
  - $100,000 deposited into a 1-year point to point on the S&P 500 with a participation rate of 30%
  - Index price on purchase date = 4,000
  - Index one year later = 4,400
  - Index up 10%, interest earned = 30% (Par Rate) of 10%, or 3%
  - New account value = $103,000

This method provides higher returns in periods of strong market growth but will provide lower returns when the market is only marginally higher

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Participation Rate (Point-to-Point)

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Performance Trigger (Point-to-Point)

- Interest credited at a specific rate ifthe index is at or above a specified level, typically its initial level
- Example:
  - $100,000 deposited into a 1 year point to point on the S&P 500 with a performance trigger of 3.5%
  - Index price on purchase date = 4,000
  - Index one year later = 4,000 or higher
  - Index at or above its initial level, interest earned = 3.5
  - New account value = $103,500

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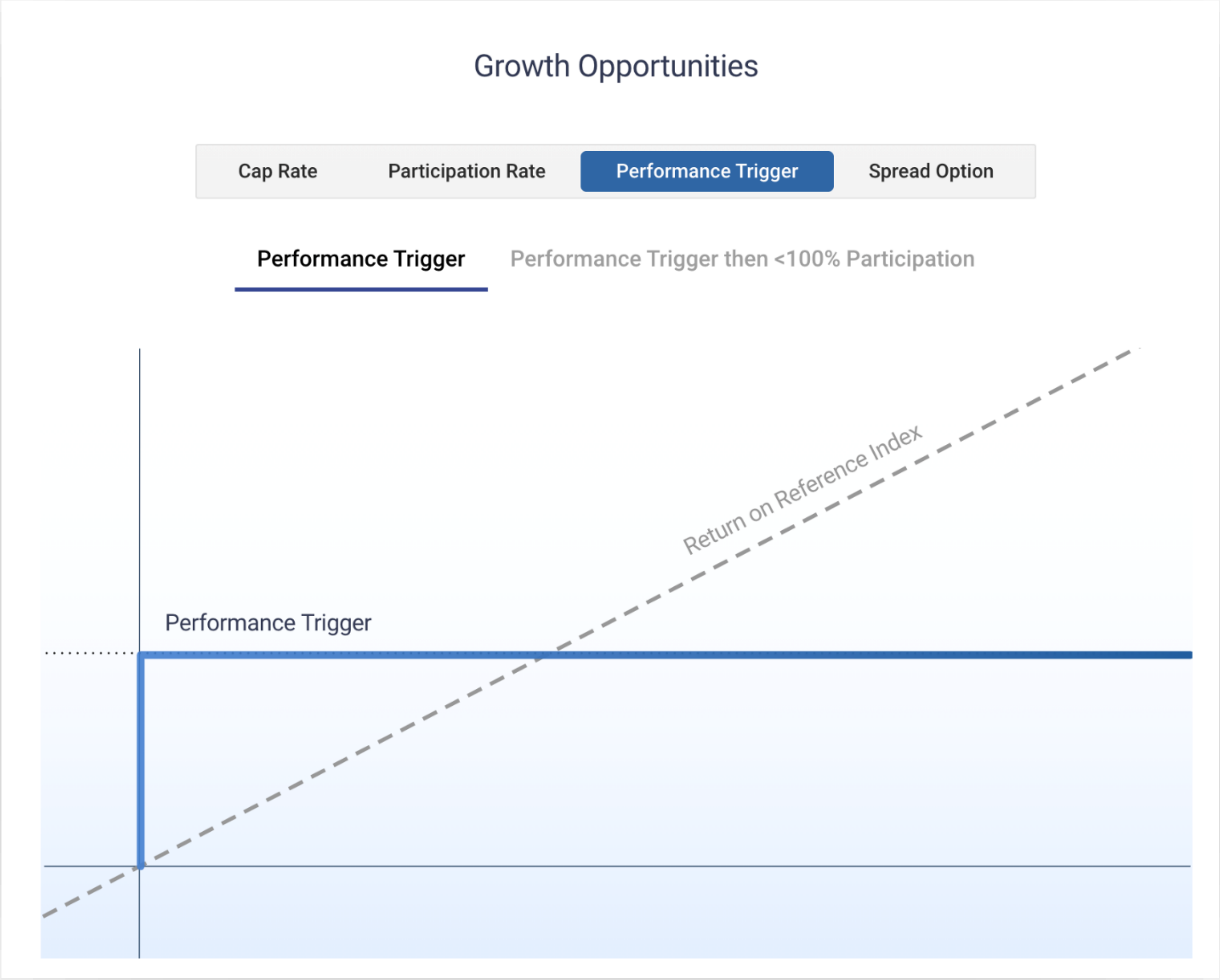
Performance Trigger (Point-to-Point)



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The Importance of the Annual Reset Feature

- For indexed annuities, each index period stands on its own
- If the index increases during the period, interest will be credited
- If the index goes down in value, you don't have to wait for it to recover before you are eligible to earn interest

How the Annual Reset Feature Works
$100,000 Initial Premium

Year 1	**Start**	**End**		**5% Cap**	**Account Value**
	1,000	1,200	= +20% Increase	5% Growth	$105,000
					Locked Gains
Year 2	**Start**	**End**		**5% Cap**	**Account Value**
	1,200	900	= -27% Loss	0% Growth	$105,000
					No Loss
Year 3	**Start**	**End**		**5% Cap**	**Account Value**
	900	990	= +10% Increase	5% Growth	$110,250
					No Recovery Needed

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Who is the Typical Indexed Annuity Buyer?

- Does not want to put their money at risk
- Is ok with knowing that there will be some time periods where no interest is credited
- Wants to earn more over the long run than traditional products that provide a guarantee of principal
- 63–65 years old
- Has money that they are confident they won't need for 3–7 years
- Average purchase size is about $120,000
- Wants to minimize their current tax liability

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- Penalties for getting out early can be substantial. In addition, withdrawals prior to the age of 59 ½ will carry an additional 10% tax penalty
- The guarantee of principal and interest is only as good as the underlying insurance company – there is no FDIC insurance
- The choice in indexes and crediting methods can make indexed annuities a relatively complex product
  - Make sure you understand the various options in order to select the most efficient investment allocation

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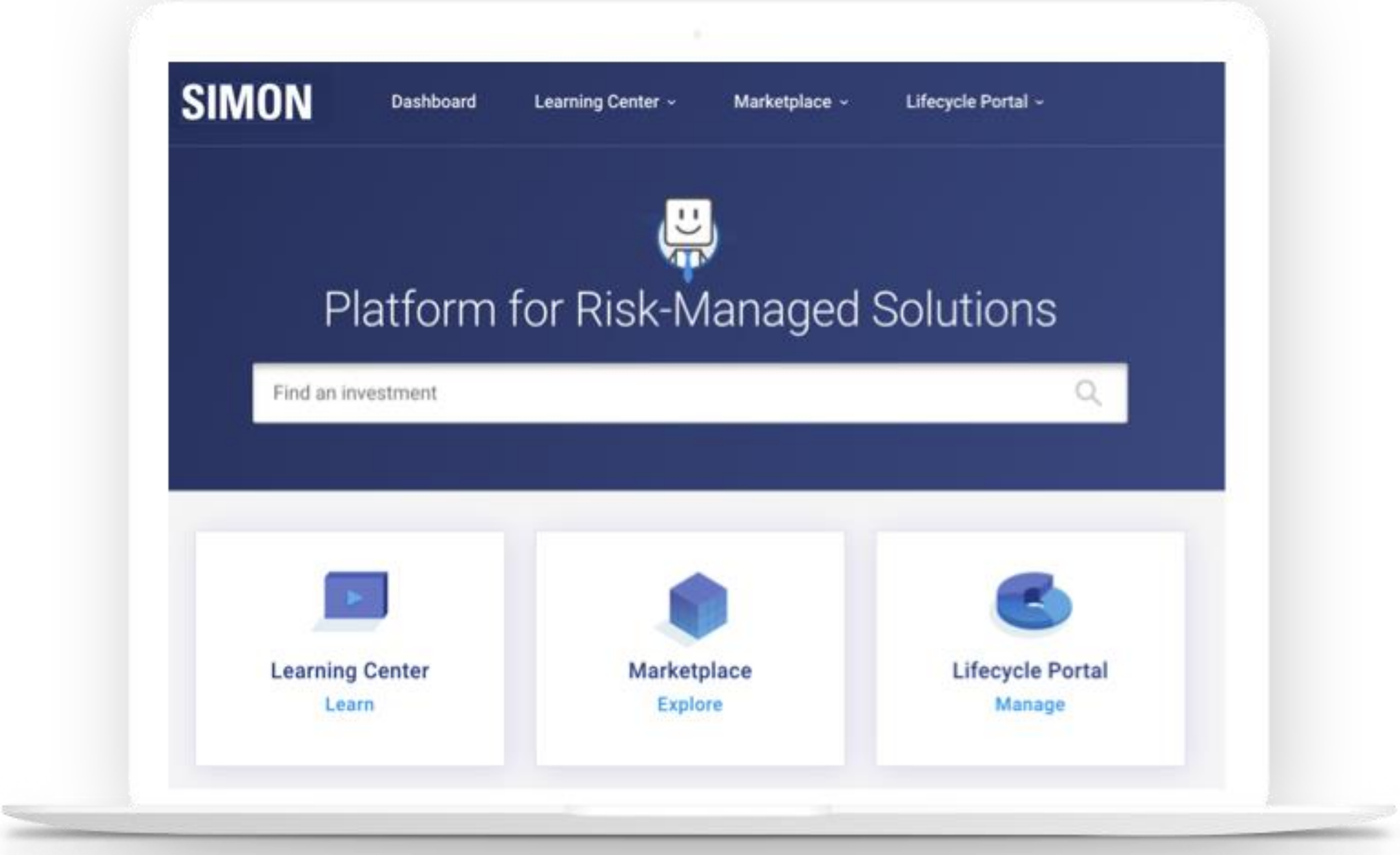
SIMON Demo: Allocation



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