KEEPING YOUR FINANCES AFLOAT.

ANNUITIES 101

AN INTRODUCTION TO BETTER UNDERSTANDING ANNUITIES

FINANCIAL PLANNING | INCOME PLANNING | RETIREMENT PLANNING | WEALTH MANAGEMENT

The Annuities 101 whitepaper was published to give readers a very general understanding of the different types of annuities that may be available. The majority of the information in the document was provided by Source Wink http://www.looktowink.com/insurance-basics/annuities/ If you are considering purchasing an annuity, you should read the prospectus and/or contract as well as discussing your situation with a financial professional. When you contact a financial professional, you should consider requesting information, including product and fund prospectuses/contracts that contain complete details on investment objectives, risks, fees, charges, and expenses as well as other information about the investment company, which should be carefully considered. Please read the prospectuses/contracts carefully prior to purchasing. The prospectuses/contracts contain this and other information on the product and underlying portfolios.

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Annuity Sales Top $220B in 2013: For the full year, industry-wide sales increased 4.2 percent to $220.9 billion from $212 billion during the previous year based on data reported by Morningstar, Inc. and Beacon Research.

INTRODUCTION

Let's assume that you don't know what an annuity is. No worries. Almost everyone knows what life insurance is, so let's start by making a comparison to life insurance.

- Life insurance protects against the risk of death, or dying too soon; if the insured person(s) die, the insurance company pays out a sum of money to one or more designated beneficiaries.
- An annuity is sometimes referred to as "the opposite of life insurance." Annuities insure against the risk of life, or living too long; the insured person receives a stream of income he or she cannot outlive from the insurance company.
- With an annuity, the purchaser pays a premium to the insurance company. In exchange, he or she receives a regular stream of income payments from the insurer that begin either immediately or at some time in the future. The payment stream continues until the purchaser dies - even if that occurs at age 127½!
- Heads up! An annuity is one of many financial products that are available as a retirement income vehicle. You should work with a trustworthy professional when determining which of these vehicles best suits your needs and retirement goals.

Hold on! Before making this decision, you should also consider a fundamental principle of risk:

Risk/Reward Tradeoff - A direct inverse relationship between possible risk and possible reward, which holds for a particular situation. To realize greater reward, one must generally accept a greater risk, and vice versa.

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In light of this tradeoff, there are three questions that must be answered, when researching what type of annuity may be right for you.

1. What level of risk am I willing to assume with the annuity?

- If interested in high minimum guaranteed interest, regardless of the lower level of interest crediting/gains, consider a Fixed Annuity.

- If willing to accept a lower minimum guarantee than a fixed annuity, but looking for potentially greater interest crediting/gains, consider a Fixed Indexed Annuity.

- If willing to accept no minimum guaranteed interest, and the possibility of unlimited loss in exchange for the possibility of unlimited interest crediting/gains, consider a Variable Annuity.

2. How soon will I need the regular stream of income payments from the annuity?

- If income will be taken within the first year, consider an immediate annuity (offered in Fixed, Fixed Indexed, and Variable types).

- If income will be taken at some time further in the future, consider a deferred annuity (offered in Fixed, Fixed Indexed, and Variable types).

3. How many premium payments will I be making into the annuity?

- If only a single payment will be made into the annuity, consider a single premium immediate annuity or a single premium deferred annuity.

- If making more than one payment to the annuity, consider a flexible premium deferred annuity. There are also two different classifications of annuities: deferred and immediate.

What is a deferred annuity?

An insurance product whereby at least a year will elapse between when the lump sum or series of premium(s) are paid, and the annuity is transitioned into a stream of income through annuitization. Deferred annuities can be Fixed, Fixed Indexed, or Variable in nature.

What is an immediate annuity?

An insurance product whereby a lump sum premium is paid and the annuity is transitioned into a stream of income through annuitization within one year from the date of purchase. Immediate annuities can be Fixed, Indexed, or Variable in nature.

Deferred annuities typically are used as vehicles for accumulation, or building additional interest until the annuitant is ready to transition the annuity to a series of payments through a process called "annuitization." Alternatively, an immediate annuity is often used as a vehicle for individuals who are ready for their income stream to begin, well, immediately.

Both deferred and immediate annuities can have their interest credited in several different ways. The two basic types of deferred and immediate annuities are Fixed and Variable. Of the fixed variety, there are (traditional) Fixed, as well as Fixed Indexed.

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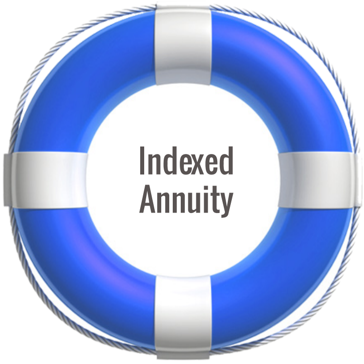
ANNUITY RISK SPECTRUM

	Guaranteed Interest	Upside Potential	Indexed Participation	Client's Risk Tolerance
Fixed (Traditional)	Typically 1.00%	Very Limited typically less than 5.50%	None	Low
Indexed	Typically 87.50% of premium@ 1.00%	Limited: typicall capped less than 9.00%	Gains based on performance of external index	Low
Variable Annuity	Fixed account only	Unlimited	Gains based directly on fund performance	Moderate

NEWSFLASH: If a salesperson suggests that Indexed Annuities provide unlimited gain potential - RUN! This individual either misunderstands or is misrepresenting the product.



Indexed Annuities provide limited gain potential and are not intended to perform comparably to securities products. Fixed Indexed Annuities merely credit interest typically based on the performance of stock market, commodities, or bond index. Don't be confused; these annuities do not allow you to invest directly in the stock market. They do, however, provide the opportunity to outpace fixed money instruments such as Certificates of Deposit (CDs) or Fixed Annuities.

What is a Fixed Annuity (FA)?

A contract issued by an insurance company that guarantees a minimum interest rate with a stated rate of excess interest credited, which is determined by the performance of the insurer's general account. Multi-Year Guaranteed Annuities (MYGAs), a type of Fixed Annuity, guarantee a minimum interest rate for more than a one-year period; this rate is also determined by the performance of the insurer's general account. A Fixed Annuity is considered a low risk/low return annuity product.

What is an Fixed Indexed Annuity (FIA)?

A contract issued by an insurance company that guarantees a minimum interest rate of zero, where crediting of any excess interest is determined by the performance of an external index, such as the Standard and Poor's 500® index. In addition, Indexed Annuities have a secondary guarantee that is payable in the event of death, surrender, or if the external index does not perform. This secondary guarantee is referred to as a Minimum Guaranteed Surrender Value (MGSV); it credits a rate of interest between 1% and 3% on a percentage of the premiums paid in to the annuity.

What is a Variable Annuity (VA)?

A contract issued by an insurance company that has no minimum guaranteed interest rate, where crediting of any excess interest is determined by the performance of underlying investment choices that the annuity purchaser selects. A Variable Annuity is considered a high risk/high return annuity product.

In your evaluation of annuities, it helps to understand the "300 foot view" of the annuity transaction. The sale of an annuity has to benefit the three parties to the annuity transaction:

1. **The annuity purchaser** - via fair interest rate crediting/gains
2. **The annuity salesperson** - via fair compensation
3. **The annuity issuer (insurance company)** - via a fair profit, i.e. a spread

We refer to this as the "three-legged stool" of the annuity transaction. To fully understand, it also helps to consider how the insurance company makes money by selling annuities. Simplistically, the insurance company invests the annuity purchaser's premium payment(s) in different investment vehicles, in order to make a return that is high enough to pay administrative costs (such as the salesperson's compensation), credit interest to the annuity purchaser, and still retain a profit.

So, let's consider an example, using Fixed Annuities as a point-of-reference.

- The Fixed Annuity purchaser submits a payment of $100,000 to the insurance company for her 10-year annuity;
- The insurance company invests the annuity purchaser's premium payment in bonds (This ensures that they will receive a guaranteed return on the monies and be able to pay the annuity purchaser a guaranteed interest rate);
- Assume that 10-year bonds are paying a rate of 4.00% to the insurance company;
- The insurance company then credits [4.00% - X] to the annuity purchaser's 10-year fixed annuity contract [the value of X is determined by knowing what amount the insurer needs to cover their expenses (i.e. salesperson's compensation) and the amount of profit the insurance company intends to keep].

Now, with Fixed Indexed Annuities, the example above is only modified slightly.

• The insurance company still invests the annuity purchaser's premium payment in bonds but not 100% of it;
• The difference of less than 5% of the payment is used to purchase options (options are what give the insurance company the ability to credit interest to the annuity purchaser, based on the performance of a stock market index);
• The determinant in the rate that is credited to the annuity is: a) the cost of the option, and b) the stock market index's performance.

So, we have established that there are several different types of annuities, the primary categories being Fixed and Variable. These products are very different, even though both may be used for the same purpose. Not everyone has similar tastes after all (hence the exhaustive list of delicacies available at The Cheesecake Factory!).

Okay - so we've seen some of the similarities in these products. So, what's different?

Who Sells This Product?

Licensed insurance agents have the ability to sell Fixed, Indexed, and Multi-Year Guaranteed Annuities, as long as they have an active life and annuity line of authority within the state that they are selling in.

Even though Fixed Indexed Annuities earn interest based on the performance of a stock market or similar index, a securities license is not required to sell Indexed Annuities. They are fixed insurance products; the annuity purchaser is never directly invested in the stock index with a Fixed Indexed Annuity.

If a securities-licensed professional (i.e. someone who sells stocks, bonds, mutual funds, etc.) wants to sell Fixed, Fixed Indexed, or Multi-Year Guaranteed Annuities, he or she can do so by obtaining a life and annuity line of authority with his or her local state insurance commissioner's office.

How Is This Product Sold?

Fixed, Indexed, and Multi-Year Guaranteed Annuities, like other insurance products, are sold via an insurance contract. This document is 15 pages, give or take. By contrast, securities products (such as Variable Annuities) are sold via a prospectus; a document that is typically more than 100 pages.

When an insurance agent sells any variety of a fixed annuity, the sales materials and product brochures will be accompanied by the following (at a minimum):
• Annuity application
• Annuity disclosure document
• Annuity suitability form
• Annuity Buyer's Guide

More forms may be required depending on the state that the purchaser lives in, whether they are replacing another annuity or investment with the current annuity purchase, and/or whether the monies that are being used to purchase the annuity are coming from a qualified plan (just to name a few variables).

Who Carries the Risk With This Product?

Fixed Annuity

The insurance company must pay out a minimum guaranteed rate of interest, regardless of what they earn on their investments with a Fixed Annuity. Let's take a look:
• An annuity purchaser buys a Fixed Annuity with a minimum guarantee of 3.00%;
• The annuity is currently credited at a rate of 4.50%;
• If the market "tanks," and the insurance carrier can only earn 2.00% on the money they have invested (i.e. on the bonds purchased by the insurer at the time the annuity was acquired), the annuity purchaser is still protected by the minimum guarantee of 3.00%;

• So, the insurance company holds the risk with a Fixed Annuity. The insurer still has to make good on the minimum guarantees in the contract, regardless of the performance of their own investments.

Fixed Indexed Annuity

The insurance company must pay out a minimum guaranteed rate of no less than 0%, regardless of what they earn on their investments with a Fixed Indexed Annuity. Let's check out an example:

• The insurance company must offer a secondary guarantee on Fixed Indexed Annuities, in the event the annuity purchaser dies or cash surrenders the annuity, or even in the event the index does not perform;
• This guarantee is called the Minimum Guaranteed Surrender Value, or MGSV;
• An annuity purchaser obtains a Fixed Indexed Annuity with a MGSV of 87.5% of premiums, credited at 3.00% interest;
• On this annuity, the maximum credited interest may not exceed a cap of 8.00% if the S&P 500 rises 8.00% or more over a one-year period;
• If the market "tanks," and the insurance carrier can only earn 1.00% on the money they have invested (i.e. on bonds purchased by the insurer at the time the annuity premium was paid), the annuity purchaser is still protected by the MGSV of 87.5% of the premiums paid accumulated at 3.00% interest.
• So, the insurance company holds the risk with an Fixed Indexed Annuity. The insurer still has to make good on the minimum guarantees in the contract, regardless of the performance of their own investments.

Variable Annuity

The Variable Annuity purchaser chooses to directly invest in an array of available stocks, bonds, mutual funds, and underlying sub-accounts on their annuity; any gain or loss is passed directly to the annuity purchaser in whole (less fees and charges). Let's review some examples of how a Variable Annuity works:

• There is a potential for the annuity purchaser to experience a loss of principal and gains with a Variable Annuity, in the event of poor market performance;
• The variable sub-accounts have no minimum guaranteed interest, but the upside potential of a Variable Annuity is greater than that of Fixed and Indexed Annuities;
• An annuity purchaser acquires a Variable Annuity with a minimum guarantee of 1.00% only on the fixed sub-account, and no minimum guarantee on the variable sub-accounts;
• Assuming 100% of the premiums are allocated to variable sub-accounts, if the market "tanks," the insurance company bears no risk, but passes it directly to the annuity purchaser through a loss in their annuity's value;
• So, the annuity purchaser holds the risk with a Variable Annuity. The insurer has no minimum guarantees to honor in the contract (they collect their fees and charges regardless of performance), and any negative performance on the underlying investments is fully-realized by the annuity purchaser.

Who Regulates Annuities?

Fixed, Fixed Indexed, and Multi-Year Guaranteed Annuities (MYGAs) are fixed insurance products, and therefore regulated by state insurance laws and the insurance commissioners that enforce them.

• Insurance agents who want to sell Fixed and Fixed Indexed Annuities must obtain a life insurance license in the state where they are practicing;
• The insurance commissioner oversees the financial regulatory practices of the insurance industry as well as the solvency of the companies selling the products;
• Insurance companies, salespeople, and annuity purchasers go through their local state insurance department when they have questions or concerns about Fixed, Fixed Indexed, or MYG Annuities.

Variable Annuities are securities products, and thereby regulated by the Securities and Exchange Commission (SEC).

- Salespeople wanting to sell Variable Annuities must obtain a life insurance license in the state where they are practicing, as well as pass a securities exam(s) and be licensed with a broker-dealer who is a member of FINRA.
- The insurance commissioner ensures the solvency of companies selling Variable Annuities;
- However, insurance companies, salespeople, and annuity purchasers go through the SEC when they have questions or concerns about Variable Annuities. In the securities industry (where products such as Variable Annuities are sold), salespeople that are licensed to sell the products are regulated by the Financial Industry Regulatory Authority (FINRA) as opposed to the state insurance commissioner.
- FINRA is a self-regulatory organization that oversees the financial regulatory practices of the securities industry;
- In a nutshell, if you hold a securities license, you must abide by the rules of the FINRA as well as the SEC, while the insurance commissioner oversees the solvency of the insurance companies you do business with.

Note that in the past, there have been a handful of Fixed and Fixed Indexed Annuities that have been filed as securities products and registered with the SEC, despite the fact that they are fixed insurance products. An insurance company's logic behind doing this may be for several reasons. One reason an insurance company may register a fixed product as a security is to accommodate a distribution that is used to selling securities products (and the prospectuses that come with them). As a comparison, historical sales of registered Indexed Annuities have been nominal in comparison to total Fixed Indexed Annuity sales. Today, there are no registered Fixed Indexed Annuity products available for sale. Both fixed and variable insurance products have rules and regulations that the insurance companies and salespeople must abide by. The insurance company's products, advertising materials, disclosures and training brochures are diligently reviewed in both the fixed and variable insurance markets. Salespeople are required to be properly licensed to sell both types of products. The market conduct of the marketing organization, broker/dealer, and salesperson are all carefully monitored, whether he or she is selling the Fixed, Indexed, or Variable variety of annuity.

Closing Thoughts

Now you should understand what an annuity is, who can sell them, and who regulates them. You should also understand quite clearly what an annuity is not. Fixed, Fixed Indexed, and MYG Annuities are not alternatives to Variable Annuities, stocks, bonds, or mutual funds; these products are "risk money places." Fixed, Fixed Indexed, and MYG Annuities are more accurately classified as "safe money places" and generally viewed as an alternative to CDs or other fixed-rate savings instruments.

Annuity Rates

Fixed Annuities have an interest rate that is declared annually by the insurance company. Multi-Year Guaranteed Annuities are like traditional Fixed Annuities in that their interest rate is also declared by the insurance company. However, Multi-Year Guaranteed Annuities' interest rates are guaranteed for longer than a one-year period. Guarantee periods on these annuities may range anywhere from two to ten years.

Most Fixed Indexed Annuities today offer some form of fixed bucket strategy. This would be a premium allocation option that receives credited interest in a manner like that of a traditional Fixed Annuity. A declared rate is set for the fixed strategy, and the annuity purchaser receives that rate if the annuity is held

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for the strategy term (usually one year). Most Variable Annuities also offer a fixed bucket for clients desiring a more conservative allocation mix. However, the line between Fixed, Fixed Indexed, and Variable is drawn when it comes to differentiating how the non-guaranteed rates are credited on these products.

Remember that with a Fixed Annuity, the insurance company declares a stated credited rate for the nonguaranteed, current interest rate. A Variable Annuity is very different in that the insurance company does not limit the potential gains of the product; the client is investing directly in the market. Therefore, a Variable Annuity purchaser may realize a gain of 18.00% if the fund they invested in grows that much over a one-year period. With a Fixed Indexed Annuity, the insurance company purchases options based on an external index's performance, and the annuity purchaser receives nonguaranteed, current interest that is limited in growth (based on the option price).

Like the handful of crediting methods that can be confusing on some Indexed Annuity products, the pricing levers that are used to determine the actual rate credited can be equally perplexing. There are three simple pricing levers that are used when calculating potential interest on Fixed Indexed products:
• **Participation Rate** — the percentage of positive index movement in the external index that will be used in the crediting calculation on an indexed product. (Note that a product with a Participation Rate may also be subject to a Cap and/or Spread.)
• **Cap** —the maximum interest rate that will be used in the crediting calculation on a fixed indexed product. (Note that a product with a Cap may also be subject to a Participation Rate and/or Spread.)
• **Asset Fee/Spread** — a deduction that comes off of the positive index growth at the end of the index term in the crediting calculation on an indexed product. (Note that a product with a Spread may also be subject to a Participation Rate and/or Cap.)

Now that all of the disclaimers are out of the way, it can simply be said that most indexed strategies that have 100% Participation utilize a Cap as the pricing lever. In turn, most indexed strategies that have less than 100% Participation utilize the Participation Rate as the pricing lever. There are also trends among indexed crediting methods; averaging strategies tend not to have Caps more often than others and utilize Spreads more frequently. Annual point-to-point methods generally utilize the Participation Rate or a Cap to limit potential indexed gains.

It is really quite simple when you break it down. For example, on a Fixed Indexed Annuity over a one-year term where the S&P 500® has experienced an increase of 20%:
• **A Participation Rate** of 55% would afford the client potential indexed crediting of 11% (20% x 55% = 11%)
• **A Cap** of 8% would pass on potential gains of 8% to the client (20% limited by an 8% cap)
• **A Spread** of 3.00% would leave the client with 17% interest credited (20% – 3% = 17%)

Typically, a Fixed Indexed Annuity utilizes only one pricing lever on each strategy. This means that when the insurance company changes the annuity's rates, or the contract comes upon the policy renewal, only the one pricing lever will be adjusted upward or downward. However, an insurance company may reserve the right to adjust more than one pricing lever in the event of declining rates. This does not necessarily mean that they alter more than one pricing lever by practice. Generally, the less "moving parts," the easier the product is to convey to both the insurance agent and the purchaser. For that purpose, many insurance companies try to limit the number of variables needed to describe each crediting method. It is important to note that there are a handful of products that use a moving part that is unique specifically to that product. These are just other pricing levers where potential interest crediting has been limited.

Fixed Indexed Annuities are also like Fixed Annuities in that they have minimum guarantees to protect the purchaser from a downturn in current credited rates or Caps, etc. Fixed and Multi-Year Guaranteed Annuities generally offer a minimum guaranteed floor of 1.00% or more. Indexed Annuities offer a guaranteed floor of no less than 0.00%. In addition, Fixed Indexed Annuities have a secondary guarantee that is payable in the event of death, surrender, or if the external index does not perform. This secondary guarantee is referred to as a Minimum Guaranteed Surrender Value (MGSV); it credits a rate of interest between 1% and 3% on a percentage of the premiums paid in to the annuity.

MGSVs can be stated in two methods: as Account Value guarantees, which must deduct the surrender charges from the calculation, or as Surrender Value guarantees, which are net of the surrender charges on the contract. An Indexed Annuity with a first-year surrender charge of 10%, and an Account Value guarantee of 100% @ 3% may be equivalent to the Surrender Value guarantee of a second product with an MGSV of 90% @ 3%. (100% – 10% surrender charge = 90%). When Fixed Indexed Annuities first emerged in 1997, their MGSVs were often based on 90% of premium, credited at 3% interest; i.e. 90% @ 3%. However, when market conditions began declining and insurance companies weren't able to offer indexed products with these guarantees, we saw MGSVs drop as low as 65% @ 3% for first-year premiums. It is important to note that annuity MGSVs most adhere to state Standard Non-Forfeiture Laws (SNFL), which are enforced by the state insurance departments. Today, more than three quarters of Fixed Indexed Annuity products have MGSVs that are based on 87.5% of premiums, and credited interest is based on the 5-year Constant Maturity Treasury rate (a rate between 1 – 3%). Today, annuity MGSVs cannot be less than 87.5% of premiums paid, credited at 1% interest.

Another very important rate to consider when evaluating which product to purchase, whether Fixed or Fixed Indexed, is the renewal rates. These are the new interest crediting rates, Caps, Participation Rates, etc. that are declared at the end of the interest crediting term (typically one year). So many products today are copied off of another popular insurance company's product. If you want to evaluate the annuity beyond the contractual features and the service and integrity of the insurance company, renewal rates should be taken into consideration. That being said, renewal rates are one of the most difficult pieces of information to get your hands on. A scant number of insurance companies feel that their renewal rates are an integral part of their sales story and actually produce marketing pieces publishing these rates. This gives the potential annuity purchaser an idea of what the insurance company may do to the future rates on the product that they purchase, based on past renewal rate histories.

ANNUITY HISTORY & FACTS

1100 – 1700 B.C. Archaeologists reveal that the legal codes of Egypt provide evidence that an annuity was purchased by a Prince ruling in Sint, in the Middle Empire.

The Very First Annuity

1100 – 1700 B.C. Archaeologists reveal that the legal codes of Egypt provide evidence that an annuity was purchased by a Prince ruling in Sint, in the Middle Empire.

The First Fixed Annuity

1759- A Pennsylvania company offers the first annuity in America to Presbyterian ministers and their families.

Fixed Annuities Now

At the close of 2012, Fixed Annuity sales were $38.0 billion.

The First Fixed Indexed Annuity

February 15, 1995—Keyport (now Sun Life) sold the Key Index Annuity for a premium of $21,000. Over a 5-year period the annuity grew to a value of $51,779. The average CD at the time would have returned $27,554 over the same five-year period, had the client continually renewed it.

Fixed Indexed Annuities Now

At the close of 2013, Fixed Indexed Annuities sales were $39.3 billion. (Investment News by: Matt Sirinides Feb 25, 2014)

The First Variable Annuity

1952- TIAA-CREF sold the first Variable Annuity for use in college and university qualified retirement plans.

Variable Annuities Now

At the close of 2012, Variable Annuity sales were $145.6 billion. (Source: U.S. Individual Annuities Sales Survey, LIMRA)

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