F I X E D A N N U I T I E S

Quick Guide

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CAUTION: This guide is intended to provide a basic understanding of fixed annuities. It is not intended to be all-inclusive. Working with a qualified professional is strongly recommended

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Introduction

A fixed annuity is a contract between you and an issuer whereby you agree to give the issuer a dollar amount and in return the issuer guarantees you a rate of interest and fixed payments over time. In a fixed annuity, the issuer carries the risk of principal loss, not the contract owner. While annuities are not insurance policies, they are issued by insurance companies.

A fixed annuity is generally considered to be a good vehicle for conservative investors who may be seeking an alternative to a Certificate of Deposit (CD). Monies are invested by the issuer primarily in government securities and high-grade corporate bonds, and they offer guaranteed interest rates. However, unlike a CD, your money grows tax-deferred, and you may be able to secure a higher rate of interest. In return for these advantages, you give up some flexibility in terms of withdrawals and timing.

The issuer will initially declare a rate of interest that is fixed for a specified period, often a year, and then will credit "renewal" interest rates that may be higher or lower for succeeding periods. However, fixed annuity contracts should also contain a minimum rate of interest that will be paid over the life of the contract. Because the issuer guarantees these rates, fixed annuities are considered a low-risk investment. Also, because fixed annuities offer guaranteed rates of return, they differ from variable annuities, which are often modeled after publicly traded mutual funds, and which carry the risk of principal loss.

An annuity is similar to a retirement plan in that all capital in an annuity grows and compounds tax-deferred until you begin making withdrawals. Unlike retirement plans, however, there is no limit as to how much you can invest in annuities. Contributions to fixed annuities are not limited if the annuity is not part of an IRA or qualified retirement plan. You generally do not have to begin withdrawals until at least age 85. If death occurs before payments begin, the balance will pass directly to a named beneficiary.

When selecting a fixed annuity, you will need to decide on the timing of the payout—i.e., whether to purchase a "deferred" annuity, where the principal continues to grow until the investor begins receiving payments starting at some later date, usually at retirement, or an "immediate" annuity, where the investor begins to receive payments immediately.

Deferred and Immediate Annuities

Deferred annuities feature an ***accumulation phase***, during which funds may be deposited and balances grow tax-deferred, and a ***payout phas***e, when the funds are distributed. People who have not yet retired will generally purchase a deferred annuity. During the accumulation phase, the current interest rate in effect will be applied to the balance in the annuity and compounding of interest will take place.

Immediate annuities, as noted above, are appropriate for investors who need to begin receiving income immediately, and want a dependable stream of regular income. For these annuities, the payout phase begins immediately as "annuitization" takes place. The amount of the payment is based on age, gender, and the balance in the contract.

Payout Phase

When the owner annuitizes a deferred fixed annuity or purchases an immediate annuity, he or she will need to choose the form of payout. Choices generally include:

Straight life: Lifetime payments that feature the highest payout, but end at the annuitant's (the person receiving the payment) death, with no payments to a beneficiary.

Life with period certain: Lifetime payments that are guaranteed for at least a certain number of payments, with any remaining payments made to a beneficiary after the death of the annuitant.

Joint and Survivor: Payments cover two lifetimes, and the amount depends on whether and how much the owner chooses to reduce the payment after the first death.

Installment refund: Lifetime payment. At the death of the annuitant, if the balance of the original investment has not been paid out, payments continue to a beneficiary until the original investment is depleted.

Fixed Period or Amount: Payment of a fixed monthly amount that ends when the balance is

depleted, or payment is made for a fixed period only. In either case, upon death of the annuitant, remaining payments would be made to a beneficiary.

These are choices that can wait until it is time to begin the payout phase, which can be deferred typically until at least age 85 (unless the annuity is in an IRA or qualified retirement plan). You can also make earlier periodic withdrawals from a deferred annuity without annuitizing (subject to early withdrawal penalties and surrender charges, if any).

IMPORTANT NOTE: It is essential to understand that once the decision is made to annuitize, you are relinquishing control of your money to the insurance company. Generally, in exchange for the company's promise to pay you income based on the option you have chosen, you can no longer withdraw a lump-sum amount or change your payout schedule. Although it is possible to potentially have a guaranteed income for life with a fixed annuity, there is no assurance that this income will keep up with inflation.

Alternate Annuity Product Features

In addition to the two basic types of fixed annuities and the different payout options, issuing companies may also offer additional product features. Here are summaries of some of the more common additional options that are made available with some fixed-annuity products. It should be noted that this is not an all-inclusive list, and that some of these features are optional and come with an additional cost that will reduce your account value, and may have longer surrender periods.

"Bailout" Provision: Some fixed annuities come with a "bailout" provision, which enables you to avoid a surrender charge if the declared interest rate decreases by a specified amount (e.g., 2%) upon renewal. In this case, you could exchange to a new annuity or liquidate, but would still be subject to early withdrawal tax penalties, if applicable.

Bonus Rates: In order to secure new business, sometimes issuers will offer a bonus interest rate that exceeds the rate it would otherwise be paying, usually in the first year of the contract. Since annuities have limited liquidity, a buyer who is offered a bonus rate should carefully review (or have his or her representative do so) the renewal rate history of the issuer before making the decision to purchase.

Multi-Year Guarantees: Some issuers may offer longer-term interest rate guarantee periods between renewals (three to ten years). Be aware that if you choose a longer period, you may encounter additional stiff penalties if you want to pull out your money prior to the end of this period.

There are other features and variations that may be available to you when making your decision. Be sure to carefully review all options.

Individual Retirement Annuities

Fixed annuities can also be purchased as part of a retirement plan. In this instance, an individual can contribute to an individual retirement annuity in his or her own name. Spousal individual retirement annuities can also be established.

Note that generally, restrictions and limitations will be the same as those for Individual Retirement Accounts (IRAs). Both Traditional and Roth IRAs can be established, subject to the maximum IRS-allowed contribution and deductibility limitations. Minimum distribution requirements (for Traditional IRAs) must also be met.

If you are purchasing an annuity to fund a tax-qualified retirement plan (IRA), you should be aware that the tax advantages are available with any investment vehicle within the plan, and not unique to an annuity within the plan. Carefully consider the features and benefits of the annuity before making the decision to purchase.

Due Diligence

Before you put money into a fixed annuity, be sure you've educated yourself with regard to the limitations and restrictions that will impact your investment.

Insurance company: Be sure that the company issuing the annuity has a solid financial underpinning, i.e., it will be able to meet its obligations. You want to be sure the company will stand behind your investment over the long term. (Fixed annuities do not carry FDIC insurance, but are guaranteed by the issuing company). All guarantees are based on the claims paying ability of the insurance company. Check the ratings of insurers from services such as AM Best, Moody's, Standard & Poor's, Duff & Phelps, and Weiss Research.

Surrender charge: If you withdraw money from a deferred annuity within a certain period after purchase, the insurer may impose a "surrender" charge. This fee, which is a percentage of your investment, usually decreases each year until it disappears (typically after six to eight years).

Other fees: There may also be fees for special features that the issuer offers. However, since they are already accounted for in the interest rate you will receive, comparing interest rates on products that include these features will, in effect, allow you to compare fees.

Also, keep in mind that subject to certain exceptions, including death, you will be assessed a 10% penalty for withdrawal of earnings prior to age 59½. Remember, annuities are meant to be long-term investments.

Taxes

Obviously, one of the most attractive features of annuities is the tax-deferred growth that occurs during the accumulation phase. It should be noted, however, that when money is withdrawn or distributed without annuitizing, all or a portion would be taxed at ordinary income tax rates. This will be the case if you make systematic or periodic withdrawals.

On the other hand, if you annuitize, only the portion of the money distributed that relates to earnings, as opposed to principal, will be taxable. In this instance, a portion of your income will be considered a "return of principal" and would not be taxable.

Note that withdrawals from qualified annuities (Individual Retirement Annuities or those within a qualified retirement plan available through an employer) are taxed, based on qualified plan rules that are generally less favorable than for "non-qualified" annuities.

Are Fixed Annuities for You?

Let's look at some of the questions that you should ask yourself when deciding whether to purchase a fixed annuity:

Are you investing for the long term? You should generally have at least a ten-year time frame for this money. Also, remember that withdrawals prior to age 59½ are subject to penalties.

Have you considered the other alternatives that may be available to you? If you are eligible for a retirement plan at work that offers a company match or pre-tax contributions, you may want to first use this vehicle for your ongoing retirement investments.

Are you looking for an alternative to CDs? CDs are deposit products issued by financial institutions, and insured by an independent agency of the Federal government that offer a fixed rate of return. Work with a qualified financial professional to understand the unique differences of CDs and annuities.

Are you in a position to benefit from tax-deferred growth?

Are you interested in potentially securing lifetime income in retirement? If so, an annuity would meet this need. On the other hand, you may have less available to leave to your heirs.

Are you a conservative, low-risk investor? If yes, then a fixed annuity may be an appropriate choice.

Do you have additional money in a taxable account that you can afford to invest for your retirement, or have allocated for retirement? If so, an annuity can be an excellent choice for such funds.

Are you self-employed? If so, an annuity may be your only source of retirement income other than your Social Security. In the early years of a business, you may be investing all of your capital into the business and not have sufficient cash to contribute to a retirement plan. In later years, you may not want to establish a retirement plan for your business since you will likely have to cover all of your employees under such a plan. In this situation, an annuity offers a good alternative way to save for your retirement.

Do you expect to be in a lower tax bracket after retirement? If so, then an annuity would become more attractive.

If you are approaching retirement, or are already retired and want a steady income, consider an immediate annuity.

Consider all of these points in coming to your decision. It may well be that, depending on the specifics of your own situation, a deferred or immediate fixed annuity may be an appropriate choice for **a portion** of your retirement savings. Remember that you should always keep at least 3 to 6 months of living expenses in liquid funds available for emergencies and shorter-term needs.

Summary

You should now have enough information to have an idea about whether a fixed annuity may be something that you should consider. Remember to review some of the main points that have been covered here as you move on to the next step: tax-deferral, long-term investing, the need for funds before and/or after retirement, and other alternatives for your money. A licensed representative can help explain your choices, and may be able to help you choose the annuity that best suits your needs. ♦