M INTELLIGENCE

Insights to fuel your success

ANNUITY FUNDAMENTALS

If a guaranteed income that you cannot outlive sounds appealing, read on. Annuities are financial instruments that traditionally provide a fixed stream of income for a period of time. In a modern annuity contract, the owner of the annuity deposits money with an insurance company into an annuity insurance contract. The insurance company agrees to provide guaranteed income, among other benefits.

Annuities, although conceptually simple, have grown to become sophisticated financial instruments. In this Advanced Markets Insight, you will receive an essential introduction to annuities, including:

- Parties to the annuity contract
- Mechanics of the annuity contract
- Optional features in modern annuity contracts

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PARTIES TO THE ANNUITY CONTRACT

INSURANCE COMPANY

The insurance company issues the annuity contract, allocates policyowner funds, and bears the responsibility and risk for paying out an income stream and underlying guarantees.

OWNER

The owner holds legal title to the annuity contract and has the right to make decisions about the annuity. This includes who the annuitants and beneficiaries will be and savings and investment decisions.

ANNUITANT

In most situations, the annuitant will be the party receiving the annuity payments. The amount of income an annuity will pay is based upon the annuitant's life expectancy. Payments generally stop at the annuitant's death.

BENEFICIARY

If the annuity contract includes a death benefit, the benefit will be payable to the beneficiary.

Annuities, although conceptually simple, have grown to become sophisticated financial instruments.

ANNUITY MECHANICS

Annuities come in many varieties and can share common benefits, such as tax-deferred accumulation and guaranteed income that cannot be outlived. Annuity payouts can begin right away (immediate annuities) or after a period of time (deferred annuities). Each payout plan serves a specific purpose.

IMMEDIATE ANNUITIES

Immediate annuities provide a guaranteed income stream beginning within one year of the contract date. Generally, in an immediate annuity there is no additional accumulation or deferral. However, contract options or riders may be added to guard against inflation.

DEFERRED ANNUITIES

Deferred annuities delay the payment of annuity benefits for two or more years. Deferred annuities are generally used to grow and/or accumulate value until such time as the owner is ready to annuitize the contract. Deferred annuities may also be used to defer income taxes prior to annuitization or surrender.

> **Deferred annuities often have the additional benefit of tax deferral, which allows the value to grow without paying current income taxes.**

GROWING THE ANNUITY VALUE: FIXED, VARIABLE, AND INDEXED ANNUITIES

Deferred annuities are generally associated with a crediting type, such as fixed, variable, or indexed. Each crediting type may be appropriate for particular circumstances based upon the owner's objectives, risk tolerance, and savings time horizon. Deferred annuities often have the additional benefit of tax deferral, which allows the value to grow without paying current income taxes. Instead, taxes are generally due when the annuity is annuitized, surrendered, or otherwise liquidated or transferred.

FIXED

Fixed annuities generally provide a guaranteed accumulation interest rate for the life of the contract. Many fixed annuities offer a higher initial guaranteed interest rate for a period of time. After the initial guarantee period, the insurance company often will set a renewal rate that is no lower than the guaranteed minimum rate.

VARIABLE

The cash value within a variable annuity is determined by the performance of underlying investment options or subaccounts. These sub-accounts are determined by the insurance carrier and selected by the policyowner. Sub-accounts act similarly to mutual funds and are generally made up of stocks, bonds, and similar instruments.

Because returns inside of a variable annuity are generally tied to the financial markets, gains and losses on the underlying investments are passed through to the annuity owner and are reflected in the value of the annuity.

INDEXED

Indexed annuities tie growth of the annuity cash value to the performance of certain indices such as the S&P 500®.[1]

The growth of the indexed annuity is generally subject to limitations imposed by the underlying insurance carrier.

Generally, indexed annuities will participate in some portion of the growth of the underlying indices, but limit or prevent any loss if the indices decline.[2]

QUALIFIED AND NON-QUALIFIED ANNUITIES

QUALIFIED ANNUITIES

A qualified annuity is associated with an IRS statutory retirement plan such as an IRA or 403(b).

Generally, pre-tax dollars are used to fund qualified annuities. Values inside the qualified annuities grow tax deferred. All payments received from a qualified annuity are subject to income taxes.

Certain early distributions from a qualified annuity (prior to age 59½) may also be subject to a 10% penalty.

NON-QUALIFIED ANNUITIES

A non-qualified annuity is any annuity that is not a qualified annuity. Contributions to non-qualified annuities are made with after-tax dollars. Non-qualified annuities, like qualified annuities, grow tax deferred. Payments from non-qualified annuities are only partially taxable, as only the growth of the annuity is subject to taxation.

ANNUITY EXPENSES AND FEES

First and foremost, annuities are insurance contracts. Insurance companies take on the risk of guaranteeing payments to the annuitant. To manage this risk, insurers build certain expenses into the management of their products. Variable annuities may have additional fees associated with the underlying investments. Insurers may also charge fees related to extra contract benefits, or riders, that a policyowner chooses to purchase.

OPTIONAL ANNUITY FEATURES

Modern annuities have various built-in and optional features designed to add value to the policyowner. Optional features or riders usually are accompanied by a fee to pay for the underlying benefits. Some of these features include:

- Principal protection
- Guaranteed or more liberal withdrawal benefits
- Guaranteed income
- Long-term and chronic care payout enhancements
- Death benefit enhancements

[1] S&P 500 is a registered trademark of Cboe or its affiliate.

[2] The specific mechanics of indexed and variable annuities are beyond the scope of this presentation.
For more detailed information regarding how indexed and variable annuities work, speak with your M advisor.

SUMMARY

By combining features such as tax deferral, guarantees, and other benefits, annuities can provide great value and have a place in developing financial plans for individuals and businesses. Annuities can be complex, but a basic understanding of how annuities work and how different features or benefits align with the annuity owner's goals can provide security, income, and peace of mind.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal.

Variable annuities are long-term investments designed for retirement. The value of the investment options will fluctuate and, when redeemed, may be worth more or less than the original cost. Withdrawals and other distributions of taxable amounts, including death benefit payments, will be subject to ordinary income tax. If withdrawals and other distributions are taken prior to age 59½ a 10% federal penalty may apply. A withdrawal charge may also apply. Withdrawals will reduce the value of the death benefit and any optional benefits.

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