# Annuity Basics

## Things to Consider Before Buying an Annuity

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**On the surface, an annuity may appear to be a simple, long-term investment product. In its most basic form, you give an insurance company an amount of money, called a *premium*, either in a lump sum or periodic payments. In return, you receive a steady stream of payments over time.**

**Below the surface, however, annuities can be quite complex and require investor due diligence. Terms and conditions can vary widely among insurance companies and annuity products. Ongoing regulatory changes may also impact annuities. Before committing yourself to an annuity, be sure you completely understand how annuities work in general and the specifics of the annuity you're considering.**

## TYPES OF ANNUITIES:

Though annuities can come in many different shapes and forms, there are some common definitions of categories and types. In exchange for premiums paid, the insurance company promises the investor periodic payments over time, beginning either immediately or after some accumulation period. The first is known as the immediate annuity. Generally, investors purchase an immediate annuity with a lump sum payment. The second refers to a deferred annuity; most deferred annuities allow for either lump sum or periodic payments.

An annuity generally has two phases: accumulation and annuitization. During the accumulation period, an investor deposits funds into the account. At the end of the accumulation period, the investor can choose to annuitize the funds, meaning converting the deposited funds into periodic payments.

The most common types of annuities are fixed and variable.

## FIXED ANNUITIES:

Fixed annuities generally guarantee a fixed or minimum rate of return over a specific time period. However, most annuities reset the fixed rate of return at the end of each pre-determined time frame, known and a *term*. Terms vary across companies and policies, but are generally one year. A fixed annuity contract can be compared to buying bank Certificates of Deposit (CD's).

## VARIABLE ANNUITIES:

Variable annuities allow premiums to be invested in a limited number of sub-accounts, similar to mutual funds. These sub-accounts may be invested in stocks, bonds, or even cash. Variable annuities may also offer a guaranteed minimum rate of return, even if the underlying investments underperform. As with all annuities, funds grow tax-deferred during the accumulation period, but the growth is taxed as ordinary income upon withdrawal.

## EQUITY-INDEXED ANNUITIES:

Equity-indexed annuities contain features of both fixed and variable annuities. Equity-indexed annuities offer investors a return based on changes in a specific market benchmark, such as the S&P 500.

## WHAT CAN INVESTORS EXPECT FROM ANNUITIES?

Annuities can offer unique features and added benefits not found in traditional investments like stocks and bonds. In exchange, annuities often require investors to accept more restrictive elements. Here are some features investors should know about annuities:

### LIQUIDITY

Immediate annuities are often nearly (or entirely) impossible to completely liquidate once purchased. Deferred annuities generally require a specific investment period (typically seven or more years) before investors can start receiving income from the account. During this accumulation phase, the annuity contract may allow for some withdrawals. However, if the distribution amount is greater than what's specified in the annuity contract, the investor could pay step penalties – even if the withdrawal is taken to satisfy a Required Minimum Distribution (RMD) from IRA assets held in an annuity. Note that the annuity contract was not written with your RMD in mind, so the distributions allowed by the annuity contract may or may not coincide with the varying amounts you are legally required to withdraw each year.

### DEATH BENEFIT & OTHER INSURANCE PRODUCTS

Some variable annuities offer built-in insurance products, even though they are not insurance policies. For example, the annuity contract may include a death benefit guarantee to pass money to a beneficiary over a set time period. But investors must pay for additional benefits, which reduces the account value over time. Instead, investors may do well to consider purchasing these benefits more cheaply through an insurance policy. Annuities may also offer other insurance-type benefits, though these benefits also come with a charge and should be carefully analyzed.

### TAXES

One appealing aspect of annuities is the tax-deferred growth of deposited funds. But if you need money from the account before you're 59 ½ years old, a 10% IRS penalty may be charged for withdrawals. Additionally, investment gains in the annuity portfolio are taxed at ordinary income tax rates. Depending on your tax status, this may present a disadvantage when compared to the tax treatment of long-term capital gains. For many investors, the long-term capital gains tax rate is lower than current income tax rates. Also worth noting is that gains from death benefit payouts may be fully taxable – unlike traditional life insurance payouts.

You should consult your tax adviser before making any long-term decisions that could influence your tax situation. This is particularly true with annuities, which typically impose penalties and condition for short-term changes.

## RETURNS

Though guaranteed, an annuity's return may be much less than traditional investments like stock and bonds over time. Prior to entering a multi-year contract, investors should compare other investment alternatives. For example, fixed annuities provide guaranteed interest, but the insurance company can reset the interest rate periodically – perhaps below what investors can get from investing on their own in government bonds or other fixed-rate investments.

The account values of variable annuities generally follow the performance of the sub-accounts' underlying investments – bonds, stocks or money markets. However, management fees, operating expenses and other charges associated with variable annuities can reduce returns relative to directly investing in bonds, stocks or money markets over time. In addition, each sub-account manager should be evaluated based on performance and fees similar to an evaluation of any other pooled investment or mutual fund.

Equity-indexed annuities provide return *based* on a stated stock index (ex. S&P 500, MSCI World Index, etc.). Though equity-indexed annuities guarantee a *minimum* return, maximum returns can be less than the full performance of the underlying index. For example, equity-indexed annuities typically subtract a "fee" from the benchmark's gain to determine your rate of return – known as "margin," "spread" or "administrative" fee. So if the benchmark rose 10% and the fee was 3% you would receive a 7% rate of return.

Over time, the differences of a few percentage points can lead to a lower account value versus investing in stocks. For example, consider the following comparison of $1 million invested in the S&P 500 Index versus buying a hypothetical annuity for the 30 years ending December 31, 2011. The hypothetical annuity offers 100% participation to the S&P 500 Index with an annual 3% minimum guaranteed rate of return and 10% cap.


| Investment of $1 Million: S&P 500 vs. Hypothetical Annuity* | | | | |
|---|---|---|---|---|
| | Amount Invested 12/31/1981 | Time Horizon | Annualized Return | End Amount 12/31/2011 |
| S&P 500 Index | $1,000,000 | 30 Year | 11.0% | $22,666,674 |
| Hypothetical Annuity | $1,000,000 | 30 Year | 7.4% | $8,514,080 |

Additionally, some annuities tie their performance to a stock index that does not include dividends. Therefore, the annuity's returns will be lower than an index *with* dividends, and this could make a difference over time. For example, from 1926 to 2011, the S&P 500's annualized return *with dividends reinvested* was 9.7% - without dividends, the S&P's return was only 5.5%.**

**Source: This example is provided for illustrative purposes only. It is not intended to reflect the returns of an actual annuity, and it is not intended to predict returns of the S&P 500 Index for any other period. Past performance is never a guarantee of future results. Investing in the stock market involves the risk of loss. Source: Global Financial Data, Inc. GFD used data from the Cowles Commission and from S&P itself to calculate total returns for the S&P Composite using official monthly numbers from 1971 to 1987 and official daily data from 1988 on.*
***Source: Global Financial Data, Inc.; as of 1/27/2012.*

## FEES AND CHARGES

Variable annuities often have high, ongoing fees compared to traditional investments (e.g., mutual funds). Here are a few investors can expect:

*Mortality and expense fees*:
Insurance companies assume risk when selling an annuity contract, so they charge these fees to compensate. These fees may also be part of a broker's commission for selling the annuity.

*Operating and administrative fees*:
These are account maintenance fees. They typically cover administrative expenses, bookkeeping, etc.

*Sub-account expense ratios*:
These are expenses tied to maintaining your underlying investments, such as transaction costs in your mutual funds, etc.

*Guaranteed Minimum Death Benefit*:
An additional fee can be charged for this optional rider, which provides a sum to beneficiaries if the annuity contract owner passes away before the contract ends.

*Guaranteed Lifetime Withdrawal Benefit*:
This optional rider, also available for an additional fee, delivers a guaranteed income stream (typically a percentage of the principal) for the remainder of the contract holder's life.

Typical Annual Fees for Variable Annuities

| Variable Annuity Expense Description | Annual Expense |
|---|---|
| Mortality & Expense Risk | 1.25%[1] |
| Administrative Fees | 0.15%[1] |
| Optional Guaranteed Minimum Death Benefit Rider | 0.61%[2] |
| Optional Guaranteed Lifetime Withdrawal Benefit Rider | 1.03%[2] |
| Fund Expense for Underlying Funds in Variable Annuity | 0.94%[2] |
| Total Cost | **3.98%** |

[1] Securities and Exchange Commission, Variable Annuities: What you should know, (Washington DC: SEC pub 011, 09/2007), 11.
[2] Insured Retirement Institute, 2011 IRI Fact Book (Washington, DC: IRI, 2011), 36-38, 56.

A few percentage points in fees can greatly impact returns over time, even if the annuity has the same performance as the stock market. Consider the following hypothetical comparison:

| Hypothetical Impact of Fees on Returns* | | | | |
|---|---|---|---|---|
| Amount Invested | Time Horizon | Average Annual Return | Annual Expenses | End Amount |
| $1,000,000 | 20 Year | 10% | 2.4% | $4,927,064 |
| $1,000,000 | 20 Year | 10% | 1.5% | $5,919,929 |

*Surrender Fees*

Deferred annuities can also carry extra charges, including surrender fees. Surrender fees are penalties for withdrawing your money before a specific "surrender" period has expired. This period is often around seven years, but potentially longer. The surrender fee is generally a percentage of the withdrawal amount and typically declines over the surrender period. For example, the fee may be 7% to withdraw in the first year, 6% in the second year, 5% in the third year and so on until the period is over.

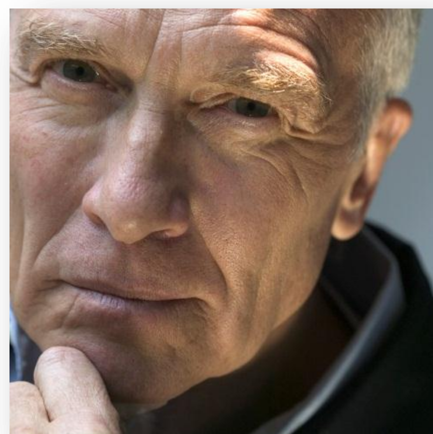
**This example is provided for illustrative purposes only. It is not intended to predict actual expenses or returns of any investment, which will vary. Past performance is never a guarantee of future results. Investing in the stock market involves the risk of loss.*

## INFLATION

Fixed annuities may not protect an investor from inflation. Inflation can be problematic because it erodes purchasing power over time. For instance, if inflation averages about 3.0% per year,* a $60,000 annual payment in 2012 and a $60,000 annual payment in 2032 are not the same. The purchasing power is vastly different - $60,000 in 2032 can only by $33,281 worth of goods and services in today's dollars. Though investors can purchase features to provide for protection from inflation, there is a fee. Similarly, adjusting your monthly payment later to account for inflation may result in penalties.

## INSURER'S FINANCIAL STRENGTH

The insurance company's financial strength will affect its ability to pay added-on benefits – death benefit, guaranteed minimum income benefit, long-term care benefit, etc. If the insurance company fails, it may default on payments, leaving the investor without the benefits they were expecting.



Although many legislative reforms are currently being considered to better protect investors from the impacts of the collapse of a financial services company, it's important investors remain wary of the possibility and ask the right questions regarding their provider's financial strength.

*Source: Global Financial Data, Inc.; as of 1/25/2012. Annualized rate of 2.99% per year. Based on US BLS Consumer Price Index from 1925-2011. Investing in securities involves the risk of loss. Past performance is no guarantee of future results.

## SHOPPING FOR AN ANNUITY:

Like any investment, be sure you understand the details before committing your hard-earned dollars. In order to fully compare the features of any annuity, you should insist on a personalized, product-specific illustration of the annuity offered.

You should always ask for a prospectus. It is a lengthy document, but it is extremely important you read and understand the contents completely. The prospectus can provide information on how death benefits, fees and surrender charges are calculated, as well as provide other critical information. Thoroughly reviewing this document can help give you a clear understanding of what you are purchasing prior to making any financial commitment. Generic sales information often does not detail all fees, calculation of returns or conditions of guarantees.

Don't be afraid to ask questions of your broker, financial planner or other financial professional – they are there to help you understand if an annuity is right for you.

## A FINAL WORD

PMRD Insurance Agency LLC is committed to helping investors with a wide array of goals and objectives plan for retirement. To get the benefit of our expertise or to learn more about your retirement options, please call us at 800.778.5198 or e-mail us at info@pmrdinsurance.com.