



# How Annuities Work

What every potential annuity owner needs to know:

How do I get money in?

How does my money grow?

How is my money protected?

How do I get money out?

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# Introduction to Annuities

## Why People buy Annuities

An annuity is a contract with an insurance company. You make either a single payment or a series of payments to the insurance company. In return, the company promises to pay you back a stream of income at some point in the future, either for a specified period of time, or for the rest of your life. The primary reason people buy annuities is to create...

### **Guaranteed Income for Life**

## Fixed vs. Variable Annuities

1. In a Fixed Annuity, your principal is protected
2. In a Variable Annuity, your principal is NOT protected. The value can go up or down with the stock market
3. Both types of annuities can enjoy gains if the stock market goes up

**A Fixed Annuity is considered a "safe" money product because your principal is guaranteed. A Variable Annuity is not because you can lose money. For the remainder of this report we're going to focus on Fixed Annuities...**



**A Fixed Indexed Annuity can be structured to provide ALL of the following:**

- 1. Guaranteed Rate of Return**
- 2. Participation in Market Gains**
- 3. Avoidance of Market Losses**
- 4. Tax Deferred Growth**
- 5. Death Benefit to Heirs**
- 6. Long-Term Care**
- 7. Lifetime Income**

# Getting Your Money In and Out

## Two Ways to Fund an Annuity

You can fund an annuity with a single up-front premium – this is referred to as a “Single Premium.” If you’re planning on taking payments within the first 12 months, it’s a “Single Premium Immediate Annuity”, or SPIA. Or, if you are planning on deferring payments until later, it’s a “Single Premium Deferred Annuity”, or SPDA.

You can also fund an annuity through a series of payments. Most non-Single Premium annuities offer “Flexible”, or, Flex” funding. This means that the insurance company will accept premium payments over time. Usually, this funding can be of varying amounts. The annuity contract specifies how and when the annuity may be funded. A typical fixed annuity requires an initial premium payment of \$5,000, or \$2,000 if the annuity is in an IRA.

## Multiple Ways to Withdraw Your Money

Sooner or later you will want to get your money out of your annuity. Most annuities offer a variety of ways to take your money out at maturity, called “Settlement Options” or “Annuitization.” Here are several common Settlement Options:

**Single Life** – With a single life settlement option, an individual will receive a fixed payment, usually monthly, for the rest of their life. Payments end with the death of the person who is receiving payment.

**Joint and Survivor Life** – With this option two persons receive a single payment, usually monthly, for the rest of their life. When the one of the couple dies, the second person continues to receive the payment until that person also dies. Payments end with the death of both persons.

**Period Certain** – This means you can take your money out over a period of 5, 10, 15, or 20 years. The insurance company guarantees to pay out all your money, plus interest, over that period. If you die before the end of the period, your beneficiary gets what’s left in your annuity over the balance of the period.

**Lump Sum** – With this option you take all your money, plus any increases in the value of your annuity, out of the annuity at one time.

*\*\* Only a small percentage of annuities are actually “Annuitized,” because once they are, the lump sum investment is no longer available. But you can purchase an optional “income rider” that will allow you the flexibility to turn income on and off, while still preserving the cash value build up in the contract. There are many variations of these riders and we use them often, but we won’t explore them in detail in this report.*

# Properties of a Fixed Annuity

## Fixed Annuity vs. Fixed Index Annuity

Before we look at the various ways your money can grow, it is important to distinguish between a fixed annuity and a fixed index annuity. First, *both* annuity types are considered fixed, and thus both provide a guarantee of principal from the insurance company, making them both what we call “safe money” products.

## Fixed Annuity vs. a CD (Certificate of Deposit)

A fixed annuity is a relatively straightforward insurance product. The primary reason someone buys them is to take advantages of several things a traditional CD doesn't offer. First, the principal earns a higher interest rate than a CD. Second, interest grows tax-deferred, and is only taxable upon withdrawal, whereas a CD creates taxable income on an annual basis, regardless of whether you actually withdraw the interest or not. And third, some states (not all) offer some level of asset protection for annuities, but not CD's (you should verify the specifics with an attorney).

It's important to note that CD's are FDIC insured up to \$250,000, and annuities aren't. But, every state has an insurance guaranty fund, and the principal amount in a fixed annuity generally falls under this protection. You should consult with your State's department of insurance or a licensed agent to find out the specifics for your state. Please note that insurance companies have a stellar track record when it comes to honoring the guarantees of fixed annuities.

## Guaranteed Rate of Return

Both Fixed and Fixed Index Annuities have a minimum guaranteed rate of return. A fixed product will have a stated fixed rate of return. A Fixed Index Annuity (FIA) will have a stated minimum rate of return, usually a nominal amount. But, an FIA is also linked to an index, such as the Standard & Poor 500 (S&P 500). If the index goes up (what we are saying is if the stock market goes up), you'll see the value of your annuity go up too, possibly significantly above the minimum guaranteed interest rate. **And, if the stock market goes down, your annuity value will not decrease!**

How can this be possible? Well, there are also caps on how much you can earn if the market goes up. You won't participate in 100% of the gain. It is precisely these caps that give the insurance company the ability to guarantee that you won't lose money. There are many variations of these “caps”, and you must understand what the caps and participation rates are and how they are applied before you purchase the annuity.

# Properties of a Fixed Annuity

## Tax Advantages

The biggest tax advantage of an annuity is that you're not taxed on the interest you earn until you withdraw the funds, giving you the benefit of tax-deferred growth, just like a traditional IRA. One advantage over an IRA is that you're not required to take taxable Required Minimum Distributions (RMD's) when you reach age 70 ½. Most annuities won't force you to withdraw money until you are 85 or even older. The IRS will impose a 10% penalty on any earned interest that you withdraw prior to age 59 ½. But, if you purchased the annuity outside of your IRA, then you did so with after-tax money, so only the *interest earned* is subject to this penalty.

## Death Benefit

Most annuities will pay the account value to your beneficiary upon your death without any surrender charge. And, some annuities will allow your spouse to keep the annuity in force. Unlike a life insurance policy, where the death benefit far exceeds the actual amount of premium paid, the death benefit of an annuity is effectively the money you put in plus any earned interest that's been credited to the account. It would be similar if you have an IRA and had named a beneficiary: They would get the actual amount in the account...the amount you had contributed plus any earned interest (gains).

## Long Term Care ("Living") Benefits

Many fixed index annuities offer options, called "riders," that will waive surrender charges if you go into a nursing home, or even offer increased payouts of income above and beyond the normal contracted rates.

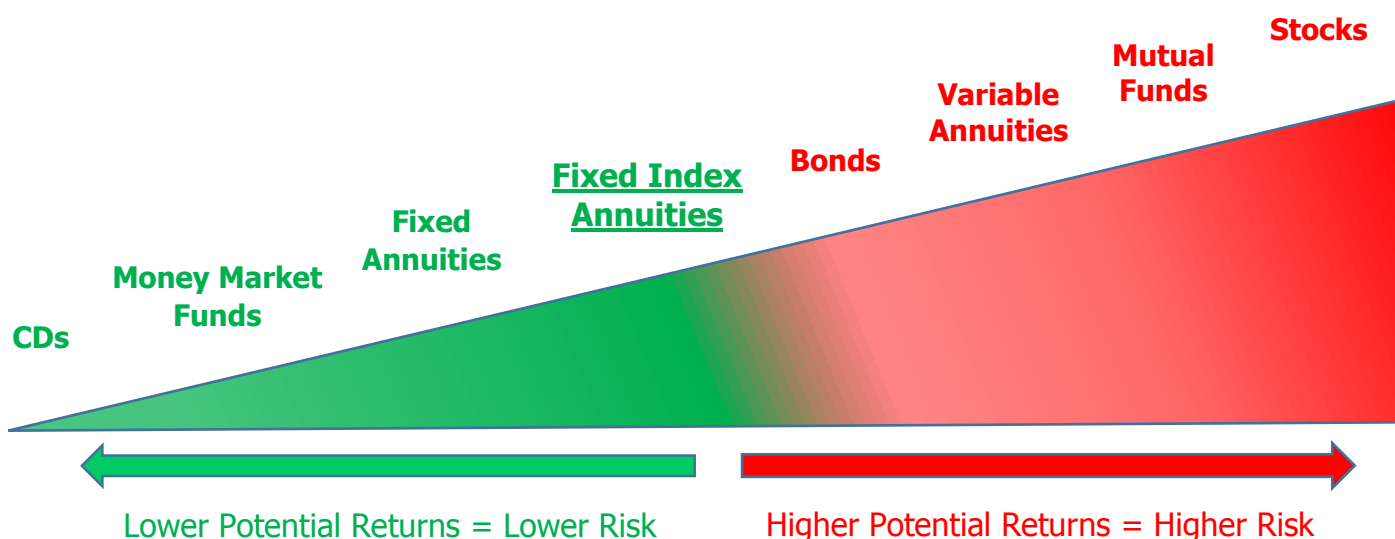
## Surrender Charges and Lack of Liquidity

Virtually every annuity carries with it a steep penalty (called a Surrender Charge) for an early withdrawal of your principal, far in excess of a typical CD. The surrender charge can be in force for several years, but the amount of the charge diminishes over time, and eventually goes away. But, most annuities will allow up to a 10% annual withdraw with no penalty. Surrender charge amounts and time restrictions can vary greatly from one annuity to another, even from the same insurance company. For these reasons, annuities are not considered liquid investments. There are also tax consequences when taking money out: Earned interest is taxed on a Last-In, First-Out (LIFO) basis when withdrawals begin.

# A Closer Look at a Fixed Index Annuity (FIA)

## Red Money Investments / Green Money Investments

Red money investment vehicles have the potential to lose money. They also have the potential for the highest gains. Green money investment vehicles are considered "Safe" Money, meaning that you cannot lose principal. That does *not* mean that green money investments have no risk...there are other types of risk besides losing principal, such as liquidity and inflation. The following chart shows various investment vehicles and where they fall on the risk/return spectrum:



## A Fixed Index Annuity is Linked to an "Index" and Provides Upside Potential

A commonly used index for an annuity is the S&P 500, a bucket of 500 large-company stocks whose cumulative movement is tracked daily. If the index increases over a specified period of time, your annuity contract will credit you with interest. The more the index increases, the more interest you will earn. *There are many other indexes that can be used besides the S&P 500.*

## A Fixed Index Annuity Provides Protection from Losses if the Index drops

What if the index loses value? Your principal will **not** lose value, and any interest earned from previous years **is also protected**. The worst you can do in a down year is 0%. This is why a Fixed Index Annuity is considered a "Green" Money Investment.

Let's look closer at how a fixed index annuity credits interest to your account...

# How Money Grows in a Fixed Index Annuity (FIA)

## Interest Crediting Methods

The annuity contract must specify what method is used to credit interest to your account. A common method is the **annual point-to-point**. Using this method, the beginning "point" will be a specific date (we will assume Jan 1) and the ending "point" will be exactly one year later (Dec 31). In our example, the index rises 20% during this 12 month period. So does that mean the annuity is credited with a 20% interest gain? Not necessarily...

## Participation Rate

The contract may have a specified participation rate. If the participation rate is 60%, then only 60% of the gain will be credited. In our example, that would be 12% (20% gain x 60% participation rate = 12% interest credit). The

## Cap

Annuity contracts may have limits, or caps, on what the total gain could be. If the contract has an annual cap of 8%, then no matter what else happens, the total interest credited cannot exceed 8%. So, in our example, the contract would be credited with 8% interest, not 12%.

It is absolutely critical that you understand the Index being used, Interest Crediting Method being used, the Participation Rate, and the Cap of any fixed index annuity contract before you purchase it. It is also important to know if and how often you can select a different interest crediting method.

## Previous Gains are Locked In

Perhaps the most overlooked advantage of a fixed-index annuity is the reset provision. Whenever a new interest crediting period begins, whatever the value of the index is on that day becomes your new starting point.

For example, if the index has dropped 20% during your crediting period (1 year), then the value of your account is unchanged (Remember 0% is your worst-case scenario). But if you had invested directly in the index, you *would* be down 20%. Worse, you would now have to earn 25% in the next year just to get back to even.

***But your annuity uses the new lower value as next year's starting point.***

Let's see how this works...

# How Money Grows in a Fixed Index Annuity (FIA)

## Example of How a Fixed Index Annuity Earns Interest

The chart on the left shows the actual change for the S&P 500 Index from the 16 year period of 2000-2015. Also, it shows the compounded growth of \$100,000 using these actual index changes over the same period.

The chart on the right shows hypothetical returns of a Fixed Index Annuity using the actual returns of this index during the same time period. For the purposes of this example, we are using a participation rate of 60%. This means that in any year the index gained, you would get credit for 60% of this gain. We are also using a cap of 8%, meaning that the maximum amount of interest credited to your account in any one year cannot exceed 8%.

| S&P 500 Index History 2000-2015 |               |                   |
|---------------------------------|---------------|-------------------|
| Starting value:                 |               | \$100,000         |
| Year                            | Annual Return | End of Year Value |
| 2000                            | -10.14%       | \$89,860          |
| 2001                            | -13.04%       | \$78,142          |
| 2002                            | -23.37%       | \$59,880          |
| 2003                            | 26.38%        | \$75,677          |
| 2004                            | 8.99%         | \$82,480          |
| 2005                            | 3.00%         | \$84,955          |
| 2006                            | 13.62%        | \$96,525          |
| 2007                            | 3.53%         | \$99,933          |
| 2008                            | -38.49%       | \$61,469          |
| 2009                            | 23.45%        | \$75,883          |
| 2010                            | 12.78%        | \$85,581          |
| 2011                            | 0.00%         | \$85,581          |
| 2012                            | 13.41%        | \$97,057          |
| 2013                            | 29.60%        | \$125,786         |
| 2014                            | 11.39%        | \$140,113         |
| 2015                            | -0.73%        | \$139,091         |

| Annuity Example with 60% Participation Rate |                   |                   |
|---|-------------------|-------------------|
| Starting value:                             |                   | \$100,000         |
| Cap: 8%                                     |                   |                   |
| Year  | Interest Credited | End of Year Value |
| 2000  | 0.00%             | \$100,000         |
| 2001  | 0.00%             | \$100,000         |
| 2002  | 0.00%             | \$100,000         |
| 2003  | 8.00%             | \$108,000         |
| 2004  | 5.39%             | \$113,826         |
| 2005  | 1.80%             | \$115,874         |
| 2006  | 8.00%             | \$125,144         |
| 2007  | 2.12%             | \$127,795         |
| 2008  | 0.00%             | \$127,795         |
| 2009  | 8.00%             | \$138,018         |
| 2010  | 7.67%             | \$148,602         |
| 2011  | 0.00%             | \$148,602         |
| 2012  | 8.00%             | \$160,490         |
| 2013  | 8.00%             | \$173,329         |
| 2014  | 6.83%             | \$185,174         |
| 2015  | 0.00%             | \$185,174         |

Is this a realistic example using real-world returns? Next, let's take a look at the results of an independent study done in 2010 by the Wharton Financial Institutions Center...



# "Real World" Index Annuity Returns

## Excerpts from the study published March 4, 2010:

"We offer the first empirical exploration of fixed indexed annuity returns based upon actual contracts that were sold and actual interest that was credited. Annuity returns have been competitive with alternative portfolios of stocks and bonds. Their design has limited the downside returns associated with declining markets. They have achieved respectable returns in more robust equity markets."

"Studies that have criticized FIAs are typically based on hypothesized crediting rate formulae, constant participation rates and caps, and unrealistic simulations of stock market and interest rate behavior. When actual policy data are used, the conclusions change."

"We believe this to be the most comprehensive data ever assembled for actual FIA performance data to date... These results are based on copies of actual customer statements... for each of the preceding five-year periods, requested on an annual basis since 2002. The returns reflect the results of products with term end point, high water mark, and annual reset designs with and without crediting rate caps, and with and without averaging..Annuitization was not required to receive these returns..."

| Time Period | S&P Return | Fixed Index Annuity Average Return | Number of Fixed Index Annuities | Return Range    |
|-------------|------------|------------------------------------|---------------------------------|-----------------|
| 1997-2002   | 9.39%      | 9.19%                              | 5                               | 7.80% to 12.16% |
| 1998-2003   | -0.42%     | 5.46%                              | 13                              | 3.00 to 7.97%   |
| 1999-2004   | -2.77%     | 4.69%                              | 8                               | 3.00% to 6.63%  |
| 2000-2005   | -3.08%     | 4.33%                              | 28                              | 0.85% to 8.6%   |
| 2001-2006   | 5.11%      | 4.36%                              | 13                              | 1.91% to 6.55%  |
| 2002-2007   | 13.37%     | 6.12%                              | 23                              | 3.00 to 8.39%   |
| 2003-2008   | 3.18%      | 6.05%                              | 19                              | 3.00% to 7.80%  |
| 2004-2009   | -1.05%     | 4.19%                              | 27                              | 2.25% to 6.83%  |

**"From 1997-2007 the 5-year annualized returns for FIA's averaged 5.79%."**

Wharton acknowledges the limitations of the data used...primarily that they could only analyze annuities from carriers who chose to participate in the study, and the carriers chose the products. And, this is not intended to predict future returns.

"Nonetheless, the 136 contracts for which we have data are real contracts and reflect actual crediting rates that were provided to annuity owners over time under twelve different crediting rate structures used in FIA designs."

If you would like a copy of the entire study, email us at: [ask@saferetirements.com](mailto:ask@saferetirements.com)

# Income You Can't Outlive

**Today, your money has to last longer than ever before.**

A Fixed Annuity is an Insurance Product, not a security. Insurance is used to protect against risk. Retirees today face many risks, such as inflation, rising healthcare costs, long-term care costs, tax liabilities on IRA distributions, stock market volatility, and unprecedented longevity.

A Fixed Index Annuity is a fairly complex product, and shouldn't be the only product an investor considers. Rather, it should be seen as a cornerstone of a "blended" strategy to create lifetime income, beat inflation, and preserve assets, while providing the flexibility to handle the unexpected. With a fixed annuity,

**Your gains are locked-in and your money is secure.**

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