Redefine Retirement

Variable Annuities

LPL Financial

Things to Consider When Planning for Retirement

People are living longer than ever before

Over the last 40 years, the average life expectancy has increased by more than 10 years.[1] In fact, statistics show that for a 65-year-old couple, there's an almost 20% chance that one of them will live to age 95.[2] This is all good news; however, the implication for today's retirees is that they need to plan carefully with the future in mind.

The traditional pension is going away

Today's investors are facing retirement income planning challenges that simply didn't exist 20 or 30 years ago. Unlike previous generations who had the luxury of having their retirement funded by guarantees made by employers and/or the government, the assets you've accumulated in your 401(k) or individual retirement account (IRA) could be your most important source of retirement income.

[1] Source: http://www.oecd.org/newsroom/healthier-lifestyles-and-better-health-policies-drive-life-expectancy-gains.htm (October 2017)
[2] Source: RP-2000 Mortality Table, Society of Actuaries

Although there are several products and strategies investors can employ to potentially generate retirement income, they may not all offer the predictability of a steady income stream. However, there are products available today that can offer guarantees and income predictability.

Investors who don't have pension plans or other guaranteed streams of income after retiring face the challenge of converting their retirement savings into an income stream to support their lifestyle. Incorporating a variable annuity with an optional feature, such as a guaranteed lifetime withdrawal benefit (GLWB), is one way of accomplishing this for a portion of their retirement assets.

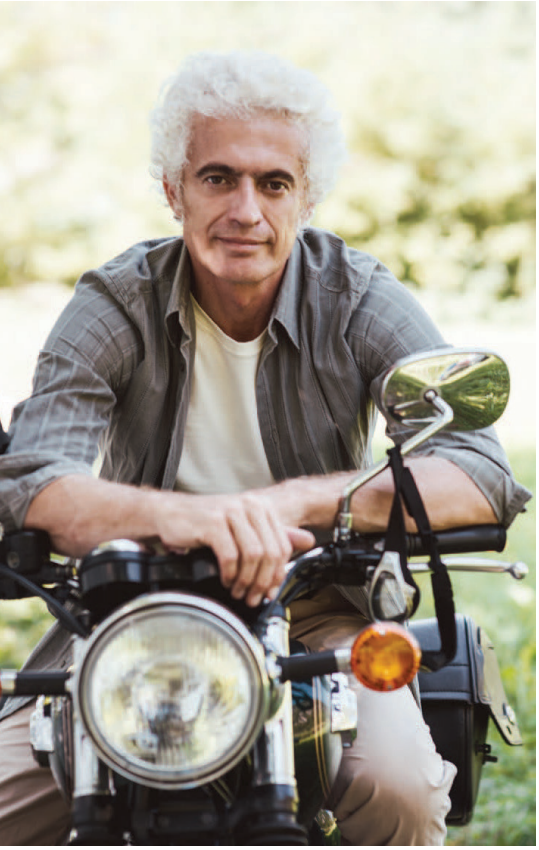
How Do These Investment Products Work?

Picture an investment account where you're allowed to take withdrawals up to a specific dollar amount each year to support your spending needs. However, with this strategy, you pay extra for a guarantee that if your account runs out of money over time due to the combination of poor performance and withdrawals, you'll receive uninterrupted payments that are paid to you by an insurance company. This is a strategy to insure your retirement assets in the form of an income stream.

A Closer Look at Variable Annuities

Variable annuities are long-term, tax-deferred investment vehicles designed to create a retirement income stream for life. They contain both an investment and insurance component, and provide tax-deferred growth, access to professionally managed investment portfolios, death benefits, and flexible withdrawal options. Variable annuities are sold only by prospectus, and guarantees are based on the claims-paying ability of the issuer.

As a means of delivering retirement income, variable annuities provide a unique advantage. They allow you to invest in equity markets with insurance features called "living benefits," which are optional benefits available for an additional fee on annuity contracts that can offer protected lifetime income. There are different types of living benefits available that can offer income, the return of principal, or both. Some of those benefits specialize in providing immediate income, while others are designed to provide you with distributions at a later date.



Benefit Base:
Equal to your initial investment, this value can increase based on positive market performance or by a fixed interest credit, typically in years where no income is taken. The benefit base value is guaranteed by the insurance company and doesn't fluctuate with market performance on a daily basis like your actual account value. Unlike your account value, which can be accessed at any time as a lump sum (subject to potential surrender charges), the benefit base is a value that is used only to calculate lifetime income payments, and therefore cannot be accessed through a lump-sum distribution.

Guaranteed Lifetime Withdrawal Benefits

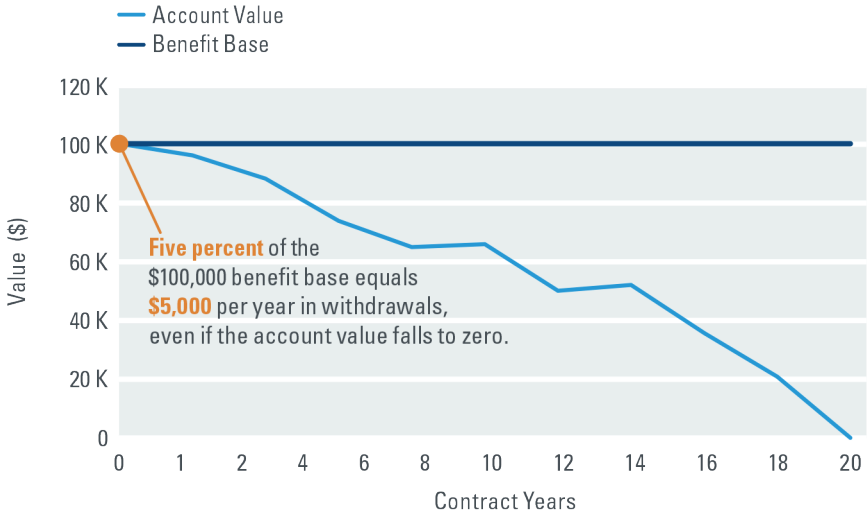
A popular living benefit employed by investors today with variable annuities is called a guaranteed lifetime withdrawal benefit (GLWB). GLWBs can range in cost from 0.40% to 1.62%,[3] depending upon the feature and the issuing insurance company. It's common for there to be a connection between the cost of the living benefit and the amount of insurance or guarantee that it provides. It's also important for you to identify how much protection you need.

When you purchase a variable annuity with a GLWB feature, you can participate in equity markets and make withdrawals each year as you would from any of your investment accounts that you use to supplement your lifestyle. However, there is an added benefit in this case: As long as your withdrawals remain within the annual withdrawal parameters of the GLWB feature and benefit base value, withdrawals will be guaranteed for your lifetime. Even if your annuity account value were to run out of money due to a combination of poor market performance and/or withdrawals, the insurance company would continue the payments pursuant to the provisions of your GLWB feature.

An Example of an Investor Looking for Income Today

An example of immediate income: An investor, age 65, invests $100,000 into a growth-with-income portfolio within a variable annuity with a GLWB (available for an additional fee) that guarantees withdrawals of up to 5% of the initial investment for the investor's life starting at age 65. This means that the investor can withdraw up to $5,000 per year for life. In this example, 20 years later, the variable annuity runs out of money due to a combination of poor performance and withdrawals. The investor continues to receive $5,000 per year for life from the insurance company as a result of the feature.

Example 1: Hypothetical Guaranteed Lifetime Withdrawal Benefits



This is a hypothetical example and is not representative of any specific situation. It does not reflect the deduction of fees and charges inherent to investing. Your results will vary.

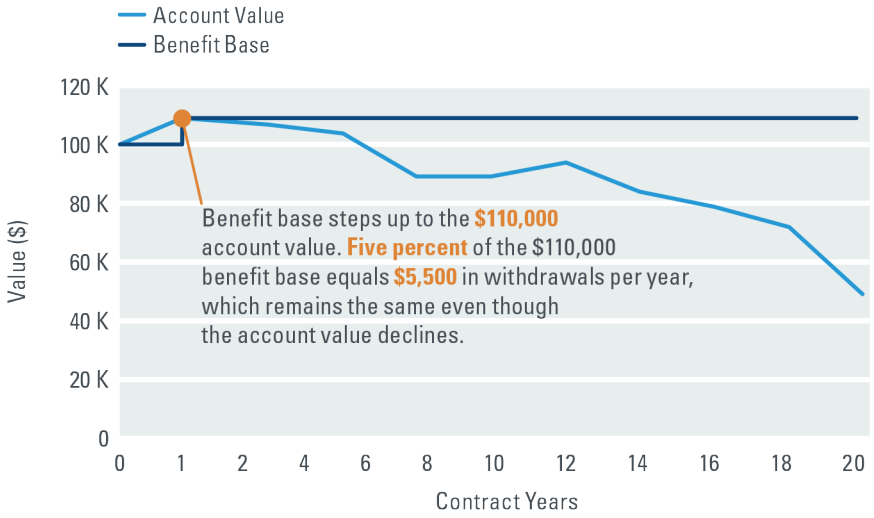
[3] Source: Morningstar Annuity Intelligence 2017

Locking In Investment Gains with GLWBs

Continuing this example, many GLWBs offer investors the ability to lock in investment gains and take income from higher account values, thus increasing the guaranteed annual lifetime income amount. This can be accomplished with a feature known as a "step-up." Step-ups exist on many GLWB features today and are a way to lock in account gains. The concept is that if the account value is greater than the existing benefit base, the benefit base steps up to equal the account value and is used as a new basis for the purpose of taking retirement income. Step-ups with GLWBs occur at a specified frequency up to a declared age. Perhaps most commonly, GLWB features offer annual step-ups that occur on the annuity anniversary, although some features may offer quarterly, monthly, or even daily step-ups.

An example of a step-up: After one year, an investor's account value grew from $100,000 to $110,000 on his contract anniversary. Since $110,000 is greater than the initial benefit base of $100,000, and assuming the investor paid for the feature that offers an annual step-up, the benefit base would now be worth $110,000, and this new value would be used to determine how much the investor can take from his annuity per year. Since the GLWB feature guarantees 5% of the benefit base for life, the investor can now withdraw $5,500 per year, which is a $500 increase over his prior lifetime withdrawal amount.

Example 2: Hypothetical Guaranteed Lifetime Withdrawal Benefits



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Things to Consider When Planning for Retirement

While there's no standard percentage or specific amount to allocate to a variable annuity, there are some steps investors can take to identify how much may be appropriate. This can be accomplished by performing a guaranteed income needs analysis with your financial advisor.

Guaranteed Income Needs Analysis

Step 1: Determine expenses and income needs for retirement

This involves identifying your expected expenses at retirement and dividing them between what you consider to be essential and discretionary.

Step 2: Analyze current guaranteed income for retirement shortfalls

Many investors have sources of recurring income at retirement. Social Security is a great example, and some may have pensions. In this step, you inventory the sum of your current sources of guaranteed income and also define what your target guaranteed income level.

Defining your target guaranteed income: Many investors seek to have all or a portion of what they consider essential expenses covered by guaranteed income. Given that variable annuity strategies with GLWBs are generally more expensive than traditional investments due to the insurance features, you'll want to weigh this carefully with how much you'll need to feel comfortable in retirement.

Finally, once you've calculated the sum of your guaranteed income and have defined your guaranteed income goal, the difference between these numbers will be your guaranteed-income shortfall.

Step 3: Inventory current assets

In this step, you calculate the sum of your investable assets from both your qualified and non-qualified accounts.

Step 4: Reposition assets to guarantee total income needs

In this step, you'll need the help of your financial advisor. He or she will understand what's available within the investment marketplace and will be able to input numbers as a proxy for what the current industry has to offer based upon your age, whether or not your goal is to cover both spouses, and when you plan on taking income.

Step 5: Identify and understand the strategy

Now that you have a rough estimate of how much you might allocate, if it is determined that a variable annuity is appropriate, you can work with your financial advisor to identify a specific product that meets your needs. While the numbers may differ slightly, it's important that you engage in this process, as you'll know roughly how much you wish to commit to this strategy given the benefits and tradeoffs.

In this step, you'll want to evaluate the underlying insurance company, since it's their claims-paying ability that will fund your guarantee. Be mindful of the investment options available to you in combination with the additional costs of the GLWB feature, since many are restrictive based upon the risk the insurance company is assuming on your behalf. Finally, analyze the liquidity options and costs associated with the variable annuity of your choosing.

Important Considerations for Variable Annuities

Potential Benefits

- Professional investment management with a variety of investment options.
- Flexibility to reallocate investment options without creating a taxable event.
- Optional GLWBs that can provide you with a minimum guaranteed lifetime income stream (even if the value of your contract diminishes), which is a unique feature compared with traditional investment products.
- Death benefits that typically provide your beneficiaries the greater of your account value or the return of your investment adjusted for proportional withdrawals.
- Tax-deferred growth on earnings until withdrawals begin.

Risks

- Withdrawals made prior to age 59½ are subject to a 10% IRS tax penalty, and surrender charges may apply.
- Gains from tax-deferred investments are taxable as ordinary income upon withdrawal.
- The investment returns and principal value of the available subaccount portfolios will fluctuate so that the value of your annuity, if redeemed, may be worth more or less than its original value.
- Taking withdrawals beyond the maximum allowable amount under a GLWB feature may negatively impact your benefit base level and leave you paying a premium for a feature you're not using. In order to maximize the strategy, you should be prepared to adhere to the limitations of the feature and have funds outside of the annuity for emergencies or other supplemental needs so as to maximize the benefit you're paying for.
- All guarantees are subject to the claims-paying ability of the issuing insurance company. If the insurance company becomes insolvent, you could lose all or a portion of your future guarantees, depending on coverage provided by your state's insurance-guarantee associations.[4]

GLWB features are considered riders, which are additional guarantee options that are available to an annuity or life insurance contract holder. While some riders are part of an existing contract, many others may carry additional fees, charges, and restrictions, and policyholders should review their contract carefully before purchasing. Guarantees are based on the claims-paying ability of the issuing insurance company.

[4] This risk extends specifically to the insurance features and not the investments. Variable annuity subaccounts are held in separate accounts and are not exposed to creditors in the event of insurer insolvency.

If you're currently in or nearing retirement and are looking for protected lifetime income, a variable annuity with a guaranteed lifetime withdrawal benefit feature may be appropriate for a portion of your retirement assets. This strategy allows you to stay invested in equity markets while also providing a protected stream of income for the rest of your life.

Talk to your financial advisor about how a variable annuity may fit into your overall investment and retirement strategy.

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