Fixed Index Annuities and How They Work

You may hear this product called a Fixed Index Annuity, Index Annuity, or Equity Index Annuity – it's all the same product!

To provide a little background, Index Annuities were first introduced in about 1995. Many people wanted the safety and guarantee of principal and earnings you get from **SAFE** vehicles like savings accounts, CDs and fixed annuities but they didn't like the interest rates – they were too low. Others wanted the potential high returns from the stock market, but they didn't want the risk of the stock market. They wanted something in between.

The Fixed Index Annuity can give you the best of both worlds: A fixed index annuity offers a guarantee of principal **and** the potential of market-linked growth with **no loss of principal or earnings** due to market downturns. You cannot lose your principal or earnings with a fixed index annuity unless you withdraw money or surrender the policy before the end of the contract.

Since index annuities were introduced in 1995, they have been one of the fastest growing retirement vehicles on the market. Today, approximately 60 different insurance companies offer over 800 annuity products!! Of these companies, approximately 50 insurance companies offer about 500 different fixed and index annuity products! Of the 500 products, approximately 260 are index annuity products!

Choosing the right annuity for your retirement is not easy! With so many choices, which product is right for you?

As independent agents, specializing in retirement management, we can seek out the best annuity products on the market for our clients. We work hard to find the index annuity products that will give our clients all of the standard benefits of an index annuity as well as the highest rate of return, liquidity when you need it and income.

The following discussion highlights the standard features offered in an index annuity as well as the features we seek for our clients.

Safety and Guarantee of Principal

A fixed index annuity provides you with the best features of a traditional fixed annuity - a guarantee of principal and no losses (unless you withdraw money or surrender the contract) and it provides the potential of stock market-linked returns without the potential of stock market-type loss. The fixed index annuity protects the contract owner from loss of principal or previously earned interest due to market downturns.

What is Indexing?

Earnings on a fixed index annuity are based on the performance of stock indexes such as the S&P 500, Dow Jones, NASDAQ and others. But what is indexing? Indexing is simply a strategy or calculation method that follows the performance of the index such as the S&P 500 Index. A fixed index annuity is linked to the performance of a market index, without the risk of directly participating in stock or equity investments. With indexing, you can participate in a diversified passive investment strategy: a link to the market and its potential gains without subjecting yourself to the potential downfalls of the market.

Expectations for the Fixed Index Annuity

Fixed index annuities have the potential for market-linked interest ***without*** exposure to the market risk. Contract owners enjoy the guarantees and safety of principal even while being linked to market growth. However, they should not expect fixed index annuities to mirror the exact performance of any stock market index.

Since a fixed index annuity uses a passive investment strategy, it will not mirror the exact return of the stock market index.

The Power of Tax Deferral

All annuity values accumulate on a tax deferred basis until withdrawn. Therefore, your money can grow faster because you earn interest on dollars that would otherwise be paid as taxes. Your principal earns interest and the interest compounds allowing you to accumulate more money over a shorter period of time, thereby earning a greater return on your money.

Understanding Annuities

An annuity is a powerful financial tool designed to meet your long-term savings and/or retirement needs. It can be used to accumulate assets on a tax-deferred basis for retirement, to be passed to your beneficiaries and/or to convert retirement assets into a stream of income.

How does an annuity differ from life insurance? While both are insurance contracts, <u>an annuity is the opposite of life insurance:</u>

- Life insurance provides financial protection against the risk of dying prematurely.
- An annuity provides financial protection against the risk of living too long and being without income during retirement.

There are three basic types of annuities, fixed annuities, variable annuities and fixed index annuities.

Fixed Annuities

A fixed annuity is the most widely used and well-known annuity. It is considered to be one of the safest investments available. A fixed annuity operates very much like a CD except that it is offered by an insurance company. You can buy a fixed annuity for one year, three years, five years or longer – based on your needs. <u>The insurance company backs your</u>

principal against any loss and gives you a fixed rate of interest for the term of the annuity. Like a CD, if you chose to "cash in" the annuity before the end of the contract term, you will pay a surrender charge based on how long you have held the annuity.

Fixed annuities have liquidity – you can have access to your money (typically the interest can be withdrawn each year), you can sometimes have up to a 10% penalty free withdrawal each year, and they can be turned into a guaranteed income stream. Fixed annuities are tax deferred, they avoid probate because they have named beneficiaries, and there are **no fees.**

Variable Annuities

Variable annuities are very different from fixed annuities. The major difference is that a variable annuity participates in the stock market with mutual fund families. Most of the protection offered by a fixed annuity has been removed and the annuity is participating directly in the stock market. You can lose your principal, your interest is not guaranteed and there are fees. The upside is that you have the potential gains offered by the stock market - but with all of the risk.

Fixed Index Annuities

Is there anything in between? The answer is a Fixed Index Annuity. The Fixed Index Annuity has all of the safety features of the fixed annuity **and** has the potential for stock-market linked returns (without participating directly in the market and with none of the downside market risk). Like Fixed Annuities, Index Annuities have no fees!

Index annuities, like fixed annuities, are one of the safest investment vehicles available. They are offered by legal reserve life insurance companies and in most states, including the state of Florida, are protected by state guaranty funds, subject to state guaranty limits. To learn more, go to www.flahiga.org and www.termlife.com/insurance-101/company-safety.

Deferred Annuities

All of the annuities described above are considered deferred annuities. A deferred annuity simply means that you can grow your asset during the "accumulation phase" and turn your asset into income during the "income phase".

During the accumulation phase, you contribute premiums to the annuity (often as one lump sum deposit), where they accumulate (earn interest) on a tax deferred basis. The accumulation phase can be as short as one year or for the life of the contract.

During the income phase, the value of the annuity may be accessed in several different ways. See the section on **Annuity Liquidity.**

Immediate Income Annuities

An immediate income annuity is purchased with a single premium and income payments begin immediately after the premium is paid. Several different income payment options are offered. An immediate annuity may or may not be appropriate for you. Please consult with your financial advisor.

Annuity Objectives

Because our clients want safety first and the potential for income and growth second, the remainder of this article will focus on Fixed Index Annuities. In planning for financial security in retirement, an index annuity can help satisfy four basic objectives:

1) To accumulate retirement assets on a tax-deferred basis. If you're already contributing the maximum to IRAs or any employer sponsored retirement plans and need to save more for retirement, a deferred index annuity may be the answer to your retirement savings need.

2) To convert assets at risk (such as assets in the stock market) to a safe investment with stock-market linked returns;

3) To convert low-yielding accounts (such as savings accounts, money markets and CDs) to a safe investment with stock-market linked returns;

4) To convert retirement assets into an income stream that you cannot outlive.

A Closer Look at Index Annuities

An index annuity is an insurance contract and not an investment in the stock market. Index annuities credit interest using a formula or crediting method based on changes in the index to which the annuity contract is linked. Interest payable (in excess of the minimum guaranteed interest rate) is determined by a formula or crediting method contained in the annuity contract. (*Because it is a fixed annuity, the insurance company must guarantee a minimum amount of growth over the length of the contract. The minimum guaranteed interest rate varies from company to company.)* The contract holder may choose annually among the indexes and crediting methods offered within their contract.

Index Annuity Contract Features

Before purchasing an index annuity, it is important to understand various contract features and their potential impact on annuity performance. We believe only certain annuity products offer the features and benefits desired by our clients. <u>The following information describes the features commonly offered in the annuities we offer to our clients:</u>

Contract Term

The contract term is the length of time during which withdrawals or surrenders are subject to a surrender penalty. <u>Depending on your needs and the features you desire</u>, an index annuity term can be as short as one year or as long as ten to twenty years. During the term of the contract, there are some restrictions on the amount of money you can withdraw each year. If you choose to withdraw all of your money before the end of the contract period, there is a declining surrender charge (like a CD). At the end of the contract term, you may withdraw all of your money (without any surrender charge) or you may keep the contract and withdraw as much as you wish at any time. Some index annuities offer a return of premium which means you can get your entire premium back any time after the first contract year.

The Index

Index annuities credit interest based on the movement of a stock market index to which the annuity is linked. A market index tracks the performance of a group of stocks representing a specific market segment. The S&P 500 is the most commonly used index because it contains the 500 biggest and best stocks in our economy today. It is considered the best indicator of overall stock market performance. Other indexes may also be used such as the Dow Jones Industrial Average, NASDAQ 100, Russell 2000 and several others.   When you buy an index annuity, it is important to understand that you are purchasing an insurance contract and not shares of any stock or index.

Indexing Method

An index annuity offers the potential for interest earnings based on the performance of the index to which the annuity is linked. The indexing method is the calculation method used to measure the amount of change in the index and, as a result, has a direct impact on the potential growth of an index annuity. Indexing methods will be explained in more detail later.

Calculation/Indexing Methods

Insurance companies offer a wide variety of calculation and indexing methods. There are several important features we look for because they bring the greatest potential for good returns to the policy holder.

Annual Reset

Annual Reset is an important part of the calculation process. It means that every contract year, the calculation process is restarted, beginning with the last index value of the previous year. For example, if the S&P 500 starting value for the first year was 1200 and the closing value was 1100, it means the contract may not have earned money that year. However, the starting value for the next year is 1100. So, if the market grows during the following year, the contract has a good chance of making money! In this way, the contract never participates in any of the down market years and has the opportunity for good earnings when the market is going up!!

Annual Lock-In of Earnings

Another powerful component of the index annuity is annual lock in. This means that each year the contract earns money, the earnings are locked into the contract, along with the principal, and no future year can take it away (unless you chose to withdraw money from the contract).

Calculation Methods: One or more of the following calculation methods are available in the index annuities we offer:

Annual Point-to-Point

This calculation method compares the change in the index at two distinct times – the beginning and ending dates of the contract year. This calculation method typically has a cap or it may also have a spread or a participation rate. The index value on the first day of the contract year is subtracted from the index value on the last day of the contract year and the percentage change is calculated. If the result is positive, the contract is credited with the percentage gain up to the annual cap. If the result is negative, there is no loss to the contract. The index is reset, as described above, at the value it closed for the year that just ended.

Monthly Point-to-Point

This calculation method compares the change in the index at the end of each contract month. This calculation method has a monthly cap. The index value on the first day of the contract month is subtracted from the index value on the first day of the second contract month and the percentage of change is calculated (positive or negative). This process continues for each contract month for the entire contract year. In any month there is a positive gain, the monthly cap is applied. At the end of the contract year, the percent of change (negative and positive) is added (just like adding deposits and subtracting checks in your checkbook). If the result is positive, the contract is credited with the percentage gain – no additional cap is applied. If the result is negative, there is no loss to the contract. The index is reset, as described above, at the value it closed for the year that just ended.

Monthly Averaging

This calculation method compares the index at the beginning of the contract year to the average index for the next 12 months. The index value for each contract month is recorded and an average is calculated for the entire 12 months. The average is compared to the starting index value for the contract year. If the result is positive, the participation rate, margin/spread or cap is applied and the contract is credited with the percentage gain. If the result is negative, there is no loss to the contract. The index is reset, as described above, at the value it closed for the year that just ended.

Daily Averaging

This calculation method compares the index at the beginning of the contract year to the average daily index for the next year. The index value for each day is recorded and an average is calculated for every day the market is open during the contract year. The average is compared to the starting index value for the contract year. If the result is positive, the participation rate, margin/spread or cap is applied and the contract is credited with the percentage gain. If the result is negative, there is no loss to the contract. The index is reset, as described above, at the value it closed for the year that just ended.

Fixed Interest

Index annuities always offer a fixed interest rate option, guaranteed for one year. You may choose to move some or all of your money to a fixed interest rate option each year. The fixed interest rate for the year is declared in advance and the insurance company may change the rate from year to year.

Inverse Performance Trigger

This is a new and interesting option that has been added to some contracts. If you choose this option for all or part of your contract, the contract will credit you a fixed rate IF the market goes down!!

Participation Rates, Margin/Spread and Caps

Each calculation method also has a participation rate, margin/spread or cap that limits the amount of growth you can achieve each year. The growth is typically much more than you can receive from a savings account or CD but it is less than the potential return you would receive from being directly in the stock market.

The Participation Rate determines how much of the increase in the index will be credited to the index annuity. For example, if the S&P 500 increases by 10% and the participation rate is 80%, the index annuity would be credited with 8%. The insurance company has the right to change the participation rate from year to year.

The Margin or Spread is a percentage that is subtracted from your index return. For example, if the S&P 500 increased by 10% and the "margin," or "spread" is 4%, the index annuity would be credited with 6%. If the index showed no increase for the year, there is no deduction made for the margin or spread. The insurance company has the right to change the margin or spread from year to year

The Cap is a maximum on the index linked interest that will be credited to the annuity. For example, if the market index increases 15% and the annuity has a 10% cap rate, only 10% will be credited to the annuity. The insurance company may also offer an option with a monthly cap. The insurance company has the right to change the cap from year to year

Annuity Liquidity

Index annuities offer the contract holder liquidity in a number of ways. Here are five ways to access money within a fixed index annuity:

- Index annuity contracts generally allow a penalty-free withdrawal after the first contract year. The withdrawal benefit is usually between 5% and 10% of the accumulation value. Many policies offer free “nursing home” riders that allow for increased surrender free withdrawals if the owner is confined to a nursing home. Other benefits may be available on some contracts.

- Index annuities were designed to be "annuitized" and provide a guaranteed income for life for you (and your spouse if applicable). You may choose from one of several different annuity payment options that best meets your needs. Once you annuitize a contract, however, you do not have access to your principal again, you may not change your payment option and the contract stops earning index credits. <u>There are times when it is appropriate to annuitize a contract, but it is an option we seldom recommend</u>.

- Many of today's index annuities offer an <u>optional income rider</u> that grows at a fixed rate each year until you begin income. When you start taking income, it is simply a withdrawal from your contract. The income is <u>guaranteed for as long as you live</u>! The contract continues to earn index credits even though you are taking income. The remaining contract value is always available to you and is passed to your beneficiaries at your death. If lifetime income is important to you, we will run an illustration for you when you meet with us. There is frequently an annual fee associated with an income rider.

- You are always able to surrender the contract before the end of the surrender/contract period. You pay a surrender penalty based on the surrender schedule in the contract and receive the balance of the contract in cash. The surrender schedule is a declining schedule so the longer you hold the contract, the less the surrender penalty.

- You may withdraw 100% of the policy value at the end of the surrender/contract period. There is <u>no longer a surrender penalty</u>. If you choose not to withdraw the funds at the end of the contract period, you are free to withdraw money whenever you wish. The contract will continue to earn index credits.

How Are Index Annuities Taxed?

- Earnings credited on the funds in an index annuity are tax deferred, meaning that the earnings are not taxed while they remain in the annuity.
- Withdrawals from an index annuity during the accumulation phase are treated as withdrawals of earnings to the extent that the cash value of the annuity exceeds the total premiums paid and are taxed as ordinary income in the year withdrawn. To the extent that a withdrawal exceeds any earnings, that portion of the withdrawal is considered a non-taxable return of principal.
- If the contract is an IRA, a 10% tax penalty may be imposed on withdrawals made before age 59-1/2, unless certain conditions are met. The penalty tax is in addition to the regular income tax on the withdrawal. All withdrawals from IRA contracts are 100% taxable at the time of withdrawal.

A professional tax advisor should be consulted for more detailed information on annuity taxation in your situation.

Advantages and Disadvantages

An index annuity can be a great way to save for retirement on a tax-deferred basis, in effect creating your own personal "pension" plan. As with any investment, however, there are also potential disadvantages that should be evaluated before purchasing an index annuity.

Advantages:

- An index annuity provides safety of principal and earnings **and** the opportunity to benefit from a rising stock market with an interest rate linked to a market index, while also offering a minimum guaranteed interest rate.
- Index annuity earnings are tax deferred so long as they remain in the annuity. When compared to an investment whose earnings are taxed each year, tax deferral offers the potential for accumulating significantly higher amounts of money over time.
- An annuity can be used to provide a steady source of retirement income that you cannot outlive.
- Subject to the terms of the contract, there is no required date by which you must begin receiving annuity income payments, providing you with the flexibility to defer payments. However, you must begin receiving annuity payments at age 100!
- At your death, and if the contract has not been annuitized, 100% of the annuity's value (without any surrender charge) passes directly to your beneficiary without probate.
- In most states, an annuity is free from the claims of a creditor.

Disadvantages:

- While you can surrender or make withdrawals from an annuity, the withdrawal may be subject to a charge if you exceed the free withdrawal benefit offered in the contract. If a full surrender is made prior to the end of the surrender period, you may be subject to a surrender charge.

- When money is withdrawn, gains are subject to ordinary income tax rates and not the lower capital gains tax rate.

Index Annuity Checklist

Once you decide that an index annuity is right for you, there are a number of factors you should consider in evaluating the specific annuity you will purchase. These include:

Insurance Company Ratings

Since an index annuity is an insurance contract, you need to be able to count on the financial strength and claims-paying ability of the insurance company from which you purchase an annuity. Ask for company rating information from respected sources, such as A.M. Best, Moody's or Standard & Poor's, before purchasing an annuity.

Annuity Features

Make sure you understand the terms and limitations of an index annuity contract before you purchase it, including:

- Annual reset and annual lock in of earnings – these are two of the most powerful components of an index annuity.
- The indexes offered, the calculation methods offered and the current rates offered (participation rate, margin/spread, and caps).
- Any additional free riders offered with the contract such as nursing home rider.
- Are there fees associated with the annuity? What are they for and how much are they?

- How much liquidity is available? How much money can you withdraw, penalty free, and when can you withdraw it?
- What are the income options available to you? .
- What is minimum guaranteed interest rate

If you're about to retire, an index annuity is a good place to rollover or direct transfer a lump sum of money that you've accumulated through a 401(k), 403(b) or other qualified retirement plans. In many cases, pension plans offer a lump sum option and these can be rolled over to an index annuity. No taxes are due at time of rollover if the annuity is a traditional IRA.

If you would like to know more about index annuities and how they might fit into your long-term saving or retirement strategy, please ask for an appointment!

As stated earlier, this information outlines the most popular features we look for in the products we offer our clients. For more extensive information on index annuities, go to www.indexannuity.org.

Important Information

THE INFORMATION, GENERAL PRINCIPLES AND CONCLUSIONS PRESENTED IN THIS REPORT ARE SUBJECT TO LOCAL, STATE AND FEDERAL LAWS AND REGULATIONS, COURT CASES AND ANY REVISIONS OF SAME. WHILE EVERY CARE HAS BEEN TAKEN IN THE PREPARATION OF THIS REPORT, NEITHER VSA, L.P. NOR THE NATIONAL UNDERWRITER COMPANY IS ENGAGED IN PROVIDING LEGAL, ACCOUNTING, FINANCIAL OR OTHER PROFESSIONAL SERVICES. THIS REPORT SHOULD NOT BE USED AS A SUBSTITUTE FOR THE PROFESSIONAL ADVICE OF AN ATTORNEY, ACCOUNTANT, OR OTHER QUALIFIED PROFESSIONAL.

ANNUITY CONTRACTS CONTAIN EXCLUSIONS, LIMITATIONS, REDUCTIONS OF BENEFITS AND TERMS FOR KEEPING THEM IN FORCE. ALL CONTRACT GUARANTEES ARE BASED ON THE CLAIMS-PAYING ABILITY OF THE ISSUING INSURANCE COMPANY. CONSULT WITH YOUR LICENSED FINANCIAL REPRESENTATIVE ON HOW SPECIFIC ANNUITY CONTRACTS MAY WORK FOR YOU IN YOUR PARTICULAR SITUATION. YOUR LICENSED FINANCIAL REPRESENTATIVE WILL ALSO PROVIDE YOU WITH COSTS AND COMPLETE DETAILS ABOUT SPECIFIC ANNUITY CONTRACTS RECOMMENDED TO MEET YOUR SPECIFIC NEEDS AND FINANCIAL OBJECTIVES.

NOTE: THIS ANNUITY DISCUSSION IS INTENDED PRIMARILY TO PROVIDE INFORMATION ON PERSONAL, NON-QUALIFIED ANNUITIES AND QUALIFIED ANNUITIES THAT ARE NOT PURCHASED TO FUND A QUALIFIED EMPLOYER-SPONSORED RETIREMENT PLAN. AN ANNUITY PURCHASED TO FUND A QUALIFIED EMPLOYER-SPONSORED RETIREMENT PLAN DOES NOT PROVIDE ANY ADDITIONAL TAX DEFERRAL, SINCE TAX DEFERRAL IS PROVIDED BY THE IRA OR QUALIFIED PLAN ITSELF. IF AN ANNUITY IS PURCHASED TO FUND AN IRA, IT SHOULD BE DONE FOR THE ANNUITY FEATURES AND BENEFITS OTHER THAN TAX DEFERRAL.