Money Matters

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Skloff Financial Group Question of the Month

By Aaron Skloff, AIF, CFA, MBA

Q: We keep hearing that annuities are great financial vehicles. What are the various types of annuities and how do they differ?

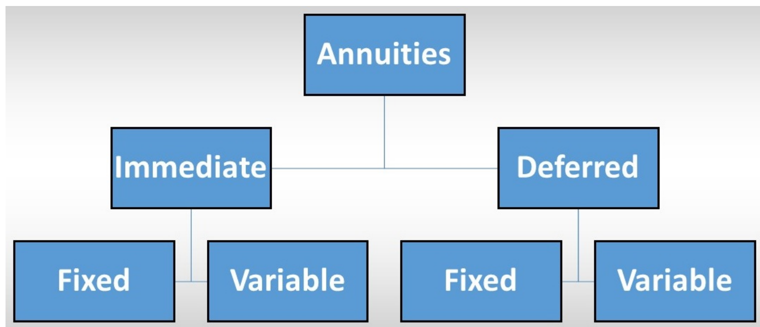
The Problem – Understanding What an Annuity is and the Various Types of Annuities
An annuity can be described in so many ways it can be difficult to decipher what is fact and what is fiction. To make matters worse, there are numerous types of annuities that offer different features.

The Solution – Identifying Which Annuities Perform What Functions
Let's start with defining an annuity. An annuity is a contract to pay a series of payments over time, including your lifetime. Examples include lottery winning payments, lawsuit payments and pension payments. According to the National Association of Insurance Commissioners (NAIC): "An annuity is a contract with an insurance company. All annuities have one feature in common, and it makes annuities different from other financial products. With an annuity, the insurance company promises to pay you income on a regular basis for a period of time you choose - including the rest of your life."

There are two primary types of annuities.

Immediate annuities can be fixed or variable and begin paying a cash flow immediately or within one year of purchase.

Deferred annuities can be fixed or variable and begin paying a cash flow at a later date.



Immediate fixed annuities pay a fixed percentage for a fixed period or over your lifetime, with "your" meaning you or you **and** your spouse. For example, you pay a $100,000 premium and over the course of 10 years you receive 4% or $4,000 per year, then you receive your $100,000 back. As another example, you pay a $100,000 premium and you receive 7% or $7,000 per year for the rest of your life. If you are worried about dying early, your spouse can receive payments for a minimum number of years or for the rest of **their** life.

Immediate variable annuities earn a return based on the performance of the investments, called "subaccounts", you choose. Since the values can increase or decrease, you may end up with less money in your annuity than you paid. For example, you pay a $100,000 premium and over the course of 10 years you withdrawal 4% or $4,000 per year, then you close the annuity out. Your ending value could be $0, $100,000 or any other value based on the performance of the subaccounts. Guaranteed growth or income benefit riders can be added for an additional cost.

Deferred fixed annuities pay a fixed interest rate for a fixed period, as you defer withdrawals. Then, withdrawals are available in full or paid over your lifetime, with "your" meaning you or you **and** your spouse. For example, you pay a $100,000 premium for a fixed annuity with a 4% interest rate, do not make withdrawals for 10 years, and then you receive $148,024. As another example, you pay a $100,000 premium, do not make with withdrawals for 10 years, and then you receive 9% or $9,000 per year for the rest of your life.

Deferred fixed indexed annuities earn interest based on price changes (not total return, which would include dividends) in a market index. Participation rates, cap rates, and spread rates define how your interest may be less than the full change in the index. If the index declines over that period, you do not earn interest, but your annuity value will not decline as long as you don't withdraw the money.

Deferred variable annuities earn a return based on the performance of the investments, called "subaccounts", you choose. Since the values can increase or decrease, you may end up with less money in your annuity than you paid. For example, you pay a $100,000 premium, do not make with withdrawals for 10 years, then you close the annuity out. Your ending value could be $0, $100,000 or any other value based on the performance of the subaccounts. Guaranteed growth or income benefit riders can be added for an additional cost.

Tax Considerations. Premiums that you invest in an annuity grow tax-deferred. Upon withdrawal, the amount you contributed to the annuity (premium) is not taxed, but your **earnings** are taxed at your income tax rate. Premiums that you invest in an annuity in pre-tax accounts like IRA's and 401(k)s are treated differently. Upon withdrawal, **premium and earnings** are taxed at your income tax rate.

Action Steps – Understand the Capabilities and Limitations of Annuities
Evaluate guaranteed outcomes versus nonguaranteed outcomes, liquidity, surrender charges, mortality and expense (M&E) charges and rider charges. Work closely with an experienced financial professional to understand all the capabilities and limitations of annuities.

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