Buying Annuities

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Once an individual decides to buy an annuity, there are still a number of factors to be considered. Where can annuities be purchased? What licenses, training, and exams are required for a person to sell annuities? What questions should be asked to make sure a particular annuity is right for the individual investor? While this chapter answers many of these questions, it is still important for people to contact investment professionals to determine how an annuity can help achieve their specific long-term financial goals, and which type of annuity may be best suited to their individual needs.

How Are Annuity Products Developed?

In the United States, commercial annuities are issued by insurance companies. When new fixed and variable products are developed, they must be filed with the state's insurance department. Before they can be sold, each state must provide written approval where the product will be sold.

Because variable annuities are considered securities as well as insurance products, when a new variable annuity is developed, a registration statement must be filed with the Securities and Exchange Commission (SEC). This statement includes a prospectus which discloses, among other things, the fees and charges associated with the annuity contract; a description of the various benefits, rights, and privileges afforded under the contract; any changes that can be made to the contract; and the risks and tax consequences associated with investing in the contract. The prospectus, which is updated annually, is a vital source of information for all contract holders and should be read thoroughly.

Who Can Sell Annuities?

People who sell variable annuities need training in both securities and insurance. This training can be obtained from many sources. Some distributors provide in-house training to their registered representatives; others utilize training provided by insurance company wholesalers and independent third-party educators.

Fixed annuity sellers receive much of the same instruction as those selling variable annuities but do not need the securities training.

In order to sell annuities, individuals must first obtain a state insurance license from the state in which their office is located. A non-resident license must be obtained for all states in which out-of-state clients reside.

Since variable annuities are considered securities under federal securities laws, individuals who wish to sell them must, in addition to having an insurance license, be associated with a broker-dealer, be federally registered as a representative, and pass a Series 6 exam, or the more comprehensive Series 7 exam. In some jurisdictions, a state securities license is also required.

Where Can Annuities Be Purchased?

Some insurance companies sell their products only through a dedicated sales force (captive agents); others use agents who represent many companies and have no primary relationship (independent agents). But annuities can also be purchased from a variety of different sources, some of which may sell both fixed and variable annuities while others may market only one type.

Variable annuities can be purchased through a number of different distribution channels, such as independent FINRA firms, wirehouses, regional investment firms, captive agents, and banks. Sales patterns for the various channels have changed significantly over the past ten years. For example, the percentage of variable annuity sales generated by captive agents declined from 37% in 1999 and 31% in 2008. Sales in national and regional brokerage firms decreased from 25% in 1999 to 20% in 2008. Sales by banks was relatively constant with 11% in 1999 to 12% in 2008. During this same period however, sales by independent FINRA firms increased from 24% to 35% during the same period.

Fixed annuities are sold through distribution channels that are similar to variable annuities, but the importance of some of the channels varies significantly. Unlike variable annuities where captive agents continue to account for a large (albeit decreasing) share of sales, the distribution of fixed annuities is dominated by independent agents and banks, which accounted for 33% and 30% respectively of all fixed annuity sales in 2008. By contrast, sales by captive agents in 2008 were only 15% of total sales.

The difference in the percent of sales by distribution channel for fixed and variable annuities may be explained, at least in part, by the fact that purchasers of fixed annuities tend to be more conservative with their investments than those who buy variable annuities.

Sales of indexed annuities (fixed annuities with an investment return that is a function of the change in the level of an index, such as the S&P 500) have overwhelmingly been concentrated in the independent agent channel, which accounted for 87% of all sales in 2008. There has been some increase in sales of indexed annuities by banks, which is not surprising since these are fixed products and they appeal to more conservative investors.

Key Questions Investors Need To Ask Before Buying an Annuity

Annuities can play an important role in retirement portfolios. While they can be used in a variety of situations, annuities are not necessarily the right choice for everyone. For example, deferred annuities are generally not appropriate for individuals who have not yet maximized contributions to their 401(k) or other qualified plan, or do not have a long-term investment horizon.

When buying an annuity, purchasers may want to consider the following questions. Additional questions can be found at these SEC websites:
http://www.sec.gov/investor/pubs/varannty.htm and
http://www.sec.gov/investor/pubs/varaquestions.htm.

1. What is the purpose of buying the annuity—to save for retirement, to generate guaranteed retirement income, or both?
Answering this question forces the prospective annuity investor to examine his or her retirement objectives. Many individuals planning for retirement have not taken the time on their own, or with a financial advisor, to realistically project the costs of their desired retirement lifestyle or to calculate the possible number of years they plan to be living in retirement. Envisioning retirement lifestyle necessities is essential to understanding the role of annuities in retirement planning.

2. When will the money invested in the annuity be needed?
Annuities are designed to be long-term retirement investments. As such, cancellation of a contract in the early years may result in a surrender fee. Therefore, if there is a good chance that a person will need to withdraw money shortly after the contract is purchased (for college payments, for example), a deferred annuity may not be the best investment; particularly if the money is withdrawn before age 59½ as tax penalties may apply. In addition, optional living benefits typically limit the amount of withdrawals that can be taken annually and withdrawals taken in excess of that limit may significantly reduce and possibly terminate the benefit. Accordingly, a prospective annuity investor should carefully consider his or her liquidity needs, or in other words, his or her potential need to access cash.

3. What percentage of assets is appropriate to invest in an annuity?
It is generally not advisable for an individual to invest 100% of his or her retirement assets in an annuity or any other single investment vehicle. Investors should plan to consult with a qualified financial/retirement planner in order to determine the most appropriate percentage of assets to invest in an annuity to meet their particular needs.

4. What guarantees are offered in a particular annuity contract?
Annuities provide a wide range of guarantees (such as lifetime income payments, death benefits, minimum accumulation/withdrawal benefits) that are unavailable in other financial instruments, making them an advantageous component of a retirement savings and income strategy. Since annuities from different providers vary, it is important to clearly understand the guarantees in a particular contract, as well as the financial strength and claims-paying ability of the insurance company issuing the annuity contract.

Investors who choose to purchase an annuity to fund a tax-qualified retirement plan (e.g., an IRA) can also take advantage of these guarantees, but should keep in mind that the annuity will not provide tax-deferred benefits on contributions beyond those already provided by the retirement plan itself.

5. What fees are associated with variable annuities?
All financial products have fees, including all "no-load" investments which are commission fee funds. While fee structures vary, it is essential that prospective investors understand the fees and charges involved in the particular variable annuity they decide to purchase. Common variable annuity fees include:

- *Insurance charges* — Insurance charges include mortality and expense risk charges (M&E fees) which support the annuities payout option, the death benefit, and the guarantee that the annual insurance charges will not increase. Optional insurance benefits such as guaranteed minimum income benefits, guaranteed minimum withdrawal benefits, and guaranteed minimum accumulation benefits, will have additional fees.

- *Administrative charges* — In addition to asset based fees, most contracts impose administrative fees, which are usually around $30 per year, that pay for administration of the contract. However, administrative fees are typically waived for larger contracts.

- *Surrender charges* — As discussed previously, cancellation of a contract in the early years may result in surrender charges. These charges generally range from 5-7% of the annuity value and usually decline to zero over a period of time, such as five to seven years.

More information about these charges is available in the prospectus for the contract that contract owners receive.

In addition, variable annuity contract owners will indirectly bear the fees and expenses associated with the mutual funds that underlie the variable investment options or subaccounts that are offered under the contract. These fees and expenses are described in detail in the prospectus for the mutual funds that contract owners receive.

6. What is the investor's risk tolerance?
An individual's risk tolerance will depend on a number of factors including age, time horizon, and retirement goals. The type of annuity purchased will depend largely on an individual's risk tolerance.

Variable annuities offer a wide range of investment choices from aggressive growth funds to more conservative investments such as money market funds and fixed-rate instruments. They can also offer optional benefits, often called riders, that provide protection against downside market risk through account balance, income, and withdrawal guarantees. Fixed annuities can help investors minimize risk by locking in a fixed rate of return. Most financial professionals and insurance companies can provide asset allocation tools and support to help individuals identify and manage their personal risk tolerance and develop an investment strategy to meet their needs.

Tips for Seniors Considering an Annuity Purchase

Annuities can meet a variety of needs for seniors. With so many different products on the market it is vital that seniors understand all their options, features, benefits, and costs with annuities to make certain that their annuity purchases will meet their specific needs.

For example, immediate annuities can provide income for life, but once assets are used to purchase the annuity, they are often no longer accessible for use in emergencies or other needs. Deferred annuities allow assets to grow tax deferred; variable deferred annuities can help seniors take advantage of the traditionally higher returns of the equity market while protecting their investments against downside market risk. But because they are long-term investments, deferred annuities often carry surrender charges if they are not held for a specified number of years and a may not be a viable option for some seniors depending on their goals and stage in the retirement process.

Age is only one of the important factors when determining the appropriateness of an annuity. Of equal importance are the nature of his or her retirement lifestyle, other assets and sources of income that the individual may have, and life expectancy.

Recognizing that annuities are becoming a progressively more popular financial product for seniors, the following tips, although not exclusive, are useful determining factors for those considering the purchase of an annuity. Individuals may find it prudent to consult with a trusted, qualified financial advisor prior to making any purchase decision.

1. Determine your retirement lifestyle goals — Your current age is important, but it is only one of the factors to consider. It is also important to determine when you expect to retire, define your personal retirement goals, and estimate how long you expect to live in retirement. This is essential for understanding the value of an annuity and whether it is to help you save for retirement, generate lifetime guaranteed retirement income, or both.

2. Calculate your retirement income needs — Try to be specific about how much income you think you will need to fund your desired retirement lifestyle and essential living expenses. (Don't forget healthcare.) In particular, determine how much additional income you will need to supplement your other retirement income sources, such as Social Security, a pension and savings.

3. Determine your investment risk tolerance — Your risk tolerance will depend on a number of factors, including your age, the number of years you expect to spend in retirement, and your retirement goals. Variable annuities offer a range of options, from aggressive growth funds to more conservative investments to meet your needs and individual risk tolerance. They also offer insurance features that provide protection against downside market risk.

4. Understand the different types of annuities and how they work — There are a number of different types of annuities and they all work differently.

- An *immediate annuity* is purchased with a single payment, and provides guaranteed income payments shortly thereafter.

- A *deferred annuity* allows your investment to grow tax deferred with the option of providing guaranteed income at a future date.

- Deferred and immediate annuities can be either *variable* or *fixed.*

- A *variable annuity* allows you to invest in a variety of subaccounts that invest in corresponding mutual funds of all types. The value of the variable annuity is determined by the performance of these investments. Many variable annuities offer optional *living benefits,* which provide principal protection against downside market risk and a variety of guaranteed options for you to access your money. These optional living benefits often include restrictions and charges that you should be aware of and understand before selecting them.

- A *fixed annuity* offers a set rate of return for a defined period of time and the option of regular, fixed income payments.

- An *indexed annuity* is a type of fixed annuity that accumulates earnings based on a formula linked to one or more equity-based indices, such as the Standard and Poor's 500 Composite Stock Price Index™ (S&P 500).

5. Understand types of annuity guarantees and investment options — Annuities can provide a wide range of guarantees that are unavailable in other financial instruments. Since annuities from different providers vary, it is important that you clearly understand the guarantees in your particular contract, and the investment options available if you are purchasing a variable annuity.

6. Understand annuity fees — All financial products have fees, including all "no-load" investments. Common variable annuity fees include an investment management fee, insurance charge, and surrender charges. While fee structures vary, it is essential that you understand what you will be charged and when.

7. Access to retirement savings and understanding surrender charges — Consider when you plan on using the money invested in the annuity. Cancellation of a deferred annuity in the early years may result in a "surrender charge." Variable annuity surrender charges are generally 5-7% of the annuity value, and usually decline to zero over a period of five to seven years. If there is a good chance that you will need to withdraw all of your money shortly after the annuity is purchased, a deferred annuity may not be the best investment for you.

8. Consider how much to invest based on retirement goals — It is generally not advisable to invest 100% of your retirement assets in an annuity or any other single investment vehicle. Consult with a qualified financial advisor to see if an annuity is right for you, and if so, how much of your retirement assets to invest.

9. Evaluate the company issuing the annuity — Be sure to verify the financial strength and claims-paying ability of the insurance company issuing the annuity. Several rating services provide this information, including A.M. Best Company, Moody's Investors Services, Fitch Ratings, and Standard and Poor's.

10. Evaluate qualifications of financial advisor — Make sure your advisor has the appropriate license(s) to sell annuities. Selling a fixed annuity requires a license by your state insurance department. A variable annuity can only be sold by a registered representative of a broker-dealer that is a member of the Financial Regulatory Authority (FINRA). Also, determine what specific training is required for the advisor to obtain their professional designations.

Additional resources and tips for seniors can be found at these SEC websites.
www.sec.gov/investor/seniors.shtml
www.usa.gov/topics/seniors.shtml