VARIABLE ANNUITIES: HELPING CLIENTS GET THE PICTURE; BEST PRACTICES FOR FINANCIAL ADVISORS

Serrano, Jan M.
Francis Marion University

ABSTRACT
Assets in variable annuity insurance contracts at the largest 25 carriers topped 1.5 trillion dollars in 2010 according to National Underwriter.[1] As the debate about the effectiveness and appropriateness of these vehicles in a person's overall financial strategy continues to be hashed out in academic circles, such contracts obviously continue to be attractive conduits for savings in the U.S., particularly during times of economic uncertainty. As millions of people in the U.S. approach retirement age, with interest rates at all time lows, and longevity increasing the threat of outliving one's savings, the guarantees that many of these contracts provide offer peace of mind that outweigh the significant costs that can be involved. These contracts are equally attractive to investment professionals who stand to benefit from healthy commissions on their sale. Given the one-two punch of these factors, there is little wonder that assets in such contracts now number in the trillions of dollars. In an age where financial advisors are coming under increased scrutiny for fulfilling fiduciary responsibilities, it is imperative that steps are taken to assure that clients understand the terms and conditions of the contracts that they own and that the process is both consistent, compliant, and documented. Having this conversation before the client makes a decision protects both the client and the financial advisor from an unexpected or unpleasant outcome down the road.

INTRODUCTION

A variable annuity is an annuity contract that has two components, an investment component and an insurance component. A deferred variable annuity has both an accumulation phase and a withdrawal phase. With this type of annuity the annuitant pays premiums either in a lump sum or over time and those premiums are invested until some future date (typically retirement) when withdrawals are made based on certain guarantees in the insurance component of the contract. Many variable annuity products offer enhanced death benefits and income guarantees for a fee. The specific terms of the contract along with explanations of the benefits and costs associated with each contract are given in the product prospectus available from the insurance company offering the product. The SEC website offers advice to investors in purchasing variable annuity products and recommends that the purchaser request a prospectus and read it thoroughly before making a decision. For anyone who has actually read one of these, however, it is obvious that these contracts can be highly complex. This paper examines common misconceptions among consumers regarding key elements of these types of variable annuity contracts. Even financial advisors may miss important nuances in the contract that only become obvious when a trigger mechanism in the contract is tripped leading to a less than desirable outcome for the client.

Unpleasant surprises can damage or destroy the client advisor relationship and the good referral pipeline necessary for a successful and growing practice.

MISCONCEPTION # 1: I RETAIN CONTROL OF THE ASSETS

Many investors simply do not understand what an annuity is, or for that matter what it means for the contract to be "annuitized". The process of "annuitization" involves the transfer of ownership of the assets to the insurance company which in turn must typically honor a promise of payments to the client over some future period. Depending on the terms of the contract, that payout period could be, for example, the annuitant's lifetime, a certain fixed number of years, the longer of lifetime **or** a fixed number of years, longer of annuitant or spouse's lifetime, etc. It is imperative that the client understands that in contracts requiring annuitization, the term "annuitized" basically means the assets no longer belong to them. They are trading a fixed amount of assets for a (sometimes undetermined) stream of payments into the future. Whether this stream of payments guarantee a return of the premium paid, whether they are the same each year, and whether they are guaranteed over the annuitant's entire lifetime depend on the specific terms of the contract. The fact that the assets themselves no longer belong to the client is not in and of itself a bad thing. That lump sum is replaced with a promised stream of payments that in some instances could amount to much more than the value of the assets turned over to the insurance company, especially in life annuities where the person is long lived. Plus, with the recent volatility in financial markets, these contracts do provide peace of mind that a certain portion of their retirement income is stable. Whatever the case may be, the client who purchases a variable annuity must understand what it means for the contract to be "annuitized" and what that will mean in terms of the subsequent payout. They should be conditioned to expect these changes when they occur. Specifics of each annuity contract should be reviewed at the annual client meeting. These steps help alleviate client uncertainty arising from the complexity of these contracts, and should lead to a more solid client relationship.

While there are perhaps hundreds of different variable annuity contracts in force at this point, with many different types of guarantees almost all of them can or must be annuitized at some point. Depending on the contract, different things could trigger annuitization. Some contracts allow withdrawals for income benefits without requiring annuitization until some trigger is hit. For example, a decline in the value of the investment component to a certain level (usually a value of zero) could automatically trigger annuitization, or the client reaching a certain age could trigger annuitization. Some contracts must be annuitized in order for **any** income benefits to be paid. The purchaser of an annuity should not only understand what the annuitization of the contract involves, but also what will trigger that event, whether it will affect the payout they receive, and how that will show up on their statement. For contracts that do not require immediate annuitization, , the value of the assets in the investment component, typically mutual funds, may appear on the client's brokerage statement each reporting period until the point that the contract is annuitized. Once annuitization has occurred, the assets belong to the insurance company and no longer show up on the individual's brokerage statement. Many bad feelings can be avoided by conditioning the purchaser of an annuity to this change in accounting that may eventually occur. A sudden decline in the individual's account balance due to annuitization can be a traumatic event for the person who does not understand the process. To ease the transition,

the financial advisor should be alert to events that trigger annuitization in their client's variable annuities. Not only should they make this a part of regular discussion during periodic client meetings, but should also make a proactive call to the client when such an event occurs to minimize the anxiety that it may cause. The financial advisor should be notified by the insurance company when annuitization has been triggered, allowing them to contact their clients and explain the resulting change in accounting.

MISCONCEPTION # 2: I CAN WITHDRAW THE GUARANTEED INCOME BENEFIT

While there are hundreds of different types of income benefits and withdrawal features available on the different variable annuity contracts, some of the most intriguing products on the market in recent years offer guaranteed income or withdrawal benefits based on market performance of funds invested. Once the premium is paid, these products have two separate components that are measured. The account balance reflects the value of the underlying assets themselves which are invested in one or more sub accounts like mutual funds. When purchased through a brokerage account, this value will actually shows up on the client's statement. The insurance component, the value of the balance upon which future guaranteed payments will be based, referred to hereafter as the income benefit, reflects the guarantees provided by the insurance company. The value of the underlying assets themselves is driven by the daily ups and downs of the investments inside the sub accounts in the annuity less fees. The value of the income benefit may be based on guaranteed annual increases, guaranteed double of the benefit balance over a certain time frame, movement in the value of the underlying assets, some combination of these, or any number of other factors. Suffice it to say that the balance on which income payments are eventually based is likely not to equal the value of the underlying assets themselves. As an illustration, assume that an insurance company offers a variable annuity contract which guarantees an income benefit based on the higher of (a) the account balance, or (b) the income benefit at the previous contract anniversary increased by five percent per year, whichever is higher. Further assume that the client purchased a $100,000 annuity contract on December 31, 2004, and invested in a portfolio of sub accounts inside the contract that yielded the hypothetical returns given in the table below. Further assume that the contract results in annual fees of 3.5% of the market value of the funds in the sub account each year and a contingent deferred sales charge of seven percent in years one, two, and three, then declining by one percent per year to a charge of zero beyond year nine. The change in the value of the benefit balance and the actual value of the underlying assets is calculated below assuming no withdrawals are made.

Year	Hypothetical Returns	Market Value Of Funds In Sub Accts	Fees 3.5% of Account Value	Account Balance (Value of Sub Accts Less 3.5% Fees)	Growth of Income Benefit at 5% Per Year	Income Benefit (Greater of Account Balance or 5% Growth)
		$100,000		$100,000	$100,000	$100,000
2005	4.49%	$104,495	$3,657	$100,837	$105,000	$105,000
2006	13.65%	$114,597	$4,011	$110,587	$110,250	$110,587
2007	10.86%	$122,595	$4,291	$118,304	$116,116	$118,304
2008	-29.81%	$83,034	$2,906	$80,128	$124,220	$124,220

In the example above the income benefit has grown to $124,220 even though the account balance is only $80,128. This represents the amount which income or withdrawal benefits guaranteed in the contract would be based if elected at this point in time. This is not the amount that the client

could withdraw and walk away with. One of the drawbacks to many of these annuities is that they assess high fees (or contingent deferred sales charges) if the contract is surrendered early. If the contract had not been annuitized yet and allowed for the client to surrender the contract, they would only receive the account balance, net of deferred sales charges of 5%, or $76,122.

Consider further, the annuitant that purchased such a contract back in 1999 with an additional guaranteed double of the income benefit if it were left in the account for 10 years. Examine the results for a portfolio with 100% of the underlying assets invested in a sub account that mimicked the S&P500.

Years	Returns on Sub Accts S&P 500	Market Value Of Funds In Sub Accts	Fees 3.5% of Account Value	Account Balance (Value of Sub Accts Less 3.5% Fees)	Growth of Income Benefit at 5% Per Year	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)
		$100,000		$100,000	$100,000	$100,000
1999	0.2104	$121,040	$4,236	$116,804	$105,000	$116,804
2000	-0.091	$106,174	$3,716	$102,458	$122,644	$122,644
2001	-0.1189	$90,276	$3,160	$87,116	$128,776	$128,776
2002	-0.221	$67,864	$2,375	$65,488	$135,215	$135,215
2003	0.2868	$84,271	$2,949	$81,321	$141,976	$141,976
2004	0.1088	$90,169	$3,156	$87,013	$149,074	$149,074
2005	0.0491	$91,285	$3,195	$88,090	$156,528	$156,528
2006	0.1579	$102,000	$3,570	$98,430	$164,354	$164,354
2007	0.0549	$103,833	$3,634	$100,199	$172,572	$172,572
2008	-0.37	$63,126	$2,209	$60,916	$181,201	$200,000

The income benefit can exceed the value of the underlying assets by a wide margin. Again, this is not a bad thing in and of itself. Invested with no fees, that same indexing strategy would result in an ending balance of only $86,988. Many investors would prefer a guaranteed income stream based off of $200,000 as opposed to an uncertain income from $86,988 invested outside an annuity. The problem is that some investors purchase these contracts under the impression that the double is a walk away amount. Imagine their surprise when they find that they can withdraw only $60,916. Again, some contracts exist that do guarantee a certain walk away amount, but it would be prudent to make these terms perfectly clear to the client before they decide to purchase the annuity. The other important point that the chart above illustrates is the importance of reiterating the difference between the account balance and the income benefit as far as the client's brokerage statement is concerned. While they should receive a quarterly statement from the insurance company with account balance and income benefits, only the account balance will show up on their statement at the brokerage firm. Many insurance companies today offer clients the benefit of online access where they can check their account balances and benefit balances at any time. In times of market volatility when statement values are declining this can be a good tool for helping clients stay the course and sleep better when they can see the balance in the income benefit that their withdrawal stream will eventually be based upon.

MISCONCEPTION # 3: INVESTMENT RETURNS COVER PRODUCT FEES

One of the biggest criticisms of variable annuities continues to be the fees charged for the product. The fees for the insurance product itself may include several components, the mortality and expense (M&E) fee, an administrative fee, fees for special riders that provide income

guarantees or enhanced death benefits, and contingent deferred sales charges to name a few. These do not include the fees charged by the investment companies responsible for management of the sub-accounts which could run 1.5% to 2% of assets. In the examples above, the fees were calculated as a percent of the market value of the sub accounts. While this makes intuitive sense, many of the variable annuity contracts in force today calculate these fees as a percentage of the income benefit. In cases where the income benefit is significantly higher than the account balance, this means it takes a larger and larger return on the underlying assets just to keep up with the fees on the annuity. To illustrate, assume the fees in the previous example are calculated based on the income benefit at the previous anniversary date instead of the market value of the funds in the sub accounts.

Years	Returns on Sub Accts S&P 500	Market Value Of Funds In Sub Accts	3.5% Fees On Income Benefit	Account Balance (Value of Sub Accts Less 3.5% Fees)	Growth of Income Benefit at 5% Per Year	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)
		$100,000		$100,000	$100,000	$100,000
1999	0.2104	$121,040	$3,500	$117,540	$105,000	$117,540
2000	-0.091	$106,844	$4,114	$102,730	$123,417	$123,417
2001	-0.1189	$90,515	$4,320	$86,196	$129,588	$129,588
2002	-0.221	$67,147	$4,536	$62,611	$136,067	$136,067
2003	0.2868	$80,568	$4,762	$75,805	$142,871	$142,871
2004	0.1088	$84,053	$5,000	$79,053	$150,014	$150,014
2005	0.0491	$82,934	$5,250	$77,684	$157,515	$157,515
2006	0.1579	$89,950	$5,513	$84,437	$165,391	$165,391
2007	0.0549	$89,072	$5,789	$83,284	$173,660	$173,660
2008	-0.37	$52,469	$6,078	$46,391	$182,343	$200,000

Just the difference in the way the fee is applied makes a significant difference in the account balance after ten years. Regardless of whether the fees are charged as a percent of the account value or the income benefit, there is no guarantee that market returns on the investments will keep up with the fees in the product. In some cases, the fees are structured so that this is highly improbable. It is imperative that the client understands how these fees are assessed and the long term (possibly permanent) nature of their commitment to this contract. Again, they should be purchasing the product for the potential for higher income at a future date, to hedge against unexpected and extended market declines and low interest rates, not as a scheme for short term gains.

MISCONCEPTION # 4: MY WITHDRAWAL AMOUNT WILL NEVER DECLINE

Some contracts must be annuitized to take advantage of income guarantees, others not. In contracts which do not have to be annuitized to begin systematic withdrawal from the account, such withdrawals reduce the account balance (value of the underlying assets) increasing the probability that annuitization will be triggered. For example, assume the contract illustrated above allows for withdrawals of 5% of the income benefit without requiring annuitization as long as the account balance remains above 20% of the income benefit. In the event that the account balance drops below this trigger amount ($40,000 in the example), the contract must be annuitized. Once the contract is annuitized, the payment stream follows the terms of the contract and cannot be altered by the client.

Years	Returns on Sub Accts S&P 500	Market Value Of Funds In Sub Accts	3.5% Fees On Income Benefit	Withdrawal	Account Balance (Value of Sub Accts Less 3.5% Fees and Withdrawals)	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)
					$100,000	$100,000
1999	0.2104	$121,040	$3,500	$0	$117,540	$117,540
2000	-0.091	$106,844	$4,114	$0	$102,730	$123,417
2001	-0.1189	$90,515	$4,320	$0	$86,196	$129,588
2002	-0.221	$67,147	$4,536	$0	$62,611	$136,067
2003	0.2868	$80,568	$4,762	$0	$75,805	$142,871
2004	0.1088	$84,053	$5,000	$0	$79,053	$150,014
2005	0.0491	$82,934	$5,250	$0	$77,684	$157,515
2006	0.1579	$89,950	$5,513	$0	$84,437	$165,391
2007	0.0549	$89,072	$5,789	$0	$83,284	$173,660
2008	-0.37	$52,469	$6,078	$0	$46,391	$200,000
2009	0.2646	$58,666	$7,000	$10,000	$41,666	$200,000
2010	0.1506	$47,940	$7,000	$10,000	$30,940	$200,000
2011				?		$200,000

One of the most important things that client and advisor should be aware of is what happens to the income benefit when the contract is annuitized. Some variable annuity riders guarantee that the client will continue to receive the same amount ($10,000 per year in this case) over a certain period or for the rest of their lifetime. Other contracts, however, calculate payments differently once the contract is annuitized. Once the contract must be annuitized, the payout percentage may be based on the annuitant's age, the spouse's age, or even rolled back to the age at which they began making withdrawals. For income benefits based on age, the older the individual, the higher the payout percentage typically is. The income benefit in the above example was based on a 5% guaranteed withdrawal rate. Perhaps this 5% is available for persons activating the income benefit between ages 60 and 65.

In the previous example, let's say the person was 52 at the time he or she originally purchased the annuity. They planned to retire at the end of 2008 at the age of 62 and begin taking payments from their annuity in 2009. The first two years they are able to withdraw 5% of $200,000 or $10,000 per year and the contract has not been annuitized. According to the terms of their contract, however, the account value drops below the trigger point and is annuitized. Suddenly, the client's annual payment drops to only $6,000 a year because the annuitized payout is only 3% per year for persons under age 65. All income guarantees are NOT created equal. Guaranteed minimum income, guaranteed minimum withdrawals, and guaranteed lifetime withdrawals may mean very different things. In some contracts, the income benefit (and resulting income payout amounts) continue to fluctuate with market performance. In some contracts, income benefits are constant, but can change once the contract is annuitized. Some contracts guarantee the same income for life regardless of what happens in the market or whether the contract is annuitized or not. Contracts with stronger guarantees on the income stream may not offer the highest percentage payouts, and insurance company salespersons may not always point out the worst case scenario. Therefore, it is imperative that the financial advisor in the presence of the client specifically ask the insurance company representative under what circumstances the income stream from the annuity could possibly decline and what impact annuitization of the contract would have on income benefits. While the lure of higher withdrawal percentages may be

attractive, many clients will prefer a product with cash flows that are guaranteed not to decline for the rest of their life.

The illustrations above assumed withdrawals reduced the account balance and income benefit dollar for dollar. In other words, with an income benefit of $200,000 and an income benefit of 5%, implies that the income benefit increases 5% of $200,000 or $10,000 per year. So long as the investor withdraws exactly $10,000 per year, the income benefit remains at $200,000. As long as the withdrawal does not exceed the guaranteed 5%, for every dollar that the investor withdraws, their income benefit is reduced by that amount. With pro rata withdrawals specified in some contracts, the income benefit is reduced by a percentage equal to the withdrawal amount divided by the account balance. Examine the withdrawal for 2009. Assuming that withdrawals are pro rata, the $10,000 represents $10,000/($58,666-$7,000) = 19.36% of the account balance after fees but before withdrawals. The income benefit is reduced by 19.36% to $200,000(1-.1936) = $161,290, thus reducing the safe withdrawal rate the next year in 2010 to 5% of $161,290 or $8,065. This $8,065/($47,940-$5,646) = 19.07%. Since the withdrawal was 19.07% of the account balance, the income benefit is reduced by this same percentage ($161,290(1-.1907)) = $130,532.

Years	Returns on Sub Accts S&P 500	Mkt Value Of Funds In Sub Accts	3.5% Fees On Income Benefit	Withdrawal	Account Balance (Value of Sub Accts Less 3.5% Fees & Withdrawals)	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)
2008	-0.37	$52,469	$6,078	$0	$46,391	$200,000
2009	0.2646	$58,666	$7,000	$10,000	$41,666	$161,290
2010	0.1506	$47,940	$5,645	$8,065	$34,230	$130,532

In this case, withdrawals can decline rapidly even when market conditions are good once withdrawals have begun because the account balance had dropped so far below the income benefit, an effect which would be exacerbated by steep market declines.

Contracts which do not have to be annuitized to begin systematic withdrawal from the account typically come with restrictions on the size of the withdrawals. In many cases, exceeding the guaranteed withdrawal amount destroys the future income guarantees. As these income guarantees may be the sole reason for purchasing the contract, it is imperative that the client understand the ramifications of withdrawing too large an amount. For the financial advisor, the implications are twofold. First, the advisor must be very careful to check and double check paperwork to initiate income benefits to assure that the amount requested does not violate the terms of the contract. The insurance company should be contacted to verify contract requirements. Secondly, as clients occasionally have a need to take withdrawals from their annuities that exceed contract limits, the financial advisor should discuss the possibility of writing two smaller contracts instead of one large ticket when purchasing these types of annuities. There is usually no additional cost, and an emergency need for cash that could be fulfilled with one of the annuities, leaving the guarantees on the other contract intact.

For persons waiting to take withdrawals until later in life, income benefits may increase. For example, the contract above might pay 5.5% after age 65, 6% after age 70, and 7% after age 80. A different insurance company may offer a product that pays 7.5% after age 80. Thus it is important to take into account the age at which the client plans to take withdrawals when

determining which contract is most appropriate. While the prospect of a guaranteed income is appealing, especially to the risk averse, once annuitized, the fixed income stream will not in most cases adjust for inflation. One strategy to offset the impact of inflation would be to set aside a small amount in products with higher payouts later in life, so that the client could gradually turn on more income as they age.

MISCONCEPTION # 5: I CAN ALWAYS TAKE MY MONEY OUT

Even in the event of solid investment performance in sub accounts, once withdrawals have begun, maintaining the same dollar amount of withdrawals each year often means that the account must eventually be annuitized. The table below illustrates the performance of the same annuity with an income benefit guarantee of account balance or 5% increase from the previous income benefit, but purchased December 31, 1989. In the ten year period from 1990 to 1999, a long running bull market would have pushed the income benefit to a level of $391,452 by the end of 1999. This would be almost twice as much as the guaranteed double over a ten year period. If the investor began taking withdrawals in 2000, maintaining withdrawals of 5% of the income benefit each year as guaranteed, the account balance would have hit zero by 2010 triggering annuitization.

Years	Returns on Sub Accts S&P 500	Market Value Of Funds In Sub Accts	3.5% Fees On Income Benefit	Withdrawal	Account Balance (Value of Sub Accts Less 3.5% Fees and Withdrawals)	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)
					$100,000	$100,000
1990	-0.031	$96,900	$3,500	$0	$93,400	$105,000
1991	0.3047	$121,859	$3,675	$0	$118,184	$118,184
1992	0.0762	$127,190	$4,136	$0	$123,053	$124,093
1993	0.1008	$135,457	$4,343	$0	$131,114	$131,114
1994	0.0132	$132,844	$4,589	$0	$128,255	$137,669
1995	0.3758	$176,454	$4,818	$0	$171,635	$171,635
1996	0.2296	$211,043	$6,007	$0	$205,036	$205,036
1997	0.3336	$273,435	$7,176	$0	$266,259	$266,259
1998	0.2858	$342,356	$9,319	$0	$333,037	$333,037
1999	0.2104	$403,108	$11,656	$0	$391,452	$391,452
2000	-0.091	$355,830	$13,701	$19,573	$322,556	$391,452
2001	-0.1189	$284,204	$13,701	$19,573	$250,931	$391,452
2002	-0.221	$195,475	$13,701	$19,573	$162,202	$391,452
2003	0.2868	$208,721	$13,701	$19,573	$175,448	$391,452
2004	0.1088	$194,537	$13,701	$19,573	$161,263	$391,452
2005	0.0491	$169,181	$13,701	$19,573	$135,908	$391,452
2006	0.1579	$157,368	$13,701	$19,573	$124,094	$391,452
2007	0.0549	$130,907	$13,701	$19,573	$97,634	$391,452
2008	-0.37	$61,509	$13,701	$19,573	$28,236	$391,452
2009	0.2646	$35,707	$13,701	$19,573	$2,434	$391,452
2010	0.1506	$2,800	$13,701	$19,573	$0	$391,452

If this contract guaranteed the continued payment of $19,573 per year for life, this might be a superior choice over a similar investment strategy undertaken outside of an annuity with no fees. If this same $100,000 were invested in the S&P 500 index with no fees, the balance at the end of 1999 would be $532,817 instead of $391,452. But if withdrawals of $19,573 were begun in the year 2000, the investment balance would have declined to only $298,453 by the end of 2010.

Whether that level of withdrawal could be maintained for life would depend entirely on market performance in future years. Alternatively, a withdrawal rate of 5% of the investment balance each year would result in a lower payout for most of the withdrawal years with varying withdrawal amounts which decline to almost half of the original amount by 2008. The point is, even with several years of good market returns, there is a likelihood that the investment will become permanent once withdrawals have begun. While technically, it may be possible to withdraw the account balance, it may not be practical. This is not in itself a bad thing, and in the right circumstances, could prove far superior to other strategies. The variable annuity portion of a person's retirement portfolio should be viewed as a permanent investment decision.

MISCONCEPTION # 6: A SPOUSAL RIDER IS ALWAYS BEST FOR A COUPLE

Spousal riders are available on many contracts for an additional fee, and allow for continued payment to a spouse upon the death of the annuitant. These riders may make the withdrawal choice more complicated if the ages of the annuitant and the spouse are very different. For one thing, the spousal rider typically provides a lower income benefit at each age bracket than a contract without the spousal rider. For example, the income guarantee may be 5% (as in our examples above) without the rider for a person age 65, while the payout for a person at age 65 with a spousal rider may be only 4%. Also, payouts based on age may be based on the age of the younger of the two individuals. The contract may not even allow withdrawals until the younger of the two has reached a certain age. Before including any spousal rider, the advisor should discuss any impact of age differences on the potential payouts with the insurance company representative in the presence of the client. The insurance company representative should also be asked directly in the presence of the client if the client dies, does the company guarantee to make the same payment to the spouse until their death. This question is of upmost importance when considering the addition of a spousal rider. The spouse is not always guaranteed to continue receiving the same payment. It will depend on the particular contract. In some contracts (even with a spousal rider), the income benefit is reset at the time of the annuitant's death and the payment to the spouse may be based on actuarial values based on her age at that time. The income benefit may be reset to a lower reflecting the withdrawals made by the annuitant to that point, etc. The reason most people buy a spousal rider is to ensure that their spouse will be able to continue receiving payments in the event of their death. Thus, it is important to determine the circumstances, if any, which could lead to a lower payment to the spouse than originally expected.

MISCONCEPTION # 7: DEATH BENEFITS ARE LIKE LIFE INSURANCE

Deferred annuities have a built in death benefit standard to most contracts guaranteeing the repayment of premiums to beneficiaries in the event that the annuitant dies before taking any withdrawals. Once withdrawals have begun, this built in death benefit may disappear altogether. Many contracts offer enhanced death benefits tied to income benefits built up during the accumulation phase. Unlike life insurance, the amount available to beneficiaries changes over time with investment performance and withdrawals. Once withdrawals commence, the balance on the death benefit is typically reduced by the amount of the payments either on a dollar-for-dollar or pro-rata basis discussed earlier. For example, assume the contract below offers an enhanced death benefit which is reset at each contract anniversary date to the greater of the

account balance or 5% growth but without the guaranteed double after ten years as with the income benefit. Further assume the death benefit is reduced dollar for dollar by withdrawals. Enhanced death benefits add additional fees to the annuity which will be deducted each year, and unlike a straight life insurance policy, the death benefit typically declines with withdrawals made from the account. Death benefits from an annuity contract may have different tax implications for beneficiaries than benefits received from a life insurance policy. As enhanced death benefit riders can be costly, it would be prudent to involve the client's tax advisor in decisions involving whether or not an enhanced death benefit is appropriate.

Years	Returns on Sub Accts S&P 500	Market Value Of Funds In Sub Accts	3.5% Fees On Income Benefit	Withdrawal	Account Balance (Value of Sub Accts Less 3.5% Fees and Withdrawals)	Income Benefit (Greater of Account Balance or 5% Growth w/Guaranteed Double)	Death Benefit (Greater of Acct Bal or 5% Growth)
					$100,000	$100,000	$100,000
1999	0.2104	$121,040	$3,500	$0	$117,540	$117,540	$117,540
2000	-0.091	$106,844	$4,114	$0	$102,730	$123,417	$123,417
2001	-0.1189	$90,515	$4,320	$0	$86,196	$129,588	$129,588
2002	-0.221	$67,147	$4,536	$0	$62,611	$136,067	$136,067
2003	0.2868	$80,568	$4,762	$0	$75,805	$142,871	$142,871
2004	0.1088	$84,053	$5,000	$0	$79,053	$150,014	$150,014
2005	0.0491	$82,934	$5,250	$0	$77,684	$157,515	$157,515
2006	0.1579	$89,950	$5,513	$0	$84,437	$165,391	$165,391
2007	0.0549	$89,072	$5,789	$0	$83,284	$173,660	$173,660
2008	-0.37	$52,469	$6,078	$0	$46,391	$200,000	$182,343
2009	0.2646	$58,666	$7,000	$10,000	$41,666	$200,000	$172,343
2010	0.1506	$47,940	$7,000	$10,000	$30,940	$200,000	$162,343

MISCONCEPTION # 8: I CAN SWITCH TO A NEW ANNUITY AT NO COST

Over time, insurance products change, including variable annuities. Many of the products offered today are far superior to products offered many years ago. Sometimes companies come out with products offering exceptional benefits compared to older annuities. As these products are tax deferred, significant penalties and taxes could apply if funds are simply withdrawn from the account. A 1035 exchange allows for a tax free exchange of one annuity for another and involves surrendering the old annuity during the accumulation period prior to annuitization. (Once the product is annuitized it cannot be surrendered or exchanged for another product.) Extreme care should be taken when considering the surrender of an existing policy, as any income or enhanced death benefits on the old product will be lost in the exchange. Examining the contract above, a surrender of the $30,940 in account value at the end of 2010 prior to annuitization would mean the loss of income on the $200,000 base and $162,343 in death benefits.

BEST PRACTICES FOR ADVISORS

Variable annuities may provide a way for advisors to offer downside protection to their clients while continuing to offer opportunities for growth in the income stream. Many of the newer variable annuity products offer attractive features which combine income guarantees with the possibility of benefiting from market advances. Investors are able to create their own pensions, similar to traditional pensions offered by company retirement plans, which offer a continued

stream of income regardless of what market forces do. They can alleviate some of the worries about longevity and outliving one's income. Annuities can provide peace of mind that a loved one will be taken care of in the event of the annuitant's death. Variable annuities are not a panacea, however. They are highly complex products, many with characteristics which could produce an unfavorable outcome under certain circumstances. They involve significant fees, and should be viewed as a long-term commitment, where the investor understands that ultimately they are trading the control of these assets for the assurance of a fixed stream of payments which typically will not adjust for inflation or increasing interest rates once annuitization has occurred. Investors in general do not like uncertainty. Much misunderstanding and apprehension about these products can be alleviated by explaining the pros and cons of the contract to the client. Recent events in financial markets have heightened sensitivity to fiduciary duties owed to clients. Making sure the client understands what he or she is purchasing not only builds a stronger client advisor relationship, but also protects the advisor against future damaging complaints.

As an insurance product, these contracts are governed by state insurance laws that differ from state to state. Income guarantees or enhanced death benefits are only as good as the insurance company making the promises. Although state insurance laws may vary, bankruptcy by the insurer during the accumulation phase of the contract could result in income guarantees which are basically worthless, leaving the individual with only the market value of the investment component if any. Consideration should be given to the insurance company rating and financial stability in determining which products are the most suitable for clients. It would be prudent to utilize only products issued by highly rated insurers.

As the underlying terms of these contracts is complex, advisors should determine which contracts work best in which situations and stick with those few contracts, learning them inside and out to be able to explain them to clients. Before meeting with the client, advisors should request that the insurance company representative (usually the internal wholesaler for their area) run hypotheticals under different return environments similar to the illustrations above. Many such hypotheticals can be run based on a particular asset allocation over a particular chosen time period. During the 2000, 2001, and 2002 period, continued declines in the stock market exhibit just the sort of returns that variable annuities are designed to protect against. Beginning a hypothetical with the year 2000 and evaluating it to the year 2010 or 2011allows for one to assess the behavior of the particular contract under very stressful conditions in the market and observe what would have happened to the account balance and income benefits during this period for a hypothetical investment. The period from 1992 to 1999 was one of sustained strength in the stock market and might provide good insight into the change in the value of the income benefit under good market conditions. Under no circumstances should the advisor attempt to present models of the product that they have designed themselves. Any explanation of the product should be based on hypothetical examples provided by the insurance company itself , and conducted with one of the insurance representatives present, either on conference call or in person. Before the client purchases the annuity, the advisor should arrange for a face to face meeting or three way conference call with the client and the insurance company representative. Before beginning any such meeting or conversation, the advisor should record the first and last name of the insurance representative and the date and time of the call. Calls made to most insurance company

annuity personnel are recorded by the insurance company. This is an easy way to provide documentation of what was discussed in the event of any future dispute. Advisors should always have the client on the phone or in the room on speaker phone and verify that on the recorded line when explaining the terms of the contract to the client or making any changes to withdrawals, investment choices, etc. The advisor should address each point, stopping before the next to ask whether the client understands the insurance company representative's response. Detailed meeting notes and any copies of hypotheticals used in the discussion should be kept on file.

To assure that the client does indeed understand the product that they are purchasing, and secondly to provide evidence to that effect, the meeting with the annuitant and insurance company representative should include a discussion with the client of the following questions.

- What is the financial rating for the insurance company issuing this product?
- What does it mean when my contract is "Annuitized"?
- Does my contract have to be annuitized?
- What triggers "annuitization" in my contract?
- What do I receive once the contract is annuitized?
- Will I receive at least the amount I paid for the contract?
- How is the payment that I receive from this annuity determined?
- Explain the fees that will be charged for this annuity and how they are calculated.
- Can I take my money out if I decide that I no longer want to own this annuity, and how does that work?
- Based on the hypotheticals, how is the account value, the income benefit, and the enhanced death benefit calculated?
- What happens if I withdraw more than the guaranteed income benefit?
- Once I begin to take withdrawals from this annuity, how long will I continue to receive payments?
- Will my payment ever go down?
- How does the spousal rider work? If I die is my spouse guaranteed to receive the same payment for the rest of their life?
- Can I access my account balance and income benefits online?

While there is no easy rule of thumb, it is generally not a good idea to place a large portion of a client's retirement assets into annuities for many reasons. Depending on the terms of the contract, the client may not be able to withdraw funds after the free look period has passed. On some contracts, withdrawing more than the guaranteed benefit can destroy future guarantees or result in significant fees or withdrawal of an account balance that is much lower than the income benefit. For this reason, advisors should consider splitting a ticket on one large annuity into two instead. An equally important point that should be discussed with the client is the possibility that rates could rise significantly in the future. Income guarantees which look generous by today's standards may seem paltry in a period of inflation and rising interest rates. It would be prudent to have some funds outside of the annuity which could be subsequently invested in income generating assets with higher interest rates or annuities with higher income guarantees. A variable annuity with guaranteed income of six percent may look terrific when CDs are paying

one percent, but not so great if CDs are paying ten or twelve percent. The nature of the guarantees and fee structure often make it impractical or impossible to surrender the annuity so that it could be reinvested elsewhere. Advisors should consider utilizing some smaller contracts with higher payouts which can be accessed when clients are older. Annuity surrender and 1035 exchanges should be undertaken with extreme caution and only after dialogue with client and insurance company representatives covering both the old contract and new contract reveal that this is the best option for the client.

Investment choices inside the fund could consist of individual sub accounts which could be combined to form a portfolio with a particular asset allocation, or premade portfolios which are designed to fit investment strategies reflecting different levels of risk tolerance. For example, the advisor may be able to select a group of sub accounts which would be suitable for a moderately conservative investor, or the product may offer a ready made portfolio of different asset classes designed to be suitable for a moderately conservative investor. Selecting individual funds inside of an annuity is decidedly more difficult to keep up with than a preset portfolio, and may be difficult to manage over many different clients with different risk tolerances unless the advisor has a consistent approach for selecting and monitoring these subaccounts for clients of varying risk tolerances. Some of the more advanced products have automatic trigger mechanisms that move the sub accounts to less risky assets in the event of large declines in the market. This may appeal to clients who prefer to limit the downside risk in the accounts and free advisors from constant monitoring of asset allocations within the different variable annuity contracts. Before discussing asset allocation strategies with clients or making any changes in sub account allocations, advisors should check first with their insurance company representatives to see if any of the investment choices would interfere with income guarantees in the contract. Particularly, investing more than a certain percentage of the assets in certain fixed income accounts could adversely affect income guarantees. Occasionally an insurance company will change the sub accounts in preset accounts. They will send a notice to the client and the advisor indicating the change that was made. Advisors should call clients to discuss such changes. Information for the performance of all but very new sub accounts will be available for the last few years from the insurance company. It would be helpful to use the returns for 2008 as a guide to the possible risk of the various investment choices available. One of the attractive features of many of these annuities is that they can provide an opportunity for growth in the income benefit to keep up with inflation while guaranteeing a floor of minimum withdrawals that will be available in the event that the market performs very poorly. For investors with very low tolerance for risk, but a need for growth to keep up with inflation, the income guarantees available in the variable annuities may be the only way that they will feel comfortable investing in equity markets. With the income guarantees in place, the temptation may be to rev up the allocation to a more aggressive investment mix. While this may make sense for more risk tolerant investors, it is important not to use an asset allocation that is very aggressive for more risk averse investors to avoid possible violation of prudent investment standards.

Financial advisors should open and review all correspondence from insurers. This may seem onerous as the paper flow related to these contracts can be tremendous. All correspondence from the insurance company should be retained in client files. Some annuities do not automatically make the guaranteed payout each year. In some contracts, the client must indicate their desired

withdrawal amount each year at the anniversary date. At least thirty days before the anniversary date of the contract, the insurance company will typically mail a notice to the client and the annuitant that they must indicate a payment choice. The financial advisor should be careful on paperwork regarding withdrawal requests, especially changes in withdrawal amounts. Withdrawing too much could damage future income benefits and failure to file required paperwork could mean forfeiture of withdrawal benefits until the next anniversary date. Any changes should be made only after conference call with client and insurance representative verifies that the amount does not exceed contract limits. Clients should be contacted in the event of changes in underlying investment options or sub accounts as well.

Even advisors who do not utilize variable annuity products in their practice should be aware of their advantages and disadvantages and keep abreast of the basics of how these contracts work, if for no other reason than to protect their clients from sales tactics of unscrupulous vendors. For those who do utilize variable annuities as one of the tools in a broad retirement plan, educating themselves and their clients about how the contracts work can go a long way in preventing undesirable outcomes and strengthening the client advisor relationship. Reviewing the terms of the annuity contract and why the contract was purchased should be a consistent discussion topic at client review meetings. The client should be conditioned to how these items appear on their brokerage statement and the statements they receive from the insurance company as well as what they can expect once the annuitization has occurred. Engaging in a regular dialogue with clients about their annuity products, reviewing their performance, and revisiting the reasoning behind their purchase can help alleviate the apprehension people have about these products that stems from their complexity. Stronger client relationships mean more referrals and fewer complaints for the successful financial advisor.

REFERENCES

1 National Underwriter (Life Health Financ Serv Ed) 115 no7
Ap 4 2011, p. 24.