

Section 7 **Understanding Annuities**

If you've read the section of this course on cash value life, you might be of the opinion that the most protective and tax-favorable/wealth-building tool at your disposal is a properly designed Indexed Universal Life (IUL) policy.

An IUL policy can be a useful wealth-building/retirement tool for many people; but there are no "secret" wealth-building tools and no "magic" concepts out there that are a good fit for everyone. If you are over the age of 65, it is going to be difficult to make a cash value life insurance policy work as a superior wealth-building tool.

Regardless of your age, one idea that has really taken hold in our society after the stock market crash of 2000-2002 (-46%) and again in 2007-2009 (-59% from the highest point to the lowest) is that of "principal protection."

Generally speaking, when the American investor thinks of wealth-building concepts that "preserve principal," they typically think of low-yielding tools like certificates of deposits (CDs), money market accounts, or potentially "fixed" annuities.

All three of the prior listed wealth-building tools guarantee your money will not go backwards, but the growth or return on each is typically very low (and CDs and money market accounts create annually taxable income).

What I will cover in the second part of this section of the course is a hybrid wealth-building tool called a Fixed Indexed Annuity (FIA). FIAs are unique wealth-building tools that in their "basic" form will be a good fit for many readers to grow wealth in a conservative manner.

Two of the key features that make FIAs an attractive wealth-building tool are:

-FIAs guarantee your money will NEVER go backwards due to downturns in the stock market.

-FIAs lock your gains every year; and once locked in, they can never be lost due to a downturn in the stock market.

While the above sounds exciting, you'll read in a bit about how an FIA can come with a 5-7% guaranteed rate of return* on an accumulation value (not walk away value) that is used to calculate/provide for you a guaranteed lifetime income* you can never outlive.

*Any guarantees mentioned are backed by the financial strength and claims-paying ability of the issuing insurance company and may be subject to caps, restrictions, fees, and surrender charges as described in the annuity contract.

In order to fully understand FIAs, it's important to have an education on annuities in general which is what I will cover in the first part of this material. You will not be an annuity expert after reading this section, but you will have a good base of knowledge that will help you whenever you decide to look at annuities as a wealth-accumulation/retirement tool.

TAX-DEFERRED ANNUITIES

INTRODUCTION

In the past three decades, tax-deferred annuities have emerged as a commonly used planning tool by financial advisors and estate planning attorneys as well as CPAs/accountants. As the financial services industry has undergone dramatic changes, depository financial institutions, brokerage firms, and insurance companies have changed their product menus to appeal to a broader spectrum of the investing public.

As the country's population has increased in age due to medical advancements that have increased longevity and the demographic bubble known as the "baby boomers," there has been an increased focus on retirement planning and [income planning](#) specifically.

As I stated in the section of the course on Bad Advisors, one of the problems facing the general public is the fact that most advisors do not have a full understanding of "all" the annuities available and how to use them to best help their clients.

Many securities licensed advisors know nothing or very little about FIAs, how they work, their living benefits, and guaranteed income riders.

WHAT IS AN ANNUITY?

An annuity is a contract between a buyer, or contract owner (typically an individual), and the issuer (typically an insurance company) whereby the contract owner agrees to pay the issuer an initial premium, or payment in a lump sum, or payments over a period of time, during which the issuer guarantees the owner a stated minimum rate of return or the opportunity to participate in growth based on an underlying group of assets. As with all contracts, there are numerous terms and conditions that influence the features and benefits that accrue to the owner.

The annuity contract is generally called a "Policy" because it is issued by an insurance company, and the owner is generally referred to as the "Policyholder." This terminology is used in general even though the annuity is technically not an "insurance policy" in the traditional sense; however, it may have some of the attributes of a life insurance policy, e.g., a death benefit. There are three general classifications of annuities: [fixed](#), [variable](#), and [immediate](#). These will all be discussed.

There are generally three parties to an annuity: owner, annuitant, and beneficiary. The **owner** is the individual or individuals who own the cash benefits of the annuity.

The **annuitant** is generally the individual on whose life the death benefit is contingent. The annuitant may be, and oftentimes is, the same as the owner; but this is not required.

The **beneficiary** is the individual or entity who is named to receive the death benefit of the annuity.

The period of time that the annuity is growing in value, which may also be increased by additional premium payments into the annuity, is referred to as the **accumulation period**. The accumulation period may be indefinite such as the case with FIAs; or there may be a set limit, generally determined by the age of the owner or annuitant or a set period following the initial premium payment.

Once the end of the accumulation period is reached, the **payout period** of the annuity begins. During the payout period, the owner will receive a series of payments, or a lump sum, that is selected from a menu of options. Once the schedule of payments is completed, or upon the death of the last-named recipient if a "life-only" payout is selected, the annuity ends and the contract, or policy, is terminated. A Single Premium Immediate Annuity ("SPIA," pronounced spee-uh) does not have an accumulation period and will be discussed later.

WHAT ARE THE COMMON CHARACTERISTICS OF ALL ANNUITIES?

TAX DEFERRAL AND WITHDRAWAL

All "tax-qualified" annuities, regardless of classification, offer **income tax deferral** of earnings until the earnings are withdrawn. If an annuity is funded with money on which no taxes have been previously paid, then it's considered a "qualified" annuity. Typically, these annuities are funded with money from 401(k)s or other tax-deferred retirement accounts, such as IRAs. When you receive payments from a qualified annuity, those payments are **fully taxable** as income.

"Non-qualified" annuities (ones NOT purchased with tax-deferred money) are treated the same when it comes to the deferral of taxes on growth, but are **taxed differently** when you remove money from the annuity.

The **initial premium** paid for a non-qualified annuity is **not taxed**. However, the growth is taxed when withdrawn at your ordinary income tax rate.

When taking money from a non-qualified annuity, there are really two ways to do it. 1) You can take withdrawals. 2) You can take a systematic income stream.

If you take a **withdrawal** (you call the company and ask for a certain dollar amount), it is assumed that the money coming from the annuity is from the **investment gains** and will be fully taxed at your ordinary income tax rate. Once all gains in the annuity have been withdrawn, the remaining money from the annuity can come out **tax free** as essentially a **return of your premium**.

When taking a **systematic income stream**, each monthly payment from a **non-qualified** annuity is made up of two parts. The tax-free part is considered the return of your cost for purchasing the annuity (your premium). The rest is the taxable balance or the earnings. The percentage of how much is deemed part of the return of your initial premium and how much is considered taxable income is somewhat complex. It's based on your age and expected date of death. For this course how to calculate it isn't necessary. That will be done by insurance company software.

1035 EXCHANGES

One annuity may be exchanged for another annuity in accordance with the Internal Revenue Code Section 1035(e). Such 1035 exchanges do not trigger a taxable event and may be affected at any time regardless of the age of the owner or annuitant. This happens often when people want to get out of riskier variable annuities into principally protected FIAs.

INVESTMENT PROTECTION

Because most non-variable annuities guarantee that your money will not go backwards, annuities provide investment/asset protection from downturns in the stock market.

Also, all annuities are also protected by the various State Guaranty Funds. These are reserve funds maintained by states to safeguard the cash value of policies, up to a certain limit in the event an issuing insurance company is unable to meet its obligations under the contracts.

PAYMENT OPTIONS

All annuities have options for payment during the payout phase. These range from a single lump sum payment to a periodic payment over the remaining life, or joint lives, of the annuitant or annuitants. In between, the owner may choose a period certain, usually no shorter than two years and no longer than thirty years. Also, the owner may select a payment for a period certain with a life option, meaning that, if the annuitant dies prior to the period certain (say 10 years), the payments would continue to the named beneficiary until the end of the stated period.

FIAs, which are the focus of the latter part of this section, do not have a set payout schedule. Typically, what happens in retirement with an FIA is that an annuity owner will decide each year (or month or quarter) how much he/she would like to withdraw from the annuity (without limitation after the surrender charge period is over). You might think of the ability to withdraw similar to taking money out of a savings account when needed.

However, what has become increasingly popular with FIAs is the option to buy one with a guaranteed income for life rider. With such a rider, with most products, you will know your guaranteed income payment the day you buy the annuity (which is both comforting and helps people better map out their retirement plans).

One drawback of most annuities is that the income, once started, does not increase with inflation. There are a few annuities that do have increasing payments, but the starting payment is usually about 20% lower than non-increasing annuities. This is an important factor when planning future income with annuities: the dollar amount you need for income today will not be sufficient to maintain your lifestyle in the future.

DEATH BENEFITS

Death benefits are also a common feature of all annuities. Some annuities impose surrender penalties, if still in force, at death whereas others do not. FIAs typically have NO surrender charges applied to the death benefit no matter when the annuitant dies.

It should be noted that death benefits from an annuity contract do not pass income tax free as life insurance death proceeds can.

SURRENDER CHARGES

Surrender charges are common on most annuities. These are imposed when you fully surrender the annuity (you take all the cash back) or can also be imposed when taking an early withdrawal (before the surrender charge period has expired) but keep the annuity in place (most FIAs give you a 10% free withdrawal each year without a surrender charge).

The length of the surrender charge can last for as little as three years to over ten years on most annuities. The best way to understand the surrender charge is to look at a schedule and apply it to an account value. The following is a typical seven-year surrender charge schedule.

Year	1	2	3	4	5	6	7	8
Surrender Charge	7%	6%	5%	4%	3%	2%	1%	0%

If you pay a \$100,000 premium into an annuity with a seven-year surrender charge and if I assumed a 5% growth rate on the annuity, the following is the surrender value if you choose to surrender the entire annuity at year end.

<u>Year</u>	<u>Start of Year Balance</u>	<u>5.00% Growth</u>	<u>Year-End Balance</u>	<u>Surrender Charge</u>	<u>Year-End value</u>
1	\$100,000	\$5,000	\$105,000	\$7,350	\$97,650
2	\$105,000	\$5,250	\$110,250	\$6,615	\$103,635
3	\$110,250	\$5,513	\$115,763	\$5,788	\$109,974
4	\$115,763	\$5,788	\$121,551	\$4,862	\$116,689
5	\$121,551	\$6,078	\$127,628	\$3,829	\$123,799
6	\$127,628	\$6,381	\$134,010	\$2,680	\$131,329
7	\$134,010	\$6,700	\$140,710	\$1,407	\$139,303
8	\$140,710	\$7,036	<u>\$147,746</u>	\$0	<u>\$147,746</u>

Surrender charges are misunderstood by many financial commentators and certainly by many state insurance departments. There has been a movement among regulators to limit the length of the surrender charge period in annuities. It sounds consumer friendly, but it's not. Limiting insurance companies from offering products with longer surrender charges limits the variety of products offered in the marketplace, and that is never good for the consumer.

What regulators do not understand is that the longer the surrender period of the annuity the better the terms (typically). What's important is that all the terms of an annuity are disclosed to the person buying it (including the surrender charge).

If a consumer wants to buy an annuity with better terms that also has a longer surrender period, there is nothing wrong with that so long as it is disclosed and understood.

PENALTIES

In addition to early surrender charges that are imposed by the issuer, the Internal Revenue Service (“IRS”) assesses a 10% penalty tax on earnings that are withdrawn if the owner is under age 59½ at the time of the withdrawal. There are numerous exceptions to the rule, e.g., disability, if taken in substantially equal payments over the remaining life of the owner, or if the payments are from a Single Premium Immediate Annuity (SPIA).

ANNUITIZATION

Annuitization is sometimes a dirty word when it comes to annuities. When you “annuitize” an annuity, you are telling the insurance company to take the money you have in the annuity and to guarantee a payout for a period of time (usually the remaining life of the annuitant). When you annuitize the annuity, you are trading the ability to withdraw cash from the annuity for the guaranteed payout. Therefore, if you had a crisis in your life that you needed cash to fix or mitigate it, if you annuitize your annuity, you will no longer have an ability to take a cash withdrawal; and you are stuck with the period annuitized payment.

To many, a guaranteed payment sounds appealing. But what many are finding more appealing are FIAs with guaranteed income riders where you DO NOT have to annuitize the annuity to receive an income stream for life.

TAXATION OF ANNUITIZED PAYMENTS

As I previously explained in more layman’s terms, the taxation of payments in annuitization from non-qualified funds (those not in a qualified retirement plan such as an IRA, 401(k), etc.) is determined by the “exclusion ratio.” The exclusion ratio is computed by dividing the amount of the initial premium by the sum of the payment to be received (determined by the mortality tables for life-only pay-out options). The exclusion ratio, which will always be less than 100%, is then multiplied by the periodic payment to determine the amount of the payment that is excluded from taxation. The amount that is not taxed, i.e., excluded, is classified as a return of principal. Obviously, if the annuity being annuitized contained qualified funds, then all the income would generally be taxable if the original contributions were made in before-tax dollars.

SALES LOADS

I’ve already discussed “surrender charges” in an earlier section that typically apply to fixed annuities.

Variable annuities (VA), on the other hand, can have up-front sales charges (loads) as well as on-going charges for management and other expenses associated with overseeing the portfolio of underlying assets (including back-end sales loads). The sales and on-going charges of VAs will be listed in the prospectus and should be reviewed carefully before purchasing.

The average ongoing expenses in a VA are 2.2%-2.7% per year. This is a heavy price to pay especially when there is NO principal protection in the product (unless you add riders that also come with an additional cost).

WHAT ARE THE DIFFERENT CLASSIFICATIONS OF ANNUITIES?

VARIABLE ANNUITIES (VAs)

The broadest classification of annuities is between fixed and variable. VAs are “securities” because, as the name implies, their value can vary, positive and negative, from the original amount of premium paid.

VAs are oftentimes referred to as “mutual funds inside an insurance wrapper” because, while the earnings are tax deferred, the underlying assets are the same or similar to those associated with mutual funds, i.e., stocks, bonds, market indexes, and general securities. Additionally, the fee structure for variable annuities is similar to mutual funds since they can include an up-front sales charge as well as on-going administrative and money management fees. In the absence of riders, the variable annuity generally does not carry any guarantees in regards to minimum earnings, death benefits, or lifetime income amounts.

Like mutual funds, variable annuities carry the risk of loss unless the buyer chooses one or more of the riders that prevent or reduce loss. These riders are generally minimum guaranteed death benefits, minimum guaranteed income benefits, and guaranteed withdrawal benefits.

The guaranteed minimum death benefit warrants that generally the value of the annuity upon the death of the owner and/or annuitant will be the highest year-end value reached by the annuity during the holding period.

If you add up all the fees on the various “riders” on VAs, they can add an additional 3.20% on top of the average other typical annual fees of 2.2%-2.7% per year. To say that VAs are very expensive would be an understatement. However, if the annual investment return is high enough in a VA, the expenses can be justified. (Everyone loves VAs in bull stock market runs and wishes they'd never heard of them when the market crashes).

NO-LOAD VAs

I wanted to briefly state that there are a handful of “no-load” VAs in the marketplace. While they do not offer protection from downturns in the stock market, they do not carry the same heavy fees as traditional VAs. The main fee in a no-load VA is a fee charged by the local financial planner who recommends and manages the investments in the VA. There are also typically no surrender charges. While I'm not a huge fan of VAs, if I were to recommend one, it would be a no-load version.

FIXED ANNUITIES

The fixed annuity's prime characteristic is that it guarantees some minimum earning rate if held for the contractual term, generally defined as the length of the surrender penalty period.

The minimum guaranteed growth is most often stated as some base interest rate, e.g., 2.5%, (a) during the period from the initial premium payment until the end of the penalty, and (b) during the total time that the owner holds the annuity in the accumulation phase. It is important to note that some issuers state their guaranteed minimum as a given rate on a percent of the initial premium, e.g., 3% on 90% of the initial premium. It is tempting to conclude that this arrangement would yield a 2.7% minimum guarantee, but doing the math will show a much lower minimum guarantee.

As I will explain, the FIAs have many of the characteristics of a variable annuity with respect to the earnings opportunity; but it still carries some minimum guaranteed earnings rate if held to term. The fixed annuity has sometimes been characterized as offering a “guaranteed return” whereas the variable annuity offers a “guaranteed opportunity” to realize a return.

SINGLE PREMIUM IMMEDIATE ANNUITY

A narrower classification identifies annuities according to the function of how they are funded. For example, the Single Premium Immediate Annuity (“SPIA”) involves the payment of a single premium followed no later than one year with a stream of income payments.

SPIAs can be either fixed or variable and should not be confused with an annuity that is in the payout phase. While both involve a stream of income payments, the SPIA has no accumulation phase.

SINGLE PREMIUM DEFERRED ANNUITY

Annuities, both fixed and variable, may be “single premium” or “flexible premium.” The former is referred to as SPDA (Single Premium Deferred Annuity) and the contract allows only one initial premium whereas the FPDA (Flexible Premium Deferred Annuity) allows additional premiums after the initial premium. These additional premiums usually must be at least a certain minimum amount and may be limited to one or more years following the initial premium.

TAX SHELTER ANNUITIES

A special class of annuities is the Tax Shelter Annuities (“TSA”) and is governed by Section 403(b), 457 and others of the Internal Revenue Code. TSAs can be fixed or variable. Generally, TSAs are available to the employees of public institutions (school teachers and policemen, as well as those of non-profit organizations), certain hospitals, and the clergy. Premiums are paid in before-tax dollars, making all withdrawals subject to ordinary taxation. The TSA generally can be opened for a very small amount, \$100; and subsequent premiums may also be small. Premium payments are routinely made through payroll deductions. The contribution and withdrawal rules vary widely according to the individual circumstances of the owner.

INDEXED-LINKED FIXED ANNUITIES (“FIA”)

The index-linked fixed annuity is commonly referred to as a Fixed Indexed Annuity (FIA). When this annuity was introduced, it was linked to an equity index only and thus the reason for the name.

The next section of this material will fully explain how FIAs work and their benefits, and so I will not take up time to discuss FIAs here.

USING ANNUITIES INSIDE QUALIFIED RETIREMENT PLANS OR IRAS

One issue I have not discussed in any detailed manner but wanted to touch on before moving on is the argument against using annuities inside qualified plans (401(k)) or IRAs.

Many CPAs for some reason caution clients to watch out for advisors selling tax-deferred annuities inside tax-deferred vehicles like 401(k) plans or IRAs. The argument is that the advisor is looking to make a quick commission when there is no benefit to using a tax-deferred vehicle inside a tax-deferred vehicle.

What CPAs and others making this argument do not understand is that the reason the annuity is being purchased is for its protective features (money never goes backwards; gains are locked in annually) and/or for a guaranteed rate of return (accumulation value) coupled with an income for life you can never outlive.

When lecturing on the proper use of annuities, I typically recommend that people buy them inside qualified retirement plans or IRAs because the growth on the annuity will all be income taxable regardless of whether it is coming out of an annuity or not.

SUMMARY OF THE BASICS OF ANNUITIES

Annuities come in many varieties, classifications, and versions; but they all have in common the feature of tax deferral. Annuities have a place in the financial plans for a large percentage of the individuals who are saving for retirement or who are already in retirement and who cannot afford to take the risk of losing some or all of their retirement nest egg.

FIXED INDEXED ANNUITIES (FIAs)

For readers who lost 40-50-60% when the stock market crashed in 2007-2009, the following material should be somewhat exciting.

The following material will cover one of my favorite retirement tools and why they can play a vital role in helping people grow and protect their wealth before and in retirement.

Most FIAs have the following characteristics:

-100% principal protection (your money will never go backwards due to negative returns in the stock market).

-Gains in a stock index are locked in every year.

Many FIAs come with the following characteristics:

-A guaranteed rate of return (accumulation value) between 5-7%* on an accumulation value (not walk-away value) that is used to calculate/provide for you a guaranteed lifetime income* you can never outlive.

*Any guarantees mentioned are backed by the financial strength and claims-paying ability of the issuing insurance company and may be subject to caps, restrictions, fees and surrender charges as described in the annuity contract.

Does a wealth-building tool with the above-mentioned characteristics interest you?

-What's sadly ironic as I explain in the Bad Advisors section of this course, the vast majority of securities licensed advisors (those who primarily sell stocks and mutual funds to make a living) either know nothing or very little about FIAs.

-What's worse is that some Broker Dealers (B/Ds) who securities licensed advisors sell their stock and mutual funds through forbid the advisors from selling or discussing FIAs with clients and many B/Ds severely limit the type of FIAs that their advisors can offer.

-What's worse is that most of these same advisors who are forbidden from selling FIAs do NOT disclose that to the clients or potential clients they are supposedly helping build wealth.

With proper asset allocation using FIAs as a wealth-building tool, the pain of stock market crashes can be significantly mitigated.

WHAT IS A FIXED INDEXED ANNUITY?

As the name indicates, a "fixed" indexed annuity is classified as a "fixed" annuity. As such, the product must be equipped with guarantees that non-fixed/variable annuities do not.

Generally speaking, most advisors explain that an FIA has a guaranteed return of zero in any given year. Therefore, when the stock market goes negative, the returns in the FIA do not; and the annuity owner is credited with a zero rate of return in negative years.

There are actual minimal contractual guarantees in an FIA (although understanding them can be a bit difficult). The following is a typical contractual guarantee from an FIA contract:

This FIA provides a guaranteed minimum value to your annuity called the Policy Value. The Death Benefit, the Annuitization Value, and the Cash Value can never be less than the Policy Value. The calculation of the Policy Value is independent of the calculation of the Accumulation Value for the first 10 Policy Years. The Policy Value is an accumulation of 87.5% of the premium at an annual rate of at least 2.45% for the first six Policy Years and at least 1% thereafter.

The above is probably clear as mud. The bottom line with the guarantee is that once funded, the money will never go backwards due to negative returns in the stock market. The guarantee, which is typically over a multi-year period, usually doesn't come into play due to the fact that FIAs usually yield better returns than the minimal guarantees; and, therefore, an FIA usually will have 0% credited in years when the measuring index goes negative.

What people are most interested in is what the word "indexed" means and why is that used in the name of a "fixed" product?

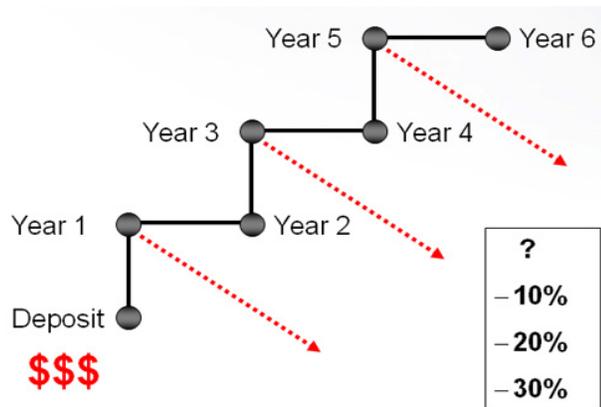
The indexed part of the name alludes to the fact that the gains in an FIA track a particular stock index. The preferred stock index that has been used since the inception of FIAs over ten years ago is the Standard and Poor's 500 stock index (although other stock indexes are now available such as the DJIA, Wilshire 2000, and NASDAQ).

The S&P 500 index is widely regarded as one of the best single gauges of the U.S. equities market and represents a sample of 500 public companies in the U.S. economy.

IF YOU ONLY KNEW!

If you only knew the stock market was going to crash in 2000-2002 and again in 2007-2009, wouldn't you have taken your money out of the market? Of course, we all would have.

The following picture illustrates in general how an FIA works in both positive and negative years in the stock market. You'll notice that, in negative years, the account value (represented by the dark line that looks like a ladder) does not decrease; it flatlines.



ZERO IS YOUR HERO

A good saying when the market goes negative is that “zero is your hero.” It's a saying that people who had FIAs during the 2000-2002 and 2007-2009 stock market crashes started to use.

Instead of going over to your neighbor's house and bragging about how well your stocks did in a bull market (which many people have a tendency to do), you would go over there and brag about how you earned ZERO.

It's crazy; but in the volatile environment we are in, when the stock market goes negative (or very negative) in a short period of time, zero sure is your hero.

Let's look at an example of zero being your hero over a five-year period with returns of 14.71%, -22%, -11%, -9%, and 21% where the starting account value is \$100,000.

<u>Year</u>	<u>\$100,000 Invested in The S&P 500</u>	<u>\$100,000 Inside an FIA with 6% cap</u>
1	\$114,710	\$106,000
2	\$89,474	\$106,000
3	\$79,632	\$106,000
4	\$72,465	\$106,000
5	\$87,682	\$112,360

As you can see, when the stock market goes backwards, so does the account balance invested in the S&P 500 stock index. However, in those same negative years, the FIA flatlined and held its highest value which came at the end of year one.

Also, you'll notice that, in the first positive year, the account value in the S&P 500 index was higher than the FIA account balance. That's because most FIAs have caps on the upside growth; and in this particular example, the cap was 6% each year.

DOES THE INSURANCE COMPANY REALLY INVEST YOUR MONEY IN THE S&P 500 STOCK INDEX?

No, although that's exactly what I thought the insurance companies did with the premium dollars when I first reviewed these products back in 1999. I figured this was a risky thing for an insurance company to do, but it seemed like insurance companies owned half the investments in this world and I figured they could afford to take that risk.

Although the gains are linked to the S&P 500 stock index (minus dividends), the premium dollars paid by insureds are NOT actually invested in the S&P 500 index (which would be very risky).

What does the insurance company do with the money to generate returns with no gains? As I explained in the section of the course on Indexed Universal Life (IUL), the insurance company does the following:

1) The insurance company receives an annuity owner's premium payment and invests the money in **income-producing bonds**.

2) Income from the bonds is then used to **purchase options** on a stock index like the S&P 500. If there is a positive return in the market over a 12-month period, the options pay off and generate the return in the FIA. If not, then the options are worthless; and the insurance company starts over for the next 12-month cycle. (This is more fully explained in the IUL section of the course material).

The option returns of an index like the S&P 500 drives the returns in the FIA. With higher bond income and/or lower options costs, the insurance company can buy more options that can generate better returns and higher caps in the FIA.

It is because of the above variables that the "**caps**" in the products (explained in an upcoming section) will have fluctuations.

What's important to understand is that, even if the S&P 500 stock index goes down **50%+** (like it did in a stretch of time between 2007-2009), the insurance company is not overly affected when it comes to the FIA portfolio.

CASH ACCOUNT VALUE (CAV) VS. CASH SURRENDER VALUE (CSV)

FIA's, like cash value life insurance, have a CAV and a CSV. The CAV is the money inside your FIA that is actually growing. The CSV is what you would receive if you said to the insurance company that you no longer wanted the annuity and would like your money back.

The CAV and the CSV are typically the same account value after the surrender charge period has expired.

When **growth is credited** to your FIA, it is credited based on your CAV.

For example: Assume you paid a \$100,000 premium into an FIA that has a 10% first-year surrender charge.

If the S&P 500 index returns 5% in year one, that 5% is credited based on your \$100,000 CAV, not your \$90,000 CSV.

Therefore, at the beginning of year two, the CAV would be \$105,000.

If you surrendered your FIA for cash in year two, you would receive 91% of \$105,000 if the surrender charge dropped from 10% to 9% in year two.

CREDITING METHODS

One of the most popular crediting methods to calculate the gain in an FIA is called the **annual point-to-point** method.

It works as follows: At the time of the initial FIA premium, the level of the S&P 500 index is recorded as the starting point and is then compared to the level of the index at the first anniversary date 12 months later. The difference in value (if positive) is used to determine the amount of earnings paid into the annuity for the first year.

Example 1: If the S&P 500 index has a value of **2,000** when an FIA is funded on January 15th and on January 15th of the following year the value is **2,100**, the FIA would be credited with growth of **4.8%** ($2,000/2,100 =$ a **4.8%** return).

Example 2: If the S&P 500 index has a value of **2,000** when the FIA is funded on January 15th and on January 15th of the following year the value is **1,900**, the FIA would be credited with growth of **0%** because FIAs do not partake in the downside of the market.

Additionally, the following year, if the S&P 500 index goes positive by 5%, the FIA would be credited with a gain starting with the already higher account balance vs. a brokerage account that would go down with the market in year two and where any following upturn in the market would then be based on a lower account value (see the next chart for an example).

The following example will illustrate how important it is to not go backwards when the stock market goes negative and to lock in gains when the market moves in a positive direction.

	Account Balance FIA	Brokerage Account Balance
Start Balance	\$100,000	\$100,000
End of year 1 (+5%)	\$105,000	\$105,000
End of year 2 (-5%)	\$105,000	\$99,750
End of year 3 (+5%)	\$110,250	\$104,740*

*This does not take into account the typical mutual fund fees applied to a brokerage account. If a 1.2% mutual fund expense is levied upon the brokerage account, the balance at the end of year three would be **\$101,060**.

CAPS

From what you've read so far you may be saying to yourself that FIAs are the greatest thing you've ever heard about. No losses, locking in of gains annually, etc.

As we all know, there is no free lunch in this world (FIAs are no different).

FIAs have "caps" on the amount of growth in the product. Most of the FIAs in the marketplace have caps that literally cap the gains of the annuity over a specified time frame.

With an annual point-to-point FIA, the annual cap typically would range from 3%-12% depending on certain variables (at the time this is being published caps are around 6% for S&P 500 index-based products).

The caps with most FIAs can change periodically. For an annual point-to-point annuity, the cap could change annually. For example, back in 1999, the annual caps on some FIAs were as high as 12%. When the market tanked the following three years, the caps with some companies went down as low as 3%.

With all FIAs, there is a contractual agreement that the company will not go below a certain cap number (like no lower than 2% annually on an annual point-to-point product).

Those "in the know" in the financial services/insurance industry know that certain companies like to play games with their caps. What games are played? Some companies have a history of offering high caps in the year the FIA is issued to entice consumers to buy their products and then lower the caps significantly the next year (whether the economic environment dictates lowering the cap or not).

PARTICIPATION RATES AND "SPREADS"

The participation rate is the percentage return in the index that is credited to the annuity as earnings. The participation rate today in most annual point-to-point S&P 500 index FIAs is 100% (but with a cap).

For example: Assume the S&P 500 index increases 16% during the year, but the participation rate in the product is 50%.

In this case, the annuity would be credited with an earning rate of 8.00% (50% of 16%). That's not bad and would outperform a 100% participation rate product with a 6% annual cap (which of course would credit 6% in this example).

Many products in the marketplace offer participation rate products with NO cap on the measuring stock index. The participation rate on S&P 500 index products are usually around 50% (give or take depending on the economic environment). Other customized non-S&P 500 indexes that I'll discuss in more detail can come with participation rates of 120%, 150%, and some are even higher (with no cap).

Also, some FIAs employ a fee, generally called the "spread," which is subtracted from the earnings rate before it is credited to the annuity.

In the foregoing example, if the spread were 2%, the 50% participation rate annuity would be credited with 6% (8% less the 2% spread).

The participation rates, caps, and spreads may be fixed for a specified time, or they may be guaranteed for the term of the annuity. Generally, if they are subject to being reset at the option of the issuer, they will also include minimum and maximum amounts that limit their variability.

The only way to determine the variables in an FIA is to carefully analyze them. I can tell you from experience that many insurance advisors selling FIAs do not fully understand how they work and the various moving parts, so make sure you read the Bad Advisors section of this course and pick a good one to help you.

VOLATILITY CONTROLLED INDEXES (VCI)

If I had written this course five years ago, there would be no section in the course on VCIs. However, in the last three years, VCIs are a tool that have been added by nearly every major insurance carrier that offers FIAs.

Why? Because our country and really the entire world has been in a low interest rate environment that has put a lot of pressure on the caps used in FIAs.

Back in 1999 when I first started looking at FIAs, caps on an annual point-to-point S&P 500 based FIA were 12%. Only a handful of years ago they were as low as 3% (although more recently they have bounced back to 6%).

What's the problem with low caps? Clients become a lot less interested in FIAs because growth on the accumulation value isn't attractive enough to tie up their money in the product.

Increasing the yield—insurance companies needed to find more yield (returns) in their FIA products, and that's what led to the advent of VCIs. With the various designs in the marketplace, VCIs have "models" that show they would have returned significantly higher internal rates of return in FIA products than the low annual point-to-point caps on S&P 500 index-based products.

The concept behind VCIs is simple. When the stock market becomes volatile, the stock index changes its investment mix to become more conservative. When volatility in the market subsides, the indexes change again to more aggressive investments.

This differs from the passive approach of simply pegging growth in an FIA to the S&P 500 index (the main index used by most products going back to their inception).

In an S&P 500 based index, if the market has a big downturn during a 12-month period, there is very little chance to recover and have a positive return. With a VCI, the design will attempt to avoid the bigger downturns and even benefit by getting back into the market as the market bounces up after a downturn.

Trying to explain exactly how VCIs work would take many pages of material with charts, graphs, etc. That is not the point of this course material. My goal is to make readers aware of VCIs and have a general understanding of how they work.

Let me try to explain how VCIs work in layman's terms.

The investment industry measures the volatility of the stock market. While not a fully accurate statement, most people think that volatility = risk. It's close enough to use that as the terminology in this material.

Volatility in the stock market is measured by something called the VIX. Here is a definition of the VIX.

The CBOE Volatility Index, known by its ticker symbol "VIX," is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange (CBOE). It is colloquially referred to as the investor fear index or the fear gauge.

What you need to understand about VCIs is that most use the VIX as a trigger when deciding how and when to change the investment mix.

A simple way of understanding how VCIs use the VIX is with an example.

In the first part of February, 2018, the VIX spiked. The VIX on January 26, 2018, was at 11.08. On February 5, 2018 it spiked to 37.32. This was one of the quickest and largest spikes in the VIX since the 2007-2009 crash.

When the VIX spikes, that's a trigger for a VCI to do something. For most VCIs that will mean to go "risk off" and move money to cash or something conservative.

When the VIX goes back down to a predetermined point, the VCI will move the money back into the market.

The movement of money is automatic with most VCIs.

If you didn't understand anything I just wrote about VCIs, just understand that VCIs are NOT buy-and-hold indexes like most FIAs have offered using the S&P 500 index over the years.

Why do VCIs provide more opportunity for growth?

1) The cost to hedge risk can be less expensive than an S&P 500 index-based strategy.

2) Many VCIs have no cap on earnings.

3) Many uncapped VCIs have a 100% participation rates in the index (most uncapped S&P 500 index-based FIAs have a participation rate of 35-60% at any given time).

4) Some uncapped VCIs have more than a 100% participation rate (some more than 150%).

Another good way to understand the benefits of a VCI is to see a the numbers. The following is a comparison between an FIA using an S&P 500 index with a 100% participation and a 6% annual cap to a VCI that has no cap and a 100% participation in the index.

I'll go back 10 years and back to 2007 (one a bull run and one picks up a big stock market crashes).

FIA using the S&P 500 index with 100% participation and 6% cap

-10-year rate of return 4.37%

-Back to 2002 rate of return 4.12%

FIA using a VCI with 100% participation and no cap

-10-year rate of return 5.87%

-Back to 2002 year rate of return 6.74%

Just because I know readers may be curious, if you used an FIA with an S&P 500 based index that has a 50% participation rate with no cap, the numbers would look like the following:

-Best 10-year rate of return 6.29%

-Back to 2002 year rate of return 6.19%

Remember there is no risk of loss in either product and gains are locked in annually in both products. These numbers are for month ending July 2020.

ARE FIAs USEFUL AS ACCUMULATION TOOLS?

This is a question many consumers and advisors have. What should a client do with his/her "safe" money? In the old days, a financial planner would use bonds as a safe haven. That is no longer the case.

Frankly, there isn't anywhere in the financial services industry I know of that provides 100% protection of principle, locks in gains annually, and is expected to return 4-6% annual over time.

The trap that many advisors and some consumers fall into is comparing FIAs to money that is earmarked for "growth" over time. When I say "growth," I mean the investor is willing to accept some or even a significant amount of risk to try and generate an 8-10% rate of return over time.

To compare an FIA to a typical investment account earmarked for growth is a mistake. It's like comparing apples to oranges.

WON'T FIAS STIFLE GROWTH OF YOUR ASSETS?

The common knock on FIAs is that, if you incorporate them into your financial plan, it will kill or certainly depress the overall return and, in turn, the value of your assets.

I could pontificate as to why that isn't the case, but I'll just show you a few charts that prove the opposite.

Let's look at two examples. Both examples will compare the S&P 500 stock index to a portfolio made up of 70% in the S&P 500 and 30% in an FIA with a no-cap volatility control index.

Which one over the last ten years (a time frame in the market) would have a greater rate of return?

Which one going back to 2007 would have a greater return?

Most people would guess that the account with 100% in the S&P 500 would kill the mix with 30% in an FIA with a 6% annual cap (locking in the gains annually).

Ten-year comparison (ending in June 2020)

-S&P 500 rate of return = 13.84%
-S&P 500 with 30% FIAs = 11.66%

Also, keep in mind that these numbers do not include money manager fees or taxes.

Most people are very surprised to learn that the numbers in the previous comparison are so close in what's been a bull market.

Comparison going back to 2007

-S&P 500 rate of return = 7.69%
-S&P 500 with 30% FIAs = 7.79%

I wonder if the second comparison will get your attention? The comparison going back to 2007 picked up a big stock market crashes which is why the portfolio with 30% FIA did about the same (slightly better).

What consumers should always look are the "risk adjusted returns" of various wealth building tools and why FIAs are such a good fit to bring down the risk of a portfolio without hurting yield.

Risk adjusted returns answers the question of which asset mix provides better returns for the amount of risk taken.

The following numbers are from the OnPointe Risk Analyzer software. It shows the risk score of the 70/30 stocks to FIA portfolio vs. the S&P 500 (SPY).

It also shows the maximum loss of the portfolios going back to 2007 and the rate of return.

The top set of numbers are for the 70/30 stock to FIA mix and the bottom set are for the S&P 500 index.



Which asset mix has better risk adjusted returns?

Considering the rate of return is nearly identical, the mix with FIAs provides a much better risk adjusted return (you should never take more risk necessary to reach your investment goals).

It's because of the previous examples that I really have a hard time understanding why all financial planners don't embrace the use of FIAs.

So, the answer to the question about whether FIAs depress the returns in an overall portfolio is no (when used in moderation to mitigate risk).

INCOME FOR LIFE PLANNING

If you think about it, what are most people trying to accomplish with their financial plan?

Is it to accumulate as much money as possible by a certain age?

Or

Is it to be able to afford a certain lifestyle in retirement no matter how long you live?

This really is a fundamental question everyone should ask themselves when planning for retirement.

What's my answer to this question?

It's to make sure I can live as I want in retirement and never run out of money no matter how long I live.

If you agree, you will like the following material.

FIAs WITH GUARANTEED INCOME FOR LIFE RIDERS

My goal when I write about the benefits of FIAs isn't to sell people on their use. It's to educate so people know they exist and can assess whether using them makes sense in a financial/retirement plan.

The same goes for FIAs with guaranteed income riders. There is some debate in the financial services industry as to whether these riders make sense. As you'll learn, the insurance company charges a fee for the rider and, for most of the income payments, is simply giving clients back their own money.

Many financial planners believe it's better to invest a client's money in the stock market because over time they will do better with it and be able to provide the income a client needs in retirement.

Most financial planners assume a client is going to die at a certain age and shoot for them to run out of money, if that's what the client would like, at a certain age (like age 87 as an example).

Here is the question I ask all financial planners:

Do you know when your clients are going to die?

Of course, the answer is no. Then I ask them how can they possibly budget clients properly to run out of money at a certain age by only investing in stocks, mutual funds, and bonds? The answer is they can't but many believe they can. The consequence to the advisor if they can't isn't too dire but can be for their clients (especially those who have limited amount of wealth).

As you'll read in the course material on investment risk, there are no guarantees in the stock market.

Let me ask you a few simple questions that will set up the remainder of this section's course material:

1) What's more important to you today when deciding how to grow your wealth?

-Reaching for 8-10-12%+ growth where your money is 100% at risk to stock market downturns and crashes?

OR

-Earning a 6-7% guaranteed return (on accumulating assets)?

2) In retirement, would you be happy if your accumulated assets could guarantee an income stream you could never outlive with the following schedule:

4.5% if activated at age 60

5% if activated at age 65

5.5% if activated at age 70

6% if activated at age 75

Most readers will like the idea of a 6-7% guaranteed return on an asset that can generate a guaranteed income payment.

HOW DO YOU RECEIVE A GUARANTEED RETURN COUPLED WITH A GUARANTEED INCOME FOR LIFE?

The first question that needs to be answered is "what investment firm, bank, or other entity is going to give someone a guaranteed rate of return and a guaranteed income for life?"

The answer is that life insurance companies offer products with such guarantees when a consumer purchases a particular type of annuity coupled with a Guaranteed Income for Life Benefit (GIB) "rider."

A rider is a contractual option that is added onto an insurance product to add one or more features/benefits to the base product.

HOW LONG HAVE GIB RIDERS BEEN AROUND?

Surprisingly, GIBs have been around for years. In the old days, these were only available on a variable annuity but have more recently been added to FIAs.

VARIABLE ANNUITIES VS. FIXED INDEXED ANNUITIES

As I just indicated, until recently, you could only purchase a GIB rider on a variable annuity (VA). However, in the last 10+ years, FIAs have been offering GIB riders. Why? Because the American consumer is clamoring for guaranteed income products, and they want to buy such products in a non-variable environment.

I'm not going to cover VAs with guaranteed income riders in this course material because most are inferior to those offered in FIAs.

GIB RIDERS—GETTING STARTED

When purchasing the annuity, you will decide if you would like to add a GIB rider to the annuity. You must add the rider at the time you purchase the FIA.

You pay your premiums to the insurance company which, in turn, funds the FIA just as it would any FIA.

However, if you choose to add on a GIB rider, the accounting in an FIA is dramatically different than an FIA without the rider.

ACCUMULATION ACCOUNT VALUE VS. ACTUAL ACCOUNT VALUE

With any FIA, the annuity owner will have a cash account value (CAV) (the amount of money actually growing at market rates in the annuity every year) and a cash surrender value (CSV) (the amount of money an owner would walk away with if he/she surrendered the annuity and asked for all the available cash). These have both been previously discussed starting on page 12.

When a GIB rider is added to an FIA, there is an additional accounting measure that must take place. The insurance company must start an accounting for what I like to call the "benefit base" (BB).

The BB is the account value that will increase at whatever the guarantee being offered by the insurance company happens to be at the time you buy the annuity with a GIB rider. If you bought an FIA with a 7% "guaranteed" return, the guarantee is applied only towards the BB, NOT the CAV or CSV (see the following example for a better understanding of the distinction).

The BB is **NOT a walk-away account value**. It is **ONLY used for calculation purposes** when determining the guaranteed income-for-life payment.

Let me use an example, and I think you'll understand how the two different account values grow. In the following chart, you will see a BB in the center column and the actual account value in the right-hand column (for this example, assume the actual account value is the CAV).

This example product has a **7% guaranteed rate of return** on the BB and a **.9% fee on the income rider**. For the CAV, I assumed a random rate of return.

	<u>Benefit Base</u>	<u>Cash Account Value</u>
Issue Age 55	\$100,000	\$100,000
Year 1 Age 56	\$107,000	\$105,046
Year 2 Age 57	\$114,490	\$110,347
Year 3 Age 58	\$122,504	\$109,354
Year 4 Age 59	\$131,080	\$114,871
Year 5 Age 60	\$140,255	\$120,668
Year 6 Age 61	\$150,073	\$126,757
Year 7 Age 62	\$160,578	\$133,153
Year 8 Age 63	\$171,819	\$131,955
Year 9 Age 64	\$183,846	\$138,613
Year 10 Age 65	<u>\$196,715</u>	<u>\$145,607</u>

As you can see, the center column grows at 7% and is much higher than the actual account value in the right-hand column.

With this example, you can see the difference between the cash account value, the benefit base (used for income purposes), and the cash surrender value.

	<u>Benefit Base</u>	<u>Cash Account Value</u>	<u>Surrender Value</u>
End of Year 1 Age 56	\$107,000	\$105,046	\$94,541
End of Year 2 Age 57	\$114,490	\$110,347	\$100,415
End of Year 3 Age 58	\$122,504	\$109,354	\$100,605
End of Year 4 Age 59	\$131,080	\$114,871	\$106,830
End of Year 5 Age 60	\$140,255	\$120,668	\$113,428
End of Year 6 Age 61	\$150,073	\$126,757	\$120,419
End of Year 7 Age 62	\$160,578	\$133,153	\$127,827
End of Year 8 Age 63	\$171,819	\$131,955	\$127,996
End of Year 9 Age 64	\$183,846	\$138,613	\$135,841
End of Year 10 Age 65	<u>\$196,715</u>	<u>\$145,607</u>	<u>\$145,607</u>

Remember that virtually all annuities have surrender charges. In this example, if you wanted to surrender (get rid of) this annuity, you would receive what's in the right-hand column.

You'll notice that in year ten the CAV and the CSV are exactly the same. That means that the surrender charge period is over after ten years.

What you should also know is that, when you buy an FIA with a GIB rider, you can typically turn it on 12 months after purchase and NOT have the surrender charge affect the guaranteed income benefit.

MINI-SUMMARY

When you buy an FIA with a GIB rider, your FIA will start with three account values.

The accumulation account value is ONLY used to calculate the guaranteed income benefit (discussed in an upcoming section).

If you want access to all of your cash, you will be given the cash surrender value, which in my example is the same as the cash account value starting in year ten.

The cash account value is the actual account value as the money grows every year in the FIA and is the amount that would pass to your heirs at death.

You can start your guaranteed income benefit while the FIA is still in the surrender charge period; doing so has NO effect on your GIB for life.

ACCUMULATION PERIOD

FIA GIB products vary on the period of time each will allow money to grow at the guaranteed rate. Most companies allow the money to grow in the accumulation account for no longer than 10 years.

Some companies allow up to 15 years.

One company allows for accumulation up to age 90, but it is a bit of a hybrid product that is somewhat difficult to explain; and, therefore, I'm not going to cover it in this material.

As far as activation is concerned, as I stated, with most products you can activate the GIB rider 12 months after purchasing the annuity. When you reach the point where the GIB will no longer accumulate because you are over the number of years for the guarantee, you are not required to activate the rider. You'd be crazy if you didn't activate it because you will no longer be receiving a guaranteed roll up, but you do not have to activate the rider.

WITHDRAWAL VS. ANNUITIZATION

One of the unique features of a GIB for life rider with an FIA is that it does NOT require annuitization. An annuitant can activate an income stream for life; but if he/she needs a lump sum of money, the money in the actual account value will be available. Withdrawals outside of the guaranteed income payment will decrease future payment streams or will cause them to cease if all of the remaining actual account value is withdrawn.

When you take a withdrawal from an FIA with a GIB rider, you are taking the withdrawal from the actual account value, not the guaranteed accumulation account value (Benefit Base account).

Let me give you an example of how taking a withdrawal can affect your income benefit. Assume you had \$100,000 in your actual account value. If you had a need for \$50,000 and removed that from your FIA, if you were to start your GIB for life benefit, your income stream would be reduced by 50% (which almost seems too logical).

CALCULATING THE GUARANTEED LIFETIME INCOME STREAM

The first thing you need to know is that different insurance companies have different ways they calculate the GIB. The basics of how the income is calculated are the same, but the amount of payments per company can vary.

The second thing you need to know/remember is that the GIB is based on the Benefit Base (the guaranteed accumulation account value).

How does the GIB for life payment work?

It's really quite simple. When you decide to activate the GIB for life, the insurance company takes the guaranteed accumulation account value (BB) at that time and then pays you a percentage of income based on that account value for life.

An example will crystallize how it works.

Assume you are 70 years old when you activate the GIB for life rider. Also assume that the guaranteed BB is \$500,000 at that time. Finally, assume that your FIA contract with the insurance carrier states that at age 70 you will be paid a guaranteed income benefit for life based on a rate of 5.5%.

The math would look as follows:

$$\$500,000 \times 5.5\% = \underline{\$27,500}.$$

Therefore, you would be paid an income benefit of \$27,500 every year so long as you live. If you die early, there will be an account balance that passes to your heirs (discussed in an upcoming section). If you live until the ripe old age of 100+, the insurance company will keep on paying you.

VARIOUS GIB PAYMENT SCHEDULES

As I indicated, GIB rider terms offered by different companies in the marketplace may vary.

Some companies use the following payment schedule:

4.5% if the rider is activated before age 65

5% if activated at ages 65-69

5.5% if activated at ages 70-74

6% if activated at ages 75-79

6.5% if activated at ages 80-84

Some companies also have worse payout bands than the above and that's something you need to understand as you compare different products.

The "fairest" payment schedule

Some companies have a payment schedule that is calculated by taking the annuitant's age at the time of activation and subtracting 15. It sounds simple enough.

4.5% if the rider is activated at age 60

4.8% if activated at age 63

6.2% if activated at age 77

6.9% if activated at age 84

Part of the problem with trying to assess which GIB rider FIA to use is that they can be somewhat confusing. It's important to know the payment bands of the FIA with GIB riders you are considering.

Let's look at an example for a 60 year old who pays a \$500,000 premium into an FIA with a GIB rider. We'll look at the guaranteed incomes at age 65 and 69. With one product we'll assume that the fairest payment schedule is used and one we'll assume the payment bands shift up every five years.

	Typical	Guaranteed	"Fairer"	Guaranteed	
Age	Payment Rate	Income	Payment Rate	Income	Difference
65	5.00%	\$35,463	5.00%	\$35,463	\$0
69	5.00%	\$44,771	5.40%	\$48,353	(\$3,582)

All things being equal, I would much rather see someone buy the FIA with the fairest payment schedule. While people may think that they know when they will be turning on the income, that rarely is the case; and a product with the fairer payment schedule builds in flexibility.

PREMIUM BONUSES

Some FIAs come with up-front premium bonuses. What does that mean? Well, it's just as it sounds. When you pay your premium, the company will give you a bonus (5%, 10%, 20%).

For example, if you paid a \$100,000 premium into an FIA that has a 10% bonus, the account value the first year would be \$110,000.

Depending on the product, that bonus could be used for the Benefit Base (to increase income), the actual account value, or both. Many companies today only use the bonus for the Benefit Base (to add it to the actual account value is possible but then the terms of the annuity tend to lag (lower cap and/or participation rates)).

At first look, you may say to yourself that you always want an FIA with a bonus, but there is no free lunch in these products. There is only so much money to go around.

Bonus products can be designed a number of different ways to make them better or worse for particular situations. If you are going to turn the income on in an FIA in the first few years, using a bonus product may make the most sense.

But many of the bonus products are NOT a great fit if you are going to wait 10 years or more to turn on the income. Usually the other terms of the annuity are not as good (lower caps for example on the gains).

I could write 100 pages on the FIAs in the marketplace to further explain the differences in products. That's not the goal of this material which is to make you familiar with what you need to know so you can assess different products and make an informed decision about what FIAs are best for your individual situation.

SIMPLE VS. COMPOUNDED GIB RIDERS

FIAs that offer GIB riders can come with a compounded income rider or a simple interest rider. Sometimes in the marketing of a product companies are not always transparent. Let's look at a comparison between the two so you can better understand the difference.

Year	Start/Year Balance	<u>Simple Interest</u> 9%	Year-End Value	Start/Year Balance	<u>Compound Interest</u> 6.63%	Year-End Balance
1	\$100,000	\$9,000	\$109,000	\$100,000	\$6,629	\$106,629
2	\$109,000	\$9,000	\$118,000	\$106,629	\$7,068	\$113,697
3	\$118,000	\$9,000	\$127,000	\$113,697	\$7,537	\$121,234
4	\$127,000	\$9,000	\$136,000	\$121,234	\$8,037	\$129,271
5	\$136,000	\$9,000	\$145,000	\$129,271	\$8,569	\$137,840
6	\$145,000	\$9,000	\$154,000	\$137,840	\$9,137	\$146,978
7	\$154,000	\$9,000	\$163,000	\$146,978	\$9,743	\$156,721
8	\$163,000	\$9,000	\$172,000	\$156,721	\$10,389	\$167,110
9	\$172,000	\$9,000	\$181,000	\$167,110	\$11,078	\$178,188
10	\$181,000	\$9,000	\$190,000	\$178,188	\$11,812	\$190,000

It's interesting to look at the numbers. The 9% simple Benefit Base account value is the same as a 6.63% compounded rate of return.

If you were going to choose one for your GIB product, you'd pick the simple interest roll up instead of the compound because in years 1-9 the benefit base was higher with the simple interest roll up.

The more interesting numbers are when you compare a 9% simple interest benefit base increase to a 7% compounding return.

Year	Start/Year Balance	<u>Simple Interest</u> 9%	Year-End Value	Start/Year Balance	<u>Compound Interest</u> 7.00%	Year-End Balance
1	\$100,000	\$9,000	\$109,000	\$100,000	\$7,000	\$107,000
2	\$109,000	\$9,000	\$118,000	\$107,000	\$7,490	\$114,490
3	\$118,000	\$9,000	\$127,000	\$114,490	\$8,014	\$122,504
4	\$127,000	\$9,000	\$136,000	\$122,504	\$8,575	\$131,080
5	\$136,000	\$9,000	\$145,000	\$131,080	\$9,176	\$140,255
6	\$145,000	\$9,000	\$154,000	\$140,255	\$9,818	\$150,073
7	\$154,000	\$9,000	\$163,000	\$150,073	\$10,505	\$160,578
8	\$163,000	\$9,000	\$172,000	\$160,578	\$11,240	\$171,819
9	\$172,000	\$9,000	\$181,000	\$171,819	\$12,027	\$183,846
10	\$181,000	\$9,000	\$190,000	\$183,846	\$12,869	\$196,715

What's interesting about the previous chart?

1) A 7% compounding return had a \$6,715 higher account value after 10 years.

2) In years 1-8, the 9% simple account value was higher.

What does that mean?

Unless you are certain you are going to wait 10 years to turn income on (all other things being equal), it may be a more prudent decision to buy the FIA that uses a 9% simple return instead of the 7% compounded return.

Do keep in mind as you are reading this material that I'm not trying to tell you specifically what current FIA product in the market is best for your situation. I'm trying to educate you on the inner workings of FIAs and FIAs with income rider so you are armed with the knowledge to be able to understand the products an advisor may present to you so you can make an informed decision about which one is best.

And the previous disclaimer is a good segue to the next section of this material.

“WHAT IF” GIB RIDERS

So far, the GIB riders I've covered are ones that have set terms the day you buy them. For example, an FIA may increase the Benefit Base value at 7% a year and have a 5% income payment at age 65.

Because insurance companies are always trying to come up with designs to generate more income for clients, some have rolled out what I call “what if” product designs.

Why do I call them “what if” product designs? Because you won't know what your income payment will be until the year you decide to turn it on.

Most of the “what if” products come with minimum guarantees that won't come into play because the “what if” in the product is typically tied to the returns of the measuring stock index that won't be zero every year.

It's a “what if” product because we don't know what the measuring index will return in the future and, therefore, we don't know the future income payment.

Why would someone use this type of product?

As I already stated, it's a design that tries to create a higher income payment than the static designs that will not fluctuate.

There are several different versions of this type of FIA in the marketplace. I'm only going to cover one in this material so you can understand why you might want to use one of these types of FIAs instead of the static Benefit Base roll up products.

The Benefit Base used to calculate the GIB for life payment for this particular example will grow based on two terms:

1) 4% guaranteed each year

2) Plus whatever the index returns

An example is the best way to describe how the Benefit Base grows in this type of product. The following example uses numbers from 2009-2018 year end with an S&P 500 based crediting strategy that has no cap and a 40% participation rate in the index (so if the index returns 20% the credited return would be 8.00%).

		Actual return	Annual Return
Year	Guarantee	of the stock index	Credited
1	4%	8.20%	12.20%
2	4%	4.47%	8.00%
3	4%	0.00%	4.00%
4	4%	4.70%	8.70%
5	4%	10.37%	14.37%
6	4%	3.99%	7.99%
7	4%	0.00%	4.00%
8	4%	3.34%	7.34%
9	4%	6.81%	10.81%
10	4%	0.00%	4.00%
			<u>8.14%</u>
			Average

You'll notice that even with a conservative example (a 40% participation rate in an uncapped S&P 500 strategy is conservative), the average Benefit Base increase ended up being 8.14% (which is much higher than a 9% simple roll up rate or a 7% compounded rate).

Let's now look at a different example which is much more common in the industry right now. I'll use the same 4% guarantee plus whatever the index returns, but I'll illustrate it using a Volatility Control Index (VCI) (I covered VCIs on page 15).

		Actual return	Annual Return
Year	Guarantee	of the stock index	Credited
1	4%	6.17%	10.17%
2	4%	13.01%	17.01%
3	4%	5.89%	9.89%
4	4%	3.58%	9.89%
5	4%	6.00%	7.58%
6	4%	8.86%	10.00%
7	4%	0.81%	12.86%
8	4%	3.53%	4.81%
9	4%	3.86%	7.53%
10	4%	0.00%	4.00%
			<u>9.37%</u>
			Average

If the previous chart doesn't pique your interest, it should.

Remember that the 9.37% return is used to grow the Benefit Base account value that is only used to calculate the guaranteed income for life payment (although it is interesting to see the actual returns in an FIA be as high as they are in this 2009-2018 example).

And not to get too into the weeds with numbers, the average return doesn't really reflect how the account actually grows. Money actually grows using the CAGR (Compounded Annual Growth Rate). The CAGR takes the actual returns each year to grow wealth and doesn't use the average to grow the money.

Let's see how the last chart would have translated into a guaranteed income payment after ten years.

<u>Year</u>	<u>Benefit Base</u>	<u>Credited Return</u>	<u>Credited Growth</u>	<u>Year-End Balance</u>
1	\$100,000	10.17%	\$10,170	\$110,170
2	\$110,170	17.01%	\$18,734	\$128,904
3	\$128,904	9.89%	\$12,743	\$141,648
4	\$141,648	9.89%	\$14,003	\$155,651
5	\$155,651	7.58%	\$11,801	\$167,453
6	\$167,453	10.00%	\$16,750	\$184,203
7	\$184,203	12.86%	\$23,681	\$207,884
8	\$207,884	4.81%	\$9,999	\$217,883
9	\$217,883	7.53%	\$16,402	\$234,286
10	\$234,286	4.00%	\$9,371	<u>\$243,657</u>

Do you remember what the Benefit Base was using a 9% simple or 7% compound growth rate when using the typical static set in stone from the start FIA with GIB?

They were \$190,000 and \$196,715.

This is why many consumers are opting for the "what if" GIB rider product. They want the opportunity for more income while still knowing there is a minimum guarantee.

I'm personally a big fan of the "what if" products and think they make more sense from a mathematical probability standpoint than the static products.

ONE, TWO, THREE, FOUR, AND FIVE-YEAR POINT-TO-POINT

I've mainly gone over this section of the material on FIAs discussing products that lock in gains annually.

There are some products in the market that have multi-year point-to-point crediting methods.

Why would companies offer multi-year point-to-point strategies?

The simple answer is that the cost to hedge risk in the FIA index is less and, therefore, the multi-year caps and participation rates on products can be higher.

That sounds great, right? Why not use a five-year point-to-point and get really high caps and/or participation rates on the measuring stock index? Because there is a very real **element of danger** in the product.

If you have a multi-year point-to-point crediting strategy in an FIA, here are the pros and cons:

-The opportunity for growth will be higher or even much higher.

-If you get a big downturn in the measuring stock index before the end of the term, you could **wipe out** two, three, four, or even five years worth of positive returns all at once.

The type of risk associated with multi-year point-to-point strategies I find a bit odd in products that are supposed to lock in gains and are considered safe money tools. For me, multi-year products may look good on paper; but I wouldn't want to have to go to my clients and tell them that, even though the measuring stock index was up 10% or even 20% or more over a 23-month period, because the index crashed in month 24, they ended up with a zero crediting rate for the entire 24-month period.

COST OF THE GIB RIDER

It would be nice if the insurance companies added guaranteed benefit income riders (GIBs) for free with their annuities. Unfortunately, that is not the case.

The GIB for life rider for FIAs varies per company but most range from 0.80% to 1.2% annually.

Be careful of how the companies remove this fee from your FIA. Some charge the fee based on your actual account value. Some charge the fee on your higher Benefit Base value. Over time this difference is significant.

RETURN OF RIDER FEE

A few companies offer an option to get your rider fee back should you not use it. One company will let you make that decision at the end of ten years. If you didn't use it or don't want to use the GIB rider, they will credit back to your actual account value the fees they charged for the rider.

HOW CAN INSURANCE COMPANIES AFFORD TO GIVE YOU A GUARANTEED RETURN AND A GUARANTEED PAYMENT FOR LIFE?

This question has probably been in the back of your mind as you've been reading this material. It had me scratching my head for a few minutes until I fully researched how these products are priced.

Remember that with an FIA the product is already designed to never have its account value go backwards due to negative market returns. Additionally, the gains are locked in annually.

THE GIB PAYMENTS ARE COMING FROM YOUR OWN FIA ACCOUNT

When the insurance company starts paying you a lifetime income stream, it is taking the money from your own FIA's actual account value. In essence, the insurance company is **giving you back your own money**.

You may think that removing money from your actual account value will quickly reduce the account value; but remember, the actual account value will still grow in years when the measuring stock index is positive with those gains locking in (which reduces the speed at which the account value is diminished).

Additionally, the insurance company has priced the product with the additional rider fee annually to help make sure the product is profitable.

Let's look at the actual numbers from an example so you don't have to take my word for it. I'm going to use an example where you can see the numbers for yourself.

As I alluded to earlier, in the "old days," one of the only ways to receive a guaranteed income benefit for life was to buy a Single Premium Immediate Annuity (SPIA). A SPIA is typically designed to pay for a set period (such as 10 years) or for someone's lifetime. The kicker is that, if you live past the ten-year period and die, with a life-only SPIA, your heirs get nothing. As you will see in the following chart, there is an account balance that will pass to the heirs until age 86.

What you'll also notice in the following chart is the fee for the GIB rider.

It will be painful to look at; but if you want to put it into perspective, if the annuity owner had his/her money in a typical mutual fund that provides **NO downside protection** in the market (let alone a 6%-7% guaranteed return on an accumulation account), the average mutual fund expense in addition to the local money manager fee would be 2-3 times that of the fee for the GIB rider.

The following are the variables used for the following chart:

-Age 55

-\$500,000 premium

-9% simple roll up (6.63% compound) upon the Benefit Base guaranteed account (which you don't see in the numbers below (the numbers below only reflect the actual account value minus fees)).

-The crediting method is random where the average rate of return over time is 5%.

-Guaranteed income payments start at age 65.

Understanding Annuities

	Start				To heirs at
Year	Balance	Income	Growth	Fee	Death
55	\$500,000		\$30,000	\$5,300	\$524,700
56	\$524,700	\$0	\$0	\$5,247	\$519,453
57	\$519,453	\$0	\$8,415	\$5,279	\$522,589
58	\$522,589	\$0	\$32,192	\$5,548	\$549,233
59	\$549,233	\$0	\$61,679	\$6,109	\$604,803
60	\$604,803	\$0	\$43,606	\$6,484	\$641,925
61	\$641,925	\$0	\$40,120	\$6,820	\$675,225
62	\$675,225	\$0	\$0	\$6,752	\$668,473
63	\$668,473	\$0	\$48,331	\$7,168	\$709,635
64	\$709,635	\$0	\$31,579	\$7,412	\$733,802
65	\$733,802	\$47,504	\$41,178	\$7,275	\$720,201
66	\$720,201	\$47,504	\$0	\$6,727	\$665,969
67	\$665,969	\$47,504	\$10,019	\$6,285	\$622,199
68	\$622,199	\$47,504	\$35,401	\$6,101	\$603,995
69	\$603,995	\$47,504	\$62,494	\$6,190	\$612,794
70	\$612,794	\$47,504	\$40,757	\$6,060	\$599,987
71	\$599,987	\$47,504	\$34,530	\$5,870	\$581,143
72	\$581,143	\$47,504	\$0	\$5,336	\$528,302
73	\$528,302	\$47,504	\$34,762	\$5,156	\$510,403
74	\$510,403	\$47,504	\$20,599	\$4,835	\$478,663
75	\$478,663	\$47,504	\$25,870	\$4,570	\$452,458
76	\$452,458	\$47,504	\$0	\$4,050	\$400,904
77	\$400,904	\$47,504	\$5,725	\$3,591	\$355,533
78	\$355,533	\$47,504	\$18,975	\$3,270	\$323,733
79	\$323,733	\$47,504	\$31,021	\$3,072	\$304,177
80	\$304,177	\$47,504	\$18,506	\$2,752	\$272,427
81	\$272,427	\$47,504	\$14,058	\$2,390	\$236,590
82	\$236,590	\$47,504	\$0	\$1,891	\$187,195
83	\$187,195	\$47,504	\$10,100	\$1,498	\$148,292
84	\$148,292	\$47,504	\$4,485	\$1,053	\$104,220
85	\$104,220	\$47,504	\$3,403	\$601	\$59,517
86	\$59,517	\$47,504	\$0	\$120	\$11,893
87	\$11,893	\$47,504	\$0	\$0	\$0
90	\$0	\$47,504	\$0	\$0	\$0
95	\$0	\$47,504	\$0	\$0	\$0
100	\$0	\$47,504	\$0	\$0	\$0

What's interesting about the previous chart?

- 1) The income continues to pay even though there is no money in the actual account value (that's the whole point of buying a GIB rider FIA).
- 2) There is a sizable death benefit depending on when the insured dies.
- 3) The total amount of fees paid (\$150,812) is approximately three years of guaranteed income.

I personally do NOT think the fees outlined in the previous chart are outrageous. As I indicated, if you had your money in a typical mutual fund with an annual expense of 1.5% every year along with the typical local money manager fee, the fee would be more than double what the GIB rider fee is for an FIA.

A financial planner may look at the previous chart and say...*why would you want to pay those fees just so the insurance company can give you back your own money. If you give me your money, I'll put it in a proper mix of stocks, bonds, mutual funds, and I'll get you more money in retirement without the fees.*

Is it possible a financial planner could do better than the FIA with guaranteed income rider?

Sure, it's possible.

But then I think of a few things that bring me back to my conclusion, which is that I'm a big fan of GIB riders.

1) No one knows when they will die and, therefore, it is impossible to realistically budget the same amount of retirement income from a proper mix of stocks, bonds, and mutual funds as would be provided from a GIB rider FIA. In order to realistically put together an investment mix that will provide income until age 100, the mix would have to be far too conservative and wouldn't be able to generate the same income as provided by a GIB rider.

2) As the DALBAR Study consistently indicated, the average investor has earned less than 4% going back 20 years (which includes a bull run that has exceeded ten years). Such returns would not be nearly sufficient to generate the income that is provided by a GIB rider FIAs.

As a general rule, the less money someone has, the more apt I am to recommend a GIB Rider annuity. Those with substantial or excess wealth can afford to take risks in the stock market. Those who don't really can't.

TIME FRAME TO ACTIVATE THE GIB RIDER

As briefly stated earlier, a GIB rider on most FIAs can usually be activated anytime after owning the annuity for 12 months. However, the annuitant for most FIAs must be age 60 or older to activate it.

ENHANCED INCOME BENEFIT

Some FIAs will provide an increased income benefit that acts like a long-term care benefit (LTC).

LTC insurance policies typically activate and pay benefits when you can't perform two of your six ADLs (Activities of Daily Living: eating, bathing, dressing, toileting, transferring (walking), and continence).

The best enhanced benefit I know of in the marketplace doubles the guaranteed income stream. Therefore, if an annuitant is 75 years old, the normal income stream would typically be 6%.

If the annuitant can't perform two of six ADLs, that income stream would be increased to 12%.

This enhanced benefit on some FIAs is free.

However, with the vast majority of (if not all) enhanced benefit riders, when the actual account value reaches \$0, the monthly benefit drops back the amount provided before the rider was triggered. Additionally, most of these riders have a maximum payout period of two years or until the account value drops to \$0.

PRODUCTS ARE CONSTANTLY CHANGING

I did want to point out the FIA products are constantly changing. While it would be nice to always have the products covered in this material up to date, that is impossible.

Therefore, if you determine based on what you've read that an FIA might be a good tool you can use to grow and protect your wealth or because you are interested in a guaranteed income for life payment, it's best to sit down with your locally trusted professional who can go over the FIAs that are currently available in the marketplace.

SUMMARY ON GUARANTEED INCOME BENEFIT RIDERS ON FIXED INDEXED ANNUITIES

If your head is spinning with all the numbers I've thrown at you in this chapter, don't worry. The bottom line with GIB riders on FIAs is very simple to understand.

The benefits to an FIA with a GIB rider are as follows:

- 1) Your money will never go backwards when the stock market declines.
- 2) You will be given a guaranteed rate of return of between 6-7% on an accumulation account inside the product.
- 3) You will be given a guaranteed income for life you can never outlive (which is based on the guaranteed accumulation account value when activated).
- 4) You have access to the money in your FIA at all times (subject to the typical surrender charges).
- 5) When you die, the account value will pass to your beneficiaries.
- 6) The guaranteed rate of return can roll up for 15+ years with certain products.

WHO ARE THE MOST LIKELY CANDIDATES TO USE FIAs TO GROW WEALTH?

A better question is who is NOT a candidate to use FIAs to grow their wealth. Let me list who I believe are NOT the ideal candidates to use FIAs to grow their wealth.

1) People who need a lot of liquidity with the money that could be allocated to the FIA.

While surrender charges typically range from 5%-12% depending on the FIA purchased and last typically less than 12 years, if you know you may need the money, an FIA may not be suitable for you. However, there is also the ability to take a 10% annual free withdrawal (and 20% as a one-time amount with some companies); but again, if much or most of the money may be needed in liquid form, then using an FIA to grow wealth will not be a good fit.

2) Anyone looking to access the funds prior to age 59½ years old.

Tax-deferred annuities are similar to qualified-retirement plans/IRAs in that there is a 10% penalty from the IRA if you take money out prior to age 59½.

This can be avoided by taking a systematic income stream vs. the ability to take a lump sum withdrawal; but as a general rule, again, if you need access to the funds prior to age 59½ years old, building wealth in an FIA may not be an appropriate place.

3) If you like action in the stock market and the potential to average 8-10%+ a year in a brokerage account, you are not a candidate for growing wealth with an FIA (but remember the DALBAR Study from the other section of the course material which indicated the average investor has averaged ONLY 3.88% over the last 20 years).

4) If you are under the age of 60 and can systematically fund X amount of dollars into a properly designed cash value life insurance policy, you may not be a candidate to grow wealth in an FIA. That's not to say that an FIA still isn't a good tool to use for a conservative portion of anyone's (at any age) portfolio.

Cash value life insurance can be a much better wealth-accumulation tool, and it is a more tax-favorable/wealth-building tool due to the fact that money can be removed from a policy income tax free.

The bottom line is that FIAs are a tremendously powerful and protective wealth-building tool that not enough advisors or their clients know about and use.

SUMMARY ON ANNUITIES

Many people and some advisors have a negative stigma about annuities. Now you know that there is a lot to like about annuities.

While the variety of annuities can be intimidating, if you know the content from this section of the course material, you will know more about the basics than many advisors selling them. Use that knowledge when working with your locally trusted advisor to pick annuities that are best to help you accomplish your retirement planning goals.