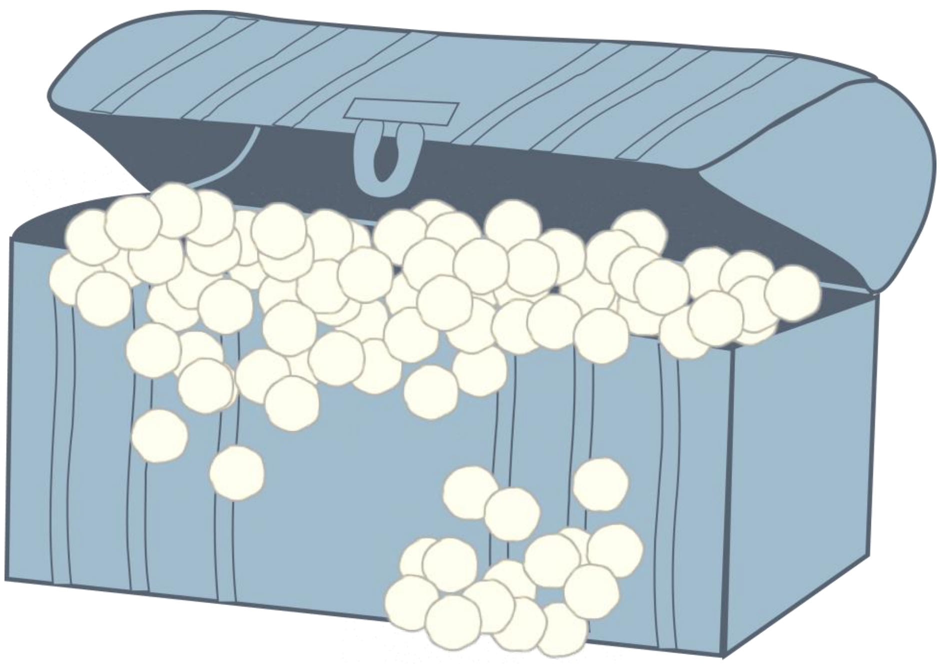
Securing Retirement Income with

Annuities



Presented By Terry Claudell, sfpkc.retirevo.com

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Why you need a secure retirement income

Americans are living longer; today's average 65-year-old can expect to live two more decades.[i] Though that itself is good news, it can give rise to justifiable worries about whether a person will suffer a drop in their standard of living due to inadequate retirement funding, or perhaps outlive their retirement savings.

Life Expectancy Based on Current Age*

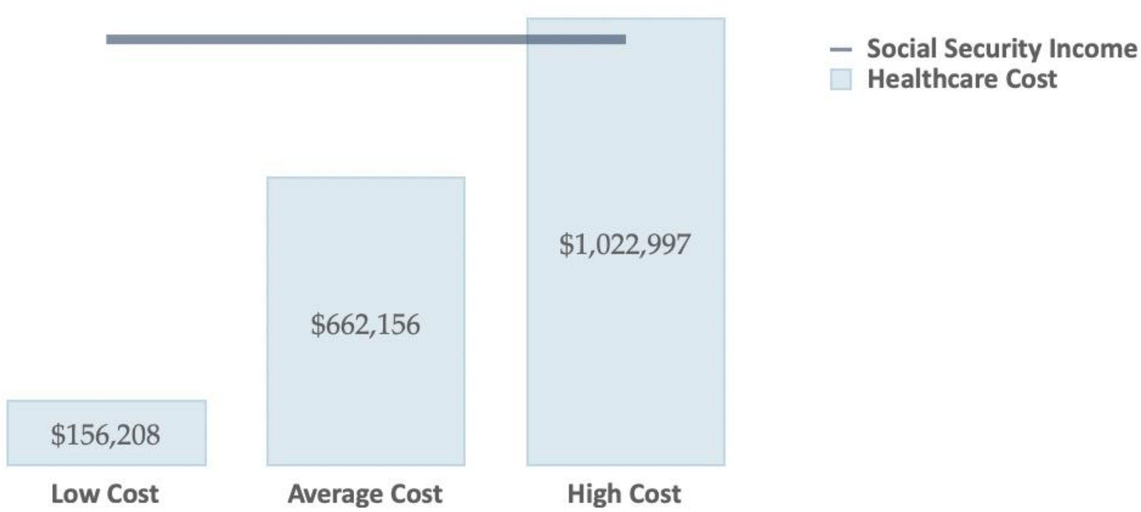
Current Age	All	Male	Female
0	78.7	76.2	81.2
5	74.3	71.8	76.7
10	69.3	66.8	71.8
15	64.3	61.9	66.8
20	59.5	57.1	61.9
25	54.8	52.4	57.0
30	50.1	47.8	52.2
35	45.4	43.3	47.5
40	40.8	38.7	42.7
45	36.2	34.2	38.1
50	31.7	29.9	33.5
55	27.4	25.7	29.0
60	23.3	21.8	24.8
65	19.5	18.1	20.7
70	15.8	14.6	16.8
75	12.3	11.3	13.1
80	9.2	8.4	9.8
85	6.6	6.0	7.0
90	4.5	4.1	4.8
95	3.1	2.8	3.2
100	2.2	2.0	2.2

* Life expectancy is defined as the average estimated number of years of life remaining for persons who have attained a given age. Source: Arias and Xu, 2020.

Setting aside other costs of living, the retirement years will typically bring a person's highest health care costs. Although Medicare shoulders a portion of this burden, medical expenses related to hearing, vision, dental care, prescription drugs, and long-term care may not be covered by a typical retiree's Medicare benefits. And while it might seem that a healthy person could expect to pay less for healthcare during retirement, their longer life expectancy means that lower annual costs could translate to a higher total cost when compared to a less healthy person, who will typically pay higher annual medical expenses but over fewer years.[ii]

An average healthy couple who begin receiving Social Security payments at age 65 can expect to spend $662,156, or 68% of their total lifetime Social Security benefit, on healthcare during their remaining years.[iii] Thus, Social Security income alone isn't likely to cover an average retired person's living expenses.

Cost of Healthcare During Retirement, Compared to Social Security income*



* Dollar values shown are estimated totals for the entire retirement period for a healthy 65-year-old couple with average life expectancy who enroll in Social Security at age 65. Such a couple can expect to receive $973,759 in Social Security income during their retirement. Source: HealthView Services, 2020.

There is also a chance that Social Security benefits will decrease in future decades due to insufficient funding. Retired Americans are living longer, and as more of our older workers retire, fewer younger workers are paying the Federal Insurance Contributions Act (FICA) tax collected on earnings each year. Consequently, a shortfall is expected in the Old Age and Survivors Insurance (OASI) trust, which funds Social Security recipients using tax dollars from current workers. Recent projections estimate that in 2033, without changes to the program, benefits would need to be reduced to 76% of their calculated level.[iv] This may be another reason to privately supplement your retirement income with an annuity.

Annuity basics

Annuities are products that you (*the contract owner*) fund through a contract with an insurance company or investment firm (*the provider*). With fixed and indexed annuities, the provider takes on all or part of the market risk, usually guaranteeing you a minimum rate of return. In exchange for this guarantee, which shields you from dips in the market, you forfeit some gains during periods of higher market yields. Variable annuities combine market risk with certain tax benefits that may appeal to particular subsets of investors.

You can fund an annuity with a lump sum or by contributing payments (*premiums*) over a period of time, using either pre-tax (*qualified*) or after-tax (*non-qualified*) money. The payout from the annuity can begin immediately or after a period of years.

An annuity might be distributed to you in cash, in one or more lump sums. Alternately, you might allow the principal to continue earning interest while you take the annual interest as income. Or you might choose to *annuitize* -- convert an annuity to a stream of income that lasts for a period of years, for a lifetime, or even longer. Self-funded annuities can be used in this way to supplement lifetime guaranteed income from other sources such as Social Security or an employer-funded pension.

Lifetime income payments are calculated by the provider at the time of annuitization, based on a mix of factors including the life expectancy of the insured person (*the annuitant*) and current interest rates. This means that women -- who have longer life expectancies than men -- will pay higher premiums for the same benefit as men their age. Younger people will also pay higher premiums.

♀ WHEN WOMEN RETIRE

Women face unique challenges when planning for a comfortable retirement. They may have accumulated less wealth during their lifetimes, due to continuing discriminatory pay practices or to taking time out of their careers to care for children, parents, or other loved ones. They also tend to live longer than men. These challenges mean that women often spend more of their retirement years lacking financial security. It's therefore crucial that women be engaged in retirement planning, and that their plan or their family's plan address their lifetime income needs.

Depending on the contract, an annuity may pay out for a fixed period of years, for an individual's lifetime (*single-life annuity*), for the annuitant's lifetime plus the lifetime of their surviving spouse or partner (*joint and survivor annuity*), or for the greater of the annuitant's lifetime or a predetermined period of years (*life and period certain*).

Different types of riders can be added to address contingencies, like adding a cost-of-living increase to the payout every year, or paying the estate or another beneficiary -- a child, for example -- a specified amount should both the annuitant and spouse die before the contract ends.

In general, annuities are considered illiquid, as they can be subject to withdrawal penalties during a *surrender period* that may last for years. They may charge annual maintenance fees, in addition to other fees which vary by provider and with the specifics of each contract. It is possible to lose some of your principal if the annual fees outstrip your earnings, or if you need to withdraw your money early and must pay a penalty to do so.

SHOP AROUND

A person selling annuities must be licensed by your state for selling life insurance, and if they are selling variable annuities, they must also have a securities license. Check out the independent ratings for your agent or broker before setting up a contract. Also compare the actual returns for different annuity products and providers before making your choice.

Unlike most bank accounts, annuities are not federally insured. However, in the event that an insurance company becomes insolvent or otherwise unable to pay out benefits, annuitants will usually be protected up to a certain amount of loss (typically $250,000 per contract) by their state guaranty association. [v]

Depending on how long you live and on how you structure your annuity, it may end up eventually paying out more than you paid into it. However, if your lifespan happens to be shorter than average, the annuity may end up paying out less than you paid to fund it. It helps to keep in mind that the point of lifetime income is not to grow your investment or even to preserve your capital, but to ensure that you (and perhaps also your spouse) don't outlive your money.

How annuities are taxed

Fixed, indexed, and variable annuities all offer tax-deferred growth. Tax deferral can make a significant difference in how an account grows over time, particularly for people in higher tax brackets.

Comparison of Taxable and Tax-Deferred Earnings*

Growth of an Account With Taxable Earnings

	Amount Contributed	Principal Amount	Interest Earned	After-tax Earnings	End-of-Year Account Value
Year 1	$10,000	$10,000	$1,000	$850	$10,850
Year 2	$10,000	$20,850	$2,085	$1,772	$22,622
Year 3	$10,000	$32,622	$3,262	$2,773	$35,395
Year 4	$10,000	$45,395	$4,540	$3,859	$49,254
Year 5	$10,000	$59,254	$5,925	$5,037	$64,290

Growth of an Annuity With Tax-Deferred Earnings

	Premium Paid	Amount Before Earnings	Interest Earned	End-of-Year Annuity Value
Year 1	$10,000	$10,000	$1,000	$11,000
Year 2	$10,000	$21,000	$2,100	$23,100
Year 3	$10,000	$33,100	$3,310	$36,410
Year 4	$10,000	$46,410	$4,641	$51,051
Year 5	$10,000	$61,051	$6,105	$67,156

* Assumes hypothetical interest rate of 10% per year and 15% annual tax rate, for the purposes of illustration only. Actual savings should be calculated using an individual's effective tax rate and the current interest rate offered for a specific annuity product.

Any portion of an annuity payout that has not already been taxed will be counted as ordinary income by the IRS. If you purchased the annuity with qualified funds, such as through an IRA or other tax-advantaged account, you will pay income tax on the entire amount of each payment you receive from it. If you purchased the annuity with nonqualified funds, you will pay taxes only on the portion of each payout that represents earnings, since the rest of the payout is considered a return of your already-taxed premiums. Once you reach the end of your expected life according to actuarial calculations, all the premiums you contributed will have been paid out. Payments made after that point will be entirely made up of taxable earnings. [vi]

Any death benefit paid will bypass probate, assuming you have designated a beneficiary on your annuity, saving your estate tax dollars and keeping the transfer of assets out of the public record. However, payments to heirs will be taxed as ordinary income on the portion that represents earnings above any premiums you paid.[vii]

Annuities for immediate income

An *immediate annuity*, also called a Single Premium Immediate Annuity (SPIA) or an income annuity, is typically funded when the contract is created and will start paying you regular income within one or two months of purchase, but no more than 12 months after purchase.

In contrast, a *deferred annuity* contract is funded through contributions over a period of time known as the *accumulation phase*. After the annuity is fully funded, then the *payout phase* can begin.

An annuity that begins paying out immediately may be the best choice in certain situations. For example, if a person unexpectedly receives a large sum of money (such as an inheritance or lottery winnings), an annuity can convert that lump sum into a guaranteed regular income, providing a consistent and long-lasting source of support. This can counter the tendency to overspend if you are inexperienced at or uninterested in managing a pot of money.

An immediate annuity can also be a good choice if you have reached a point in life where securing your principal is more important than growing it, or you no longer can afford to leave your principal untouched for decades in order to take advantage of market gains while confidently riding out the inevitable downturns.

For those who worry about health care costs later in life, an immediate annuity may offer the potential to preserve some capital for your heirs in the event that your medical costs exceed your ability to pay.

STRATEGIES FOR IMMEDIATE ANNUITIES

- convert unexpected lump sum into regular long-term income
- move funds from an existing annuity into a better one
- preserve principal from erosion by inevitable market downturns
- potentially prevent impoverishment of one spouse when the other has high medical expenses

For example, you may become ill or disabled enough to move into a nursing home, and unable to keep up with the cost of long-term care. In order to qualify for federal Medicaid assistance, you will need to spend down your assets to a certain threshold, and in order to remain eligible, you must forfeit any personal income -- whether it comes from a pension, Social Security, or other sources -- above a certain threshold as well.

In this case, a deferred annuity would be considered an asset that you must spend down before qualifying for Medicaid, whereas payouts from an immediate annuity would be subject to the income threshold as you receive them. If you were to die while money still remained to be paid out, that money could pass to your heirs (depending on the particulars of your contract). Note that you would only be eligible to pursue this strategy if you had structured your annuity to be Medicaid compliant.[viii]

Another use for an immediate annuity -- if you get to the point of enrolling in Medicaid -- would be ensuring income for your spouse who is not on Medicaid. Since a spouse's income is exempt from the Medicaid spenddown requirement, it's possible to use an immediate annuity to convert a countable asset into an income stream for your spouse, rather than spending down that asset. With a large enough Medicaid compliant annuity, the non-Medicaid spouse could use income from the annuity to build up their savings, as their assets will not trigger ineligibility for the spouse who has already qualified for Medicaid.

You may already own a deferred annuity which has been accumulating funds. When you are ready to convert it to an income stream, rather than simply annuitizing it with your current provider, check around for better deals, including those offered by different providers. You can then use a tax-free 1035 exchange to transfer your deferred annuity to an immediate annuity of your choice. [ix]

Fixed annuities

Fixed annuities are among the safest investment strategies, preserving your principal while paying the promised rate of return regardless of the rise and fall of markets or of interest rates.

With a fixed annuity, you are not directly investing in the market. You pay the provider, who typically invests the money in high-quality government bonds. You are not exposed to market risk, and your contract generally will guarantee a minimum rate of return. However, you'll want to understand the fine print, as it may allow the insurer to adjust this rate of return based on portfolio yield or another stated formula after the *initial guarantee period* has passed.

A fixed annuity offers a predictable return. Including it as one component of your retirement plan can free you to take more risks in other areas of your plan.

Multi-year guaranteed annuities

One type of fixed annuity is known as a *multi-year guaranteed annuity (MYGA)* or a CD-type annuity. Like a bank certificate of deposit (CD), a MYGA is generally funded with a lump sum that earns annually compounded interest. However, you must pay taxes annually on earnings from savings accounts and CDs, while you will only pay taxes on MYGA earnings as they are paid out to you.

Because it offers tax-deferred growth, a MYGA is similar to investing in an IRA or 401(k), but without the contribution limits or maximum income restrictions. In fact, those who have maxed out their IRA contributions may turn to this type of annuity as a way to shield more of their income from taxes and increase their future retirement income.

MYGA rates vary slightly from carrier to carrier and change daily. They are usually higher than CD rates and savings account rates. With compounding interest, a small difference in the rate can make a large difference in eventual earnings, so it is worth shopping around for the best terms.

Unlike a straight fixed annuity, which may vary the interest rate after a certain initial period, a MYGA guarantees an interest rate for the duration of the contract. However, some providers will charge a withdrawal fee if you want access to the money before the contract expires. If you are willing to sign a contract that includes a withdrawal penalty, you may be able to lock in a higher rate of return.

After the contract expires, you will have the option to take back your principal plus the interest generated, or to re-up your MYGA contract and continue earning interest. This can be a useful option if you don't anticipate needing the money for an additional number of years but want to achieve a specific rate of return. Your provider may also offer an option to annuitize your MYGA, or convert it into an income stream.

Indexed annuities

Indexed annuities, sometimes called fixed indexed annuities (FIA) or equity-indexed annuities (EIA), offer a guaranteed minimum payout plus an add-on portion of the market yield above a predetermined rate. This rate is generally tied to the performance of a market index such as the S&P 500.

This type of annuity can allow you to benefit from some portion of market gains, while still providing the security of a steady base income. It is structured like a fixed annuity, so you are not exposed directly to the market. However, unlike a fixed annuity, it is possible to lose some of your principal with an indexed annuity if the market doesn't perform well over a period of time.[x]

In exchange for shielding you from market drops, indexed annuities will pass along only a portion of the gains when the market rises. They may pay a rate that is some percentage of the market gain (a *participation rate*), or a rate that is the market gain minus a fixed percentage (the *spread*, *margin*, or *asset fee*). In addition, your earned interest rate may be capped. Each of these variables will affect your final payout amount.

While choosing among the available products, pay close attention to how they calculate rates of return. For instance, some will base their rate on the high water mark for the year, in which case your earnings will reflect the highest movement of the market during that period. Other products may use the market's movement on your contract anniversary date, which would likely yield a lower return.

Commonly, indexed annuities credit earnings every year, and gains credited during one year do not go away even if the market later drops. Some products only add interest but do not compound it (in other words, they don't pay interest on earnings from previous years).

Variable annuities

Variable annuities are structured differently than fixed and indexed annuities. Instead of paying an insurance provider, who guarantees certain returns based on actuarial tables and other inputs, you directly invest your money in one or more securities funds (similar to mutual funds) offered by the provider. Variable annuities and the agents who sell them are regulated by the Financial Industry Regulatory Authority (FINRA)[xi] and the Securities Exchange Commission (SEC)[xii].

Because they are based on ownership in market securities, variable annuities have the potential to earn more when the market performs well. However, they also bear the full risk of loss when the market declines – known as market risk. This may have the effect of reducing the underlying principal, so holding retirement saving in a variable annuity vehicle could not be categorized as secure.

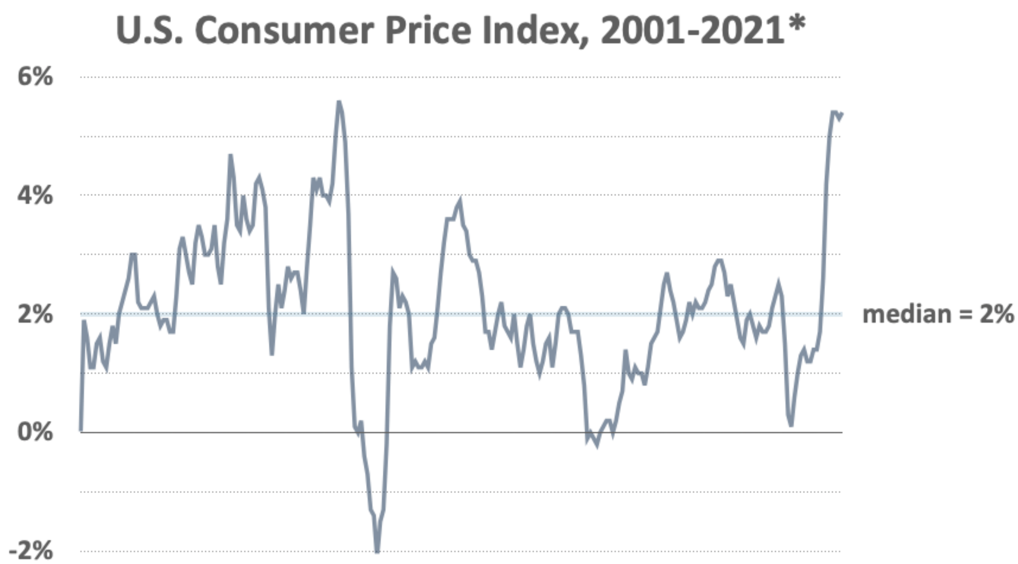
In contrast to the predictable returns promised by fixed annuities, and the minimum guaranteed returns from indexed annuities, earnings (and associated payouts) from variable annuities will go up and down based on the performance of the underlying investment portfolio.

Variable annuities come with a collection of annually recurring fees: management fees, fees charged by the underlying securities that are passed along to you by the annuity provider, and fees that fund certain provisions in the contract, such as a death benefit paid to your chosen beneficiary when you pass away. These fees are significant enough that variable annuities will not yield more than you would get from simply investing the same principal directly in similar funds.

Certain investors may still choose to place some of their savings into variable annuities in order to maximize tax-deferred growth without a contribution or income limit, to bypass probate and deliver a death benefit to an heir, or to eventually convert them into an income stream. However, it is possible to get all of these benefits from less risky types of annuities. Aside from the chance at a higher payout in a rising market, the only unique feature of a variable annuity is the opportunity to pivot your investment strategy and rebalance your portfolio by moving your money between the available funds without incurring capital gains taxes.

Planning for an uncertain future

It can be hard to see into the future. Certain changes can be anticipated, while others will be unexpected. Here are some ways you can build in flexibility when you include annuities in your financial planning.



* Change in all items over the previous 12 months, not seasonally adjusted. Monthly data. Source: Bureau of Labor Statistics, U.S. Department of Labor.

Though nothing is certain, if the past is any indicator, cost of living will likely continue to increase in the future. During the past two decades of monthly figures showing growth over the previous 12 months in the U.S. Consumer Price Index (CPI), only 11 of those months (fewer than 5%) have shown negative growth, and the median 12-month change has been a 2% increase.[xiii]

With many annuities, you can purchase a "cost of living rider" that will adjust your payments for inflation based on changes in the CPI. This is the same index the Social Security program uses to calculate annual changes to its benefits. Another option is a graded annuity, which includes a built-in rider that will increase your monthly benefit by a fixed annual percentage, to help protect you against inflation and cost-of-living increases. These riders are generally not indexed to inflation, so in some years they may increase more than the CPI and in other years less.

Some percentage of annuitants will incur an unexpected large expense, in which case being able to liquidate an annuity and use that money elsewhere would make all the difference. Often there is a high penalty (i.e. a *surrender fee*) to pay if you want to access the funds in an annuity during the lock-in period, which could extend 5 to 10 years after signing the contract. When shopping for annuities, you may want to ensure that your contract contains a bailout or escape clause, which waives the surrender fee in certain circumstances such as terminal illness, disability, or entry into a nursing home.

Purchasing multiple annuities rather than a single annuity offers flexibility, plus other potential benefits. It will spread out your risk, and it may capture more gains as well. Choosing different providers protects you if one provider happens to go out of business. Setting up annuities in different years -- sometimes called staggering or laddering -- will expose you to changing interest rates and could result in a better overall yield. Staggered annuitization dates will allow for higher income; part of the funds could continue accumulating even as you receive regular income from one annuitized fund, and later payouts will be higher as they are based on a shorter remaining life expectancy.[xiv,xv]

You can also stagger your income from multiple sources. Set up an annuity that will start paying you a regular income after you anticipate that you will have spent other retirement funds, such as those in your IRA (from which you must withdraw a certain amount of the principal each year beginning in your 70's).

If you do your research and think of annuities in the larger context of your retirement and estate plans, they can be helpful strategies that add a layer of security later in life when you may appreciate it the most.

THE CURVE BALL

We all know that life rarely happens exactly as planned. Rather than annuitizing your entire savings into a guaranteed lifetime income, consider setting aside a portion of your funds to be more easily accessible in the likely instance that life throws a curve ball your way. Whether it's a medical crisis or an unplanned trip-of-a-lifetime, being able to pay for it without penalty can help you navigate the unexpected with more confidence and tranquility.

Sources

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[iii] However, this figure will vary widely, within an estimated range of $156,208 to $1,022,997, depending on "factors such as the state in which they retire, coverage choices and chronic health conditions." *2021 Retirement Healthcare Costs Data Report*, December 8, 2020 (HealthView Services). Available at https://hvsfinancial.com/wp-content/uploads/2020/12/2021-Retirement-Healthcare-Costs-Data-Report.pdf

[iv] *Status of the Social Security and Medicare Programs: A Summary of the 2021 Annual Reports*, 2021 (Social Security and Medicare Boards of Trustees). Available at https://www.ssa.gov/OACT/TRSUM/index.html

[v] *What Happens When an Insurance Company Fails?*, July 6, 2021 (National Organization of Life and Health Guaranty Associations). Available at https://www.nolhga.com/policyholderinfo/main.cfm/location/insolvencyprocess

The National Organization of Life and Health Insurance Guaranty Associations maintains a state-by-state list of guaranty associations where you can look up the one for your state, in the event that your insurance provider becomes insolvent. The list is available at https://www.nolhga.com/factsandfigures/main.cfm/location/gacontactlist

[vi] You can find a detailed explanation of how to calculate the portion of annuity income that is taxable in *IRS Publication 939*, available at https://www.irs.gov/publications/p939

[vii] *Updated Investor Bulletin: Variable Annuities*, modified Sept. 18, 2019 (U.S. Securities and Exchange Commission Office of Investor Education and Advocacy). Available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_variableannuities

[viii] *How Purchasing a Medicaid Compliant Annuity Impacts Eligibility for Medicaid Long-Term Care*, updated January 5, 2021 (American Council on Aging). Available at https://www.medicaidplanningassistance.org/eligibility-by-annuity/

The American Council on Aging offers details for how to ensure that your annuity is Medicaid compliant, and how an existing annuity might be converted to a Medicaid compliant annuity in certain situations.

[ix] Nuss, Ken. "Don't Automatically Annuitize an Annuity – Shop Around First." *Kiplinger*, Aug 1, 2021. Available at https://www.kiplinger.com/retirement/annuities/603216/dont-automatically-annuitize-an-annuity-shop-around-first

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[xi] Read more about the regulation of insurance agents at https://www.finra.org/investors/learn-to-invest/choosing-investment-professional/insurance-agents

[xii] Read more about the laws that govern the sale of securities at https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry

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