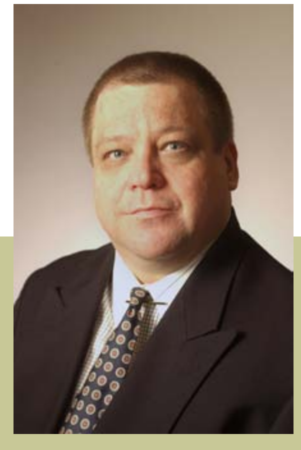

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Retirement Planning with Annuities

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Duane's Instructor Corner

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Estimating Your Retirement Income Needs

You know how important it is to plan for your retirement, but where do you begin? One of your first steps should be to estimate how much income you'll need to fund your retirement. That's not as easy as it sounds, because retirement planning is not an exact science. Your specific needs depend on your goals and many other factors.

Use your current income as a starting point

Many financial professionals suggest that you'll need about 70 percent of your current annual income to fund your retirement. This can be a good starting point, but will that figure work for you? It depends on how close you are to retiring. If you're young and retirement is still many years away, that figure probably won't be a reliable estimate of your income needs. That's because a lot may change between now and the time you retire. As you near retirement, the gap between your present needs and your future needs may narrow. But remember, use your current income only as a general guideline, even if retirement is right around the corner. To accurately estimate your retirement income needs, you'll have to take some additional steps.

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Project your retirement expenses

Your annual income during retirement should be enough (or more than enough) to meet your retirement expenses. That's why estimating those expenses is a big piece of the retirement planning puzzle. But you may have a hard time identifying all of your expenses and projecting how much you'll be spending in each area, especially if retirement is still far off. To help you get started, here are some common retirement expenses:

- Food and clothing
- Housing: Rent or mortgage payments, property taxes, homeowners insurance, property upkeep and repairs
- Utilities: Gas, electric, water, telephone, cable TV
- Transportation: Car payments, auto insurance, gas, maintenance and repairs, public transportation
- Insurance: Medical, dental, life, disability, long-term care
- Health-care costs not covered by insurance: Deductibles, co-payments, prescription drugs
- Taxes: Federal and state income tax, capital gains tax
- Debts: Personal loans, business loans, credit card payments
- Education: Children's or grandchildren's college expenses
- Gifts: Charitable and personal
- Savings and investments: Contributions to IRAs, annuities, and other investment accounts
- Recreation: Travel, dining out, hobbies, leisure activities
- Care for yourself, your parents, or others: Costs for a nursing home, home health aide, or other type of assisted living
- Miscellaneous: Personal grooming, pets, club memberships

Don't forget that the cost of living will go up over time. The average annual rate of inflation over the past 20 years has been approximately 3 percent. (Source: Consumer price index (CPI-U) data published annually by the U.S. Department of Labor, 2010) And keep in mind that your retirement expenses may change from year to year. For example, you may pay off your home mortgage or your children's education early in retirement. Other expenses, such as health care and insurance, may increase as you age. To protect against these variables, build a comfortable cushion into your estimates (it's always best to be conservative). Finally, have a financial professional help you with your estimates to make sure they're as accurate and realistic as possible.

Decide when you'll retire

To determine your total retirement needs, you can't just estimate how much annual income you need.

You also have to estimate how long you'll be retired. Why? The longer your retirement, the more years of income you'll need to fund it. The length of your retirement will depend partly on when you plan to retire. This important decision typically revolves around your personal goals and financial situation. For example, you may see yourself retiring at 50 to get the most out of your retirement. Maybe a booming stock market or a generous early retirement package will make that possible. Although it's great to have the flexibility to choose when you'll retire, it's important to remember that retiring at 50 will end up costing you a lot more than retiring at 65.

Estimate your life expectancy

The age at which you retire isn't the only factor that determines how long you'll be retired. The other important factor is your lifespan. We all hope to live to an old age, but a longer life means that you'll have even more years of retirement to fund. You may even run the risk of outliving your savings and other income sources. To guard against that risk, you'll need to estimate your life expectancy. You can use government statistics, life insurance tables, or a life expectancy calculator to get a reasonable estimate of how long you'll live. Experts base these estimates on your age, gender, race, health, lifestyle, occupation, and family history. But remember, these are just estimates. There's no way to predict how long you'll actually live, but with life expectancies on the rise, it's probably best to assume you'll live longer than you expect.

Identify your sources of retirement income

Once you have an idea of your retirement income needs, your next step is to assess how prepared you are to meet those needs. In other words, what sources of retirement income will be available to you? Your employer may offer a traditional pension that will pay you monthly benefits. In addition, you can likely count on Social Security to provide a portion of your retirement income. To get an estimate of your Social Security benefits, visit the Social Security Administration website (www.ssa.gov) and order a copy of your statement. Additional sources of retirement income may include a 401(k) or other retirement plan, IRAs, annuities, and other investments. The amount of income you receive from those sources will depend on the amount you invest, the rate of investment return, and other factors. Finally, if you plan to work during retirement, your job earnings will be another source of income.

Make up any income shortfall

If you're lucky, your expected income sources will be more than enough to fund even a lengthy retirement. But what if it looks like you'll come up short? Don't panic--there are probably steps that you can take to bridge the gap. A financial professional can help you figure out the best ways to do that, but here are a few suggestions:

- Try to cut current expenses so you'll have more money to save for retirement
- Shift your assets to investments that have the potential to substantially outpace inflation (but keep in mind that investments that offer higher potential returns may involve greater risk of loss)
- Lower your expectations for retirement so you won't need as much money (no beach house on the Riviera, for example)
- Work part-time during retirement for extra income
- Consider delaying your retirement for a few years (or longer)

The longer your retirement, the more years of income you'll need to fund it.

Annuities and Retirement Planning

You may have heard that IRAs and employer-sponsored plans (e.g., 401(k)s) are the best ways to invest for retirement. That's true for many people, but what if you've maxed out your contributions to those accounts and want to save more? An annuity may be a good investment to look into.

Get the lay of the land

An annuity is a tax-deferred investment contract. The details on how it works vary, but here's the general idea. You invest your money (either a lump sum or a series of contributions) with a life insurance company that sells annuities (the annuity issuer). The period when you are funding the annuity is known as the accumulation phase. In exchange for your investment, the annuity issuer promises to make payments to you or a named beneficiary at some point in the future. The period when you are receiving payments from the annuity is known as the distribution phase. Chances are, you'll start receiving payments after you retire.

Understand your payout options

Understanding your annuity payout options is very important. Keep in mind that payments are based on the claims-paying ability of the issuer. You want to be sure that the payments you receive will meet your income needs during retirement. Here are some of the most common payout options:

- You surrender the annuity and receive a lump-sum payment of all of the money you have accumulated.
- You receive payments from the annuity over a specific number of years, typically between 5 and 20. If you die before this "period certain" is up, your beneficiary will receive the remaining payments.
- You receive payments from the annuity for your entire lifetime. You can't outlive the payments (no matter how long you live), but there will typically be no survivor payments after you die.
- You combine a lifetime annuity with a period certain annuity. This means that you receive payments for the longer of your lifetime or the time period chosen. Again, if you die before the period certain is up, your beneficiary will receive the remaining payments.
- You elect a joint and survivor annuity so that payments last for the combined life of you and another person, usually your spouse. When one of you dies, the survivor receives payments for the rest of his or her life.

When you surrender the annuity for a lump sum, your tax bill on the investment earnings will be due all in one year. The other options on this list provide you with a guaranteed stream of income. They're known as annuitization options because you've elected to spread payments over a period of years. Part of each payment is a return of your principal investment. The other part is taxable investment earnings. You typically receive payments at regular intervals throughout the year (usually monthly, but sometimes quarterly or yearly). The amount of each payment depends on the amount of your principal investment, the particular type of annuity, the length of the payout period, and other factors.

If you've maxed out your contributions to your IRAs and employer-sponsored plans and want to save more, an annuity may be a good investment to look into.

Consider the pros and cons

An annuity can often be a great addition to your retirement portfolio. Here are some reasons to consider investing in an annuity:

- Your investment earnings are tax deferred as long as they remain in the annuity. You don't pay income tax on those earnings until they are paid out to you.
- An annuity is free from the claims of your creditors in most states.
- If you die with an annuity, the accumulated value will pass to your beneficiary without having to go through probate.

- Your annuity can be a reliable source of retirement income, and you have some freedom to decide how you'll receive that income.
- You don't have to meet income tests or other criteria to invest in an annuity.
- You're not subject to an annual contribution limit, unlike IRAs and employer-sponsored plans. You can contribute as much or as little as you like in any given year.
- You're not required to start taking distributions from an annuity at age 70½ (the required minimum distribution age for traditional IRAs and employer-sponsored plans). You can typically postpone payments until you need the income.

But annuities aren't for everyone. Here are some potential drawbacks:

- Contributions to nonqualified annuities are made with after-tax dollars and are not tax deductible.
- Once you've elected to annuitize payments, you usually can't change them, but there are some exceptions.
- You can take your money from an annuity before you start receiving payments, but your annuity issuer may impose a surrender charge if you withdraw your money within a certain number of years (e.g., seven) after your original investment.
- You may have to pay other costs when you invest in an annuity (e.g., annual fees, investment management fees, insurance expenses).
- You may be subject to a 10 percent federal penalty tax (in addition to any regular income tax) if you withdraw your money from an annuity before age 59½, unless you meet one of the exceptions to this rule.
- Investment gains are taxed at ordinary income tax rates, not at the lower capital gains rate.

Choose the right type of annuity

If you think that an annuity is right for you, your next step is to decide which type of annuity. Are you overwhelmed by all of the annuity products on the market today? Don't be. In fact, most annuities fit into a small handful of categories. Your choices basically revolve around two key questions.

First, how soon would you like annuity payments to begin? That probably depends on how close you are to retiring. If you're near retirement or already retired, an immediate annuity may be your best bet.

This type of annuity starts making payments to you shortly after you buy the annuity, typically within a year or less. But what if you're younger, and retirement is still a long-term goal? Then you're probably better off with a deferred annuity. As the name suggests, this type of annuity lets you postpone payments until a later time, even if that's many years down the road.

Second, how would you like your money invested? With a fixed annuity, the annuity issuer determines an interest rate to credit to your investment account. An immediate fixed annuity guarantees a particular rate, and your payment amount never varies. A deferred fixed annuity guarantees your rate for a certain number of years; your rate then fluctuates from year to year as market interest rates change. A variable annuity, whether immediate or deferred, gives you more control and the chance to earn a better rate of return (although with a greater potential for gain comes a greater potential for loss). You select your own investments from the subaccounts (which invest directly in mutual funds) that the annuity issuer offers. Your payment amount will vary based on how your investments perform.

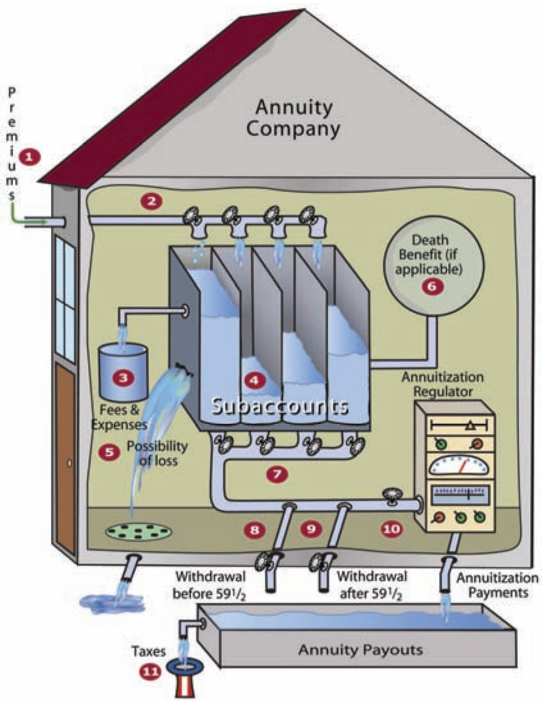
A note about variable annuities

Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.

Shop around

It pays to shop around for the right annuity. In fact, doing a little homework could save you hundreds of dollars a year or more. Why? Rates of return and costs can vary widely between different annuities. You'll also want to shop around for a reputable, financially sound annuity issuer. There are firms that make a business of rating insurance companies based on their financial strength, investment performance, and other factors. Consider checking out these ratings.

How a Variable Annuity Works



1. In the accumulation phase, you (the annuity owner) send your premium payment(s) (all at once or over time) to the annuity issuer. If these payments are made with after-tax funds, you may invest an unlimited amount.

2. You may choose how to allocate your premium payment(s) among the various investments offered by the issuer. These investment choices, often called subaccounts, typically invest directly in mutual funds. Generally, you can also transfer funds among investments without paying tax on investment income and gains.

3. The issuer may collect fees to manage your annuity account. These may include an annual administration fee, underlying fund fees and expenses which include an investment advisory fee, and a mortality and expense risk charge. If you withdraw money in the early years of your annuity, you may also have to pay the issuer a surrender fee.

4. The earnings in your subaccounts grow tax deferred; you won't be taxed on any earnings until you begin withdrawing funds or begin taking annuitization payments.

5. With the exception of a fixed account option where a guaranteed* minimum rate of interest applies, the issuer of a variable annuity generally doesn't guarantee any return on the subaccounts you choose. While you might experience substantial growth in your investments, your choices could also perform poorly, and you could lose money.

6. Your annuity contract may contain provisions for a guaranteed* death benefit or other payout upon the death of the annuitant. (As the annuity owner, you're most often also the annuitant, although you don't have to be.)

7. Just as you may choose how to allocate your premiums among the subaccount options available, you may also select the subaccounts from which you'll take the funds if you decide to withdraw money from your annuity.

8. If you make a withdrawal from your annuity before you reach age 59½, you'll not only have to pay tax (at your ordinary income tax rate) on the earnings portion of the withdrawal, but you may also have to pay a 10 percent premature distribution tax.

9. After age 59½, you may make withdrawals from your annuity proceeds without incurring any premature distribution tax. Since nonqualified annuities have no minimum distribution requirements, you don't have to make any withdrawals. However, your annuity contract may specify an age at which you must begin taking income payments.

10. To obtain a guaranteed income stream* for life or for a certain number of years, you can annuitize which means exchanging the annuity's cash value for a series of periodic income payments. The amount of these payments will depend on a number of factors including the cash value of your account at the time of annuitization, the age(s) and gender(s) of the annuitant(s), and the payout option chosen. Usually, you can't change the payments once you've begun receiving them.

11. You'll have to pay taxes (at your ordinary income tax rate) on the earnings portion of any withdrawals or annuitization payments you receive.

*All guarantees are subject to the claims-paying ability of the issuing company.

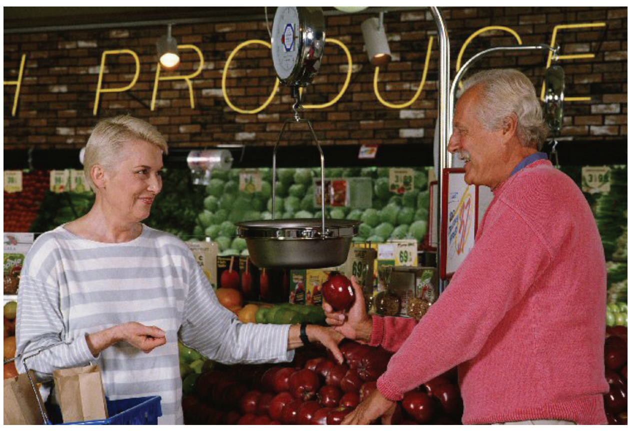
A note about variable annuities

Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.

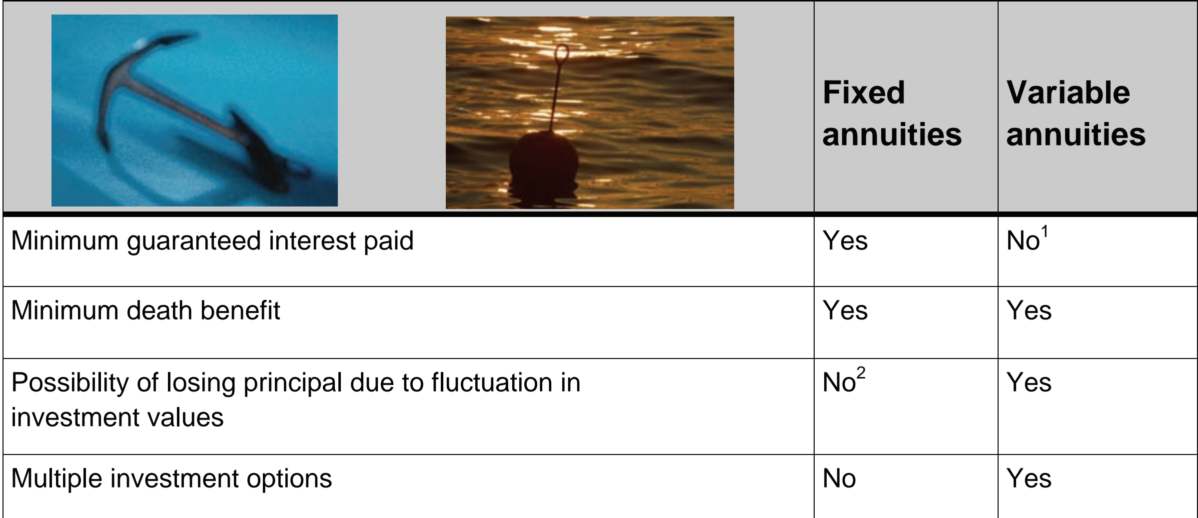
Immediate vs. Deferred Annuities

Immediate annuities	Deferred annuities
Payout begins shortly after the premium is paid.	Payout begins at some specified future date, allowing time for accumulation.
Purchase with a single premium.	Purchase with either a single premium or periodic premiums.
Contract is usually irrevocable--after you enter into the contract, it can't be changed.	Contract can be surrendered or exchanged for another annuity (Section 1035 exchange).
Assets do not accumulate on a tax-deferred basis. They are distributed using a predetermined formula, such as for life, for a fixed period, in a fixed amount, and so on.	Assets accumulate on a tax-deferred basis. When distributions begin, they are made using a predetermined formula, such as for life, for a fixed period, in a fixed amount, and so on.
Each distribution is part tax-free return of premium and part ordinary income, depending on age and the distribution method.	Distributions are first made from any gains/interest earned and taxed at ordinary income tax rates; tax-free return of premium is distributed last.
No tax penalty on lifetime payments started before age 59½.[1]	A 10 percent nondeductible tax penalty is assessed on the gains (or interest) withdrawn before the annuitant reaches age 59½, unless an exception applies.

[1] Unless the immediate annuity is purchased with proceeds from a deferred annuity.



Fixed vs. Variable Annuities

	Fixed annuities	Variable annuities
Minimum guaranteed interest paid	Yes	No[1]
Minimum death benefit	Yes	Yes
Possibility of losing principal due to fluctuation in investment values	No[2]	Yes
Multiple investment options	No	Yes

[1] Unless fixed account option is available and elected

[2] Guarantees subject to the claims-paying ability of the annuity issuer

Note: *Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.*

Handling Market Volatility

Conventional wisdom says that what goes up, must come down. But even if you view market volatility as a normal occurrence, it can be tough to handle when it's your money at stake.

Though there's no foolproof way to handle the ups and downs of the stock market, the following common sense tips can help.

Don't put your eggs all in one basket

Diversifying your investment portfolio is one of the key ways you can handle market volatility. Because asset classes often perform differently under different market conditions, spreading your assets across a variety of different investments such as stocks, bonds, and cash alternatives (e.g., money market funds, CDs, and other short-term instruments), has the potential to help manage your overall risk. Ideally, a decline in one type of asset will be balanced out by a gain in another, but diversification can't eliminate the possibility of market loss.

One way to diversify your portfolio is through asset allocation. Asset allocation involves identifying the asset classes that are appropriate for you and allocating a certain percentage of your investment dollars to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives). An easy way to decide on an appropriate mix of investments is to use a worksheet or an interactive tool that suggests a model or sample allocation based on your investment objectives, risk tolerance level, and investment time horizon.

Focus on the forest, not on the trees

As the market goes up and down, it's easy to become too focused on day-to-day returns. Instead, keep your eyes on your long-term investing goals and your overall portfolio. Although only you can

decide how much investment risk you can handle, if you still have years to invest, don't overestimate the effect of short-term price fluctuations on your portfolio.

Look before you leap

When the market goes down and investment losses pile up, you may be tempted to pull out of the stock market altogether and look for less volatile investments. The small returns that typically accompany low-risk investments may seem downright attractive when more risky investments are posting negative returns.

But before you leap into a different investment strategy, make sure you're doing it for the right reasons. How you choose to invest your money should be consistent with your goals and time horizon.

For instance, putting a larger percentage of your investment dollars into vehicles that offer safety of principal and liquidity (the opportunity to easily access your funds) may be the right strategy for you if your investment goals are short-term (e.g., you'll need the money soon to buy a house) or if you're growing close to reaching a long-term goal such as retirement. But if you still have years to invest, keep in mind that stocks have historically outperformed stable value investments over time, although past performance is no guarantee of future results. If you move most or all of your investment dollars into conservative investments, you've not only locked in any losses you might have, but you've also sacrificed the potential for higher returns.

Look for the silver lining

A down market, like every cloud, has a silver lining. The silver lining of a down market is the opportunity you have to buy shares of stock at lower prices.

One of the ways you can do this is by using dollar cost averaging. With dollar cost averaging, you don't try to "time the market" by buying shares at the moment when the price is lowest. In fact, you don't worry about price at all. Instead, you invest a specific amount of money at regular intervals over time. When the price is higher, your investment dollars buy fewer shares of stock, but when the price is lower, the same dollar amount will buy you more shares. Although dollar cost averaging can't guarantee you a profit or protect against a loss, a regular fixed dollar investment may result in a lower average price per share over time, assuming you invest through all types of markets. Please remember that since dollar-cost averaging involves continuous investment in securities regardless of fluctuating price levels of such securities, you should consider your financial and emotional ability to continue purchases through periods of low price levels.

Don't count your chickens before they hatch

As the market recovers from a down cycle, elation quickly sets in. If the upswing lasts long enough, it's easy to believe that investing in the stock market is a sure thing. But, of course, it never is. As many investors have learned the hard way, becoming overly optimistic about investing during the good times can be as detrimental as worrying too much during the bad times. The right approach during all kinds of markets is to be realistic. Have a plan, stick with it, and strike a comfortable balance between risk and return.

Don't stick your head in the sand

While focusing too much on short-term gains or losses is unwise, so is ignoring your investments. You should check up on your portfolio at least once a year, more frequently if the market is particularly volatile or when there have been significant changes in your life. You may need to rebalance your portfolio to bring it back in line with your investment goals and risk tolerance. If you need help, a financial professional can help you decide which investment options are right for you.

Asset Allocation

Asset allocation is a common strategy that you can use to construct an investment portfolio. Asset allocation isn't about picking individual securities. Instead, you focus on broad categories of investments, mixing them together in the right proportion to match your financial goals, the amount of time you have to invest, and your tolerance for risk.

The basics of asset allocation

The idea behind asset allocation is that because not all investments are alike, you can balance risk and return in your portfolio by spreading your investment dollars among different types of assets, such as stocks, bonds, and cash alternatives.

Asset allocation isn't about picking individual securities. Instead, you focus on broad categories of investments, mixing them together in the right proportion to match your financial goals, the amount of time you have to invest, and your tolerance for risk.

Different types of assets carry different levels of risk and potential for return, and typically don't respond to market forces in the same way at the same time. For instance, when the return of one asset type is declining, the return of another may be growing (though there are no guarantees). If you diversify by owning a variety of assets, a downturn in a single holding won't necessarily spell disaster for your entire portfolio.

Using asset allocation, you identify the asset classes that are appropriate for you and decide the percentage of your investment dollars that should be allocated to each class (e.g., 70 percent to stocks, 20 percent to bonds, 10 percent to cash alternatives).

The three major asset classes

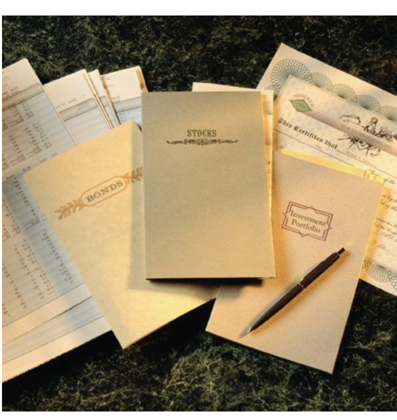
Here's a look at the three major classes of assets you'll generally be considering when you use asset allocation.

Stocks: Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return than other investments, including bonds and cash equivalents. However, stocks are generally more volatile than bonds or cash equivalents. Investing in stocks may be appropriate if your investment goals are long-term.

Bonds: Historically less volatile than stocks, bonds do not provide as much opportunity for growth as stocks do. They are sensitive to interest rate changes; when interest rates rise, bond values tend to fall, and when interest rates fall, bond values tend to rise. Because bonds offer fixed interest payments at regular intervals, they may be appropriate if you want regular income from your investments.

Cash alternatives: Cash alternatives (or short-term instruments) offer a lower potential for growth than other types of assets but are the least volatile. They are subject to inflation risk, the chance that returns won't outpace rising prices. They provide easier access to funds than longer-term investments, and may be appropriate if your investment goals are short-term.

Not only can you diversify across asset classes by purchasing stocks, bonds, and cash alternatives, you can also diversify within a single asset class. For example, when investing in stocks, you can choose to invest in large companies that tend to be less risky than small companies. Or, you could choose to divide your investment dollars according to investment style, investing for growth or for value. Though the investment possibilities are limitless, your objective is always the same: to diversify by choosing complementary investments that balance risk and reward within your portfolio.



Decide how to divide your assets

Your objective in using asset allocation is to construct a portfolio that can provide you with the return on your investment you want without exposing you to more risk than you feel comfortable with. How long you have to invest is important, too, because the longer you have to invest, the more time you have to ride out market ups and downs.

When you're trying to construct a portfolio, you can use worksheets or interactive tools that help identify your investment objectives, your risk tolerance level, and your investment time horizon. These tools may also suggest model or sample allocations that strike a balance between risk and return, based on the information you provide.

For instance, if your investment goal is to save for your retirement over the next 20 years and you can tolerate a relatively high degree of market volatility, a model allocation might suggest that you put a large percentage of your investment dollars in stocks, and allocate a small percentage to bonds and cash alternatives. Of course, models are intended to serve only as general guides. You may want to work with a financial professional who can help you determine the right allocation for your individual circumstances.

Build your portfolio

The next step is to choose investments for your portfolio that match your asset allocation strategy. If, like many other investors, you don't have the time, expertise, or capital to build a diversified portfolio of individual securities on your own, you may want to invest in mutual funds.

Mutual funds offer instant diversification within an asset class, and if the fund is actively managed, the benefits of professional money management. Investments in each fund are chosen according to a specific objective, making it easier to identify a fund or a group of funds that meet your needs. For instance, some of the common terms you'll see used to describe fund objectives are capital preservation, income (or current income), income and growth (or balanced), growth, and aggressive growth.

Pay attention to your portfolio

Once you've chosen your initial allocation, revisit your portfolio at least once a year (or more often if markets are experiencing greater short-term fluctuations). One reason to do this is to rebalance your portfolio. Because of market fluctuations, your portfolio may no longer reflect the initial allocation balance you chose. For instance, if the stock market has been performing well, eventually you'll end up with a higher percentage of your investment dollars in stocks than you initially intended. To rebalance, you may want to shift funds from one asset class to another.

In some cases you may want to rethink your entire allocation strategy. If you're no longer comfortable with the same level of risk, your financial goals have changed, or you're getting close to the time when you'll need the money, you may need to change your asset mix.

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