Understanding annuities and how they may benefit your retirement
Prepared especially for Duke employees
Thanks for being here. We want to give you some things to consider while you’re saving for retirement and a brief overview of the different types of annuities available and their features that may benefit you in preparing for retirement.
CHALLENGES RETIREES FACE TODAY
Challenges retirees face today

**Live retirement on your terms**

> Achieving financial security so you can live comfortably during retirement depends on how well you plan and save while working ... and how effectively assets are conserved during retirement.

[read slide]

Remember, annuities aren’t necessarily for everyone, but depending on the type of annuity and the options you select, it’s possible to guarantee you have a predictable, guaranteed income stream for as long as you need.
More people are living longer these days, and healthcare costs continue to rise. That means you will probably need more guaranteed income in retirement to cover the increasing healthcare expenses.

Where will that income come from?
Past generations could rely on guaranteed retirement income from pension plans. However, many employers have scaled back the benefits or have done away with these plans altogether. Only about 49% of the workforce today is covered by a private pension.

Some people choose to begin taking Social Security as early as age 62, but if you do, your Social Security benefits will be reduced. Also, regardless of the age you start receiving Social Security, the Social Security replacement rate only covers a portion of your pre-retirement income and that replacement rate is expected to decrease even more in the years to come.

**Challenges retirees face today**

**Baby Boomers may face significant challenges as they approach retirement including:**

- Rising healthcare expenses
- Fewer pension plans
- Potentially reduced Social Security benefits
Converting retirement savings into a guaranteed income annuity can help reduce the risks you face in retirement, such as interest rate, market, withdrawal, sequence of returns and longevity risks.

Let's take a closer look at these risks.
Does anybody remember – with great fondness – the double-digit interest yields of the early 1980s?

Those days are long gone, and 1-3% yields are the norm these days. What this means is that a six-figure sum simply doesn’t generate much in the way of meaningful income.

Take a typical five-year CD for $100,000. At about 1.75% interest, you’d collect about $1,770 a year in interest. That number wouldn’t come close to covering the rent in most homes today.
If you’re depending on some declining assets to fuel your future retirement income, the math of making up what you’ve lost seems unfair. For example, if something drops by 50%, how much must it grow to get back where it started?
A: 100%
And if something drops by 30%, it has to grow by more than 40% to get back where it started.
Withdrawal rate risk is the risk of withdrawing too much money from your retirement savings, causing you to run out of money during your lifetime. Traditionally, a 4% withdrawal rate has been suggested as a “safe withdrawal rate.” However, even a 4% withdrawal rate may not be sustainable in today’s low interest rate environment.

Bottom line – What is a safe withdrawal rate?

- An income annuity can provide a guaranteed annual payout rate over 6.0% for a 65-year-old and for a 70-year-old the annual payout rate could be over 6.5%.


Withdrawal rate risk is the risk of withdrawing too much money from your retirement savings, causing you to run out of money during your lifetime. Traditionally, a 4% withdrawal rate has been suggested as a “safe withdrawal rate” that would increase your chances of not depleting assets too quickly in retirement.

However, there have been a number of studies recently (“Say Goodbye to the 4% Rule for Retirement,” WSJ.com March 3, 2013 and “The 4 Percent Rule is Not Safe in a Low-Yield World,” Michael S. Finke, Wade D. Pfau, David Blanchett: SSRN, January 2013) indicating that, in today’s environment of prolonged low interest rates, even a 4% withdrawal rate may not be sustainable in retirement.

A possible solution for you to help mitigate withdrawal risk is the use of an income annuity. An income annuity can provide guaranteed income for life that is not affected by the market and annual payout rates for income annuities can exceed 5.5% for a 65-year-old and even more if you are older. A 70-year-old could expect a guaranteed annual payout rate of over 6%. We will talk more about the annual payout rates later in the presentation.
A 10% return does not guarantee success. Most people would jump at the chance to earn a 10% average annual return in retirement. But averages can be misleading, especially for portfolios used to generate retirement income. In retirement, it’s often the sequence of returns that will lead to investment success or failure. Investment losses early in retirement may jeopardize the sustainability of a portfolio and its ability to generate meaningful income that will last a lifetime.

The example on this slide shows two hypothetical retirement portfolios, both with an average return of 10% over 20 years. The initial portfolio for both was $500,000, annual withdrawals of $30,000 increased each year by 3% for inflation. In this hypothetical chart -- for illustration purposes -- Portfolio 1 and Portfolio 2 have exactly the same annual returns over the hypothetical 26-year period ... but in the exact opposite order. Portfolio 1 starts out with losses in year 1, 3, 6 and 9 ... with some good growth years later. Portfolio 2 starts out with substantial growth in year 1, 4, 6, 7, and 9... with losses hitting after year losses hitting mostly after year 10. Both provided nearly $800,000 in withdrawals. However, Portfolio 2 had an ending account balance of $1.25M and Portfolio 1 ended with less than less than $55K, barely enough for one more inflation increased withdrawal.

Fixed and income annuities could be an attractive alternative for providing retirement income if clients are looking for:

- Guaranteed income for life (depending on the option chosen), no matter how long one lives
- Higher fixed income than other methods
- Protection from stock market volatility
- Automatic payment increase options
- Income payments that are partially tax free when funded with after-tax assets

We’ll talk more about that in a few minutes.
It’s important to understand that life expectancy numbers are averages - the actual outcome for any individual or couple will be in a range. For example, if a 65-year-old has a life expectancy of 21 years, that doesn’t mean every 65-year-old will live for exactly 21 years to age 86. Some will die; others will live past 100.

That distribution range becomes even more important for a couple. As the chart shows, for two 65-year-olds, there’s a 50% chance at least one of them will live to age 92, and a 25% chance that at least one of them will live to be 97.

What can a couple do to help mitigate the risk that their money will run out while they’re still alive? By guaranteeing income for life, annuities can help address the risk of outliving their retirement assets.
One of the first steps in planning for retirement is finding out how much income you will need in retirement and determining how much income will be covered by retirement income sources.

Your income needs may include housing, food, healthcare and various other essentials. Income sources are typically guaranteed income streams like Social Security, employer pension plans, or working part-time.

The difference between the income needs and the income sources is your “retirement income gap.” This is the amount you should be looking for from other savings and sources to make sure your needs are covered.
Now, let’s talk about the basics of annuities and what most annuities have in common.
The basics of annuities

**Lets start at the beginning**

> Annuities are long-term products designed for retirement purposes and some offer the opportunity for tax deferral. Depending on options selected, annuities can help provide an income stream for life.

> Annuities can also be used for estate planning because, generally, annuities avoid probate.

> You should always talk with a financial professional to help assess your personal situation and help determine if an annuity is a good choice for you.

> And … guarantees for all annuities are backed by the claims-paying ability of the issuing insurance company.
The basics of annuities

Annuities 101: The basics

An annuity is a contract between you and an insurance company. The contract, depending on type of annuity and options chosen, can offer a steady income stream during retirement through a variety of money management choices.

<table>
<thead>
<tr>
<th>Three parties enter into a contract with the issuing insurance company:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Owner</td>
</tr>
<tr>
<td>Annuitant</td>
</tr>
<tr>
<td>Beneficiary(ies)</td>
</tr>
</tbody>
</table>
Depending on your personal goals, a financial advisor can help determine an annuity strategy to fit your future needs.

There are four basic types of annuities:

Income annuities
- Immediate and deferred income annuities offer guaranteed income for life that can begin now or in the future

Fixed annuities
- Tax-deferred, fixed annuities offer a fixed interest rate, plus guaranteed income choices when you’re ready for income

Index annuities
- These products offer interest based on a fixed interest rate and/or based in part on the performance of one or more indices, plus standard and optional guaranteed lifetime income choices

Variable annuities
- Based on market participation, variable annuities can also offer standard and optional guaranteed lifetime income choices
If you’re considering an annuity, you'll need to decide not only the type of annuity, but also if that annuity will be qualified or nonqualified. So what’s the difference?

[Read slide]
The basics of annuities

Qualified vs. nonqualified (continued)

Nonqualified:

- Nonqualified annuities are purchased with monies which have not enjoyed any tax-sheltered status and for which taxes have already been paid

- Nonqualified annuities may be purchased by:
  - Employers for deferred compensation or supplemental income programs, OR
  - Individuals investing after-tax savings

[read slide]
It's common for fixed and index annuity contracts to have a market value adjustment, or MVA. An MVA is either a positive or negative adjustment to withdrawal amounts based on changes in the current interest rate environment during the MVA term. The MVA feature is designed to encourage long term saving. The MVA has no effect on the annuity if the contract is not surrendered before the end of the MVA term and there are no withdrawals above the free amounts. The owner simply enjoys the higher interest rate earned over non-MVA annuities.

[read slide]
Fixed, index and variable annuities can offer what is called a guaranteed minimum withdrawal benefit rider. This allows the owner access to income without annuitization. So control is maintained by the owner. The contract will state the eligible percentage that may be withdrawn and is typically based on the owner’s age at the time of the first withdrawal under the benefit. The benefit continues even if the annuity value is exhausted and payments usually started and stopped.

Fixed, index and variable annuities may all offer a version of the GMWB.
Other options to receive income for life, are income payment options where you’ll need to “annuitize.” These options are available for no annual fee. Take a look at the chart and let’s review the basic lifetime income payout options that are usually available to choose from.

- If you choose the “life only” payout option, the issuing insurance company will pay income for as long as you live. Note that the insurance company doesn’t make any payments to anyone after the contract owner dies. This payment option usually pays the highest income possible.
- The “life income with period certain” option provides for payments over your lifetime or a set number of years, typically, whichever is longer. If the guaranteed period has not expired at the time of death, payments are usually paid to the beneficiary(ies), as scheduled.
- The “joint and survivor” option provides payments as long as either you or your beneficiary live.
Remember, payout options may vary among insurance companies and annuity contracts. Let’s also review some examples of payment options:

**Life Annuity with Installment Refund:** Based on the lifetime of the annuitant and provides a guaranteed income for life. Provides a guarantee of principal – payments will continue to the annuitant for as long as they live, however, if the annuitant dies before the principal has been returned, the beneficiary(ies) will continue to receive payments until they add up to the initial premium amount used to purchase the annuity. This payment option guarantees that the client will not lose any of the single premium purchase amount.

**Life Annuity with Period Certain:** Based on the life of the annuitant. Guaranteed for the life of the annuitant. Period certain may vary from five to 40 years. If annuitant dies before the end of the period selected, income payments continue to the designated beneficiary(ies) until the end of the pre-selected time period.

**Period Certain Annuity:** Payout term of five to 40 years. Period certain will provide the annuitant with a guaranteed income for the time selected. Upon the annuitant’s death the beneficiary or estate will receive payment for the remainder of the selected period of time.

**Joint Life with Period Certain:** Similar to the single life with period certain. Offers option of five to 40 years guarantee of income. If the surviving annuitant dies before the end of the selected time period then full income payments will continue to the designated beneficiary(ies) until the end of that period. The life portion will be provided to the survivor according to the percentage selected.

**Life Only Annuity (non-refund):** Based on the lifetime of the annuitant with no refund upon death. Life only option will generate a higher benefit than most other options because the obligation is only for the lifetime of the annuitant. This choice is popular with pension plans and annuitants with no family.

**Joint Life Only:** Based on the lifetimes of the annuitant and the joint annuitant with no further payments upon the survivor’s death. Offers the option to reduce a certain percentage upon either death or the primary annuitant’s death only. Usual reductions are 25%, 33⅓%, 50% or 100% (no reduction). This is popular with pension plans; providing lifetime benefits to both spouses.
Now, let’s take a few minutes and talk about income annuities.
Income annuities

**Income NOW** with a single premium immediate annuity (SPIA)

- Income payments must begin within 12 months
- Automatic payment increase options
- Advance payment withdrawal options
- Withdrawal benefit

**Income in the FUTURE** with a deferred income annuity (DIA)

- Payments begin more than 12 months up to 40 years
- Income start date adjustment options
- Pre-commencement death benefit
- Automatic payment increase options
- Advance payment withdrawal options

With some exceptions, in exchange for higher payments, income annuities permanently convert principal to a guaranteed income stream.
With an income annuity, a portion of retirement savings can be converted into a guaranteed income stream. Income annuities may be a good fit for individuals who are in or approaching retirement because income annuities offer predictable income that is guaranteed for life or for a certain period of time or both. The income cannot be affected by market fluctuations. Income annuities are customizable, meaning the client decides when to begin receiving income payments, how often to receive the income, and how long the payments last. There is also the option to add a cost of living adjustment feature which can increase the annuity payments over time. An array of annuity options are available to provide the flexibility a client needs - such as life only or joint life only (use to cover one life and the life of a spouse). Additionally, options are available that protect the premium paid in the event of premature death, allowing a beneficiary to collect any remaining guaranteed payments.
Income annuities

If you want income NOW

A SPIA can be a good match for those wanting to receive income immediately.

Here's what a SPIA can offer:

- Guaranteed, predictable income now to cover essential retirement expenses and supplement Social Security
- Income guaranteed for life*
- No exposure to market volatility
- Customizable income payment options
- The ability to schedule income at time of purchase

* Depending on the selected payout option.
Income annuities

If you want to wait and have income LATER

The longer you defer, the higher your income may be.

Here’s what a DIA can offer:

- Guaranteed, predictable income in near future (12 months – 40 years) to cover essential retirement expenses
- Income guaranteed for life*
- No exposure to market volatility
- Customizable income payment options
- The ability to schedule income at time of purchase

* Depending on the selected payout option.
The question is always, What’s the big deal about fixed annuities? Well, they can be a low-risk, long-term retirement solution.
So what's the big deal about fixed annuities?
[read slide]
With a fixed annuity, the power of compounding interest can be your ally. Take a look at this hypothetical example to get an idea of how you can benefit from tax deferral. The chart illustrates the additional growth and income you receive when you withdraw your funds at the end of 30 years from a tax-deferred account compared to a taxable account.

As you can see, tax deferral can help your money work harder for you. Over the 30 year period, the value of the tax-deferred account is $5,609 higher than the taxable account. Bear in mind that this example is only for illustrative purposes. It doesn’t reflect the performance of any particular investment, nor does it take into account the differences in risk, maturity and credit quality when comparing identical tax-deferred and taxable yields.
There are two phases to a fixed annuity contract. The saving your money or accumulation phase, and the income payout. We call that annuitization.

[Read directly from slide]
Unexpected changes in your life can throw your original plan off track. So, it’s well worth your time to clearly understand your annuity withdrawal options—just in case you need easy access to your money.

Many annuities allow for penalty-free withdrawals up to a specific amount during the annuity’s buildup phase. Some annuities also provide early withdrawal charge waivers you can use under certain situations. For instance, you might be able to use the waivers if you need to stay in a nursing home, are unable to perform certain activities of daily living, or if you discover you have a terminal illness. Note that early withdrawal charge privileges differ among insurance companies and annuity contracts.

Keep in mind that while many annuities offer withdrawal privileges, if you withdraw more than the permitted free withdrawal amount, you may have to pay a contractual early withdrawal charge. Remember, the IRS rules also apply to withdrawal.
Another important component of an annuity contract is the withdrawal/surrender charge schedule. Annuities are intended to be long-term contracts. With that being said if you take monies out of the contract there could be penalties imposed. These apply in the early years of the contract and vary by issuer. A withdrawal charge schedule is usually 10 years and typically decline over time. Most contracts will incorporate some type of free withdrawal usually up to a certain percentage of the prior anniversary value, usually 10%.
What about index annuities?
We’ve discussed the power of tax deferral and compounding interest, so let’s take a moment and see other ways an index annuity may be able to grow your retirement savings.

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Index annuities

Important terms

Here's some lingo you'll need to understand:

> **Index Rate Cap** – The maximum amount of interest that can be credited for a contract year

> **Participation Rate** – The percentage of the year-to-year index return that's used to calculate the interest in an index interest account

> **Spread** – A percentage subtracted from the percentage change in an index
## Calculating interest based on an index

Interest is credited based on the index account chosen

<table>
<thead>
<tr>
<th>Index Interest Account</th>
<th>Index Interest Calculation is Based on:</th>
<th>Index Rate Cap</th>
<th>Spread</th>
<th>Participation Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Point-to-Point</td>
<td>Annual point-to-point change in the index from one contract anniversary to the next, subject to a rate cap.</td>
<td>Yes</td>
<td>No</td>
<td>100%</td>
</tr>
<tr>
<td>Annual Point-to-Point Participation Rate</td>
<td>Annual point-to-point change in the index from one contract anniversary to the next, subject to a participation rate.</td>
<td>No</td>
<td>No</td>
<td>Variable (5% - 100%)</td>
</tr>
<tr>
<td>Monthly Point-to-Point Additive</td>
<td>Sum of 12 monthly point-to-point percentage changes, subject to a rate cap, in the index from one contract anniversary to the next.</td>
<td>Yes</td>
<td>No</td>
<td>100%</td>
</tr>
<tr>
<td>Monthly Average</td>
<td>Percentage difference between the average of the index’s monthly anniversary values and the index value at the beginning of that contract year, reduced by a spread.</td>
<td>No</td>
<td>Yes</td>
<td>100%</td>
</tr>
<tr>
<td>Two-Year Point-to-Point</td>
<td>Change in the index at the end of the two-year period, reduced by a spread.</td>
<td>No</td>
<td>Yes</td>
<td>100%</td>
</tr>
</tbody>
</table>
Index annuities

Growth potential of index annuities

Index Annuities would have provided more interest than 90-day U.S. Treasury Bills over 10 years ended 12/31/15

Note: Past performance does not guarantee future results. The hypothetical index annuity illustrated includes returns on withdrawals and an annual guaranteed minimum benefit rider. The chart is intended only to show how the S&P 500® Annual Pool for 90-Day U.S. Treasury Bills would have performed from 12/31/05 to 12/31/15. The annualized rate of return for the S&P 500® Annual Pool is based on the closing index value on 12/31/15 and the index value at the end of each calendar year, which may be higher or lower than the previous year's end index value. The hypothetical index annuity performance chart is illustrative only, and the hypothetical index annuity's performance may be higher or lower than the S&P 500® annual return. The annualized return for the hypothetical index annuity is based on the closing index value on 12/31/15 and the index value at the end of each calendar year, which may be higher or lower than the previous year's end index value. Performance is shown net of all fees and expenses, and is not subject to federal income tax. The S&P 500® is widely regarded as the standard for measuring U.S. stock market performance. Index Annuities and ETFs (an index fund) offer different objectives and time horizons while subject to different fees and expenses. The U.S. Treasury Bills goal is a short-term time horizon, and is subject to federal income tax. Growth Annuities offer a fixed rate of return and fixed principal value, even in a falling market. Growth Annuities are subject to federal income tax. Growth Annuity performance may be subject to federal income or sales taxes. 

Embedded Account

60-Day U.S. Treasury Bills

[read slide]
Index annuities

Other index annuity benefits

Index annuities offer a variety of optional income benefits. In exchange for some of these options, there may be additional costs

- Guaranteed lifetime withdrawal benefit riders
- Death benefits
- Income plan options
- Liquidity riders for life events
Finally, let’s discuss variable annuities.
Variable annuities

**Variable annuities: Market participation and guarantees**

**Market investment is for the long-term**

> A variable annuity gets its name because its value can fluctuate based on performance of the underlying market investments. The contract owner chooses various investment options like stock or bond funds that can increase or decrease in value.

> The important thing to remember is that total contract value, when redeemed, may be worth more or less that their original value.

> Variable annuities are typically tax deferred because they are intended for retirement income.

> Investments are made in subaccounts and this product can only be sold by prospectus.

[read slide]
Variable annuities

What’s in it for me?

If you want the potential for growth from market participation and optional income protection features, a variable annuity may be a good choice. Remember, they come with more risk because performance is tied to the underlying market investment.

Here’s what a variable annuity can offer:

> Optional income guarantees for life
> Tax-deferred growth
> Tax-free transfers between investment subaccounts
> Death benefit with optional enhanced benefit such as maximum anniversary value
> Optional fixed options with interest guarantees

Variable annuities are subject to a separate account fee, administrative charges and portfolio operating expenses associated with the underlying investment portfolios. Early withdrawals may be subject to withdrawal charges. Income protection features and enhanced death benefits are optional and available for an additional cost.

[read slide]
Tax-qualified contracts such as IRAs, 401(k)s, etc., are tax deferred regardless of whether or not they are funded with an annuity. If you are considering funding a tax-qualified retirement plan with an annuity, you should know that an annuity does not provide any additional tax-deferred treatment of earnings beyond the treatment by the tax-qualified retirement plan itself. However, annuities do provide other features and benefits such as income options.

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Understanding annuities and how they may benefit your retirement
Prepared especially for Duke employees

Thank you