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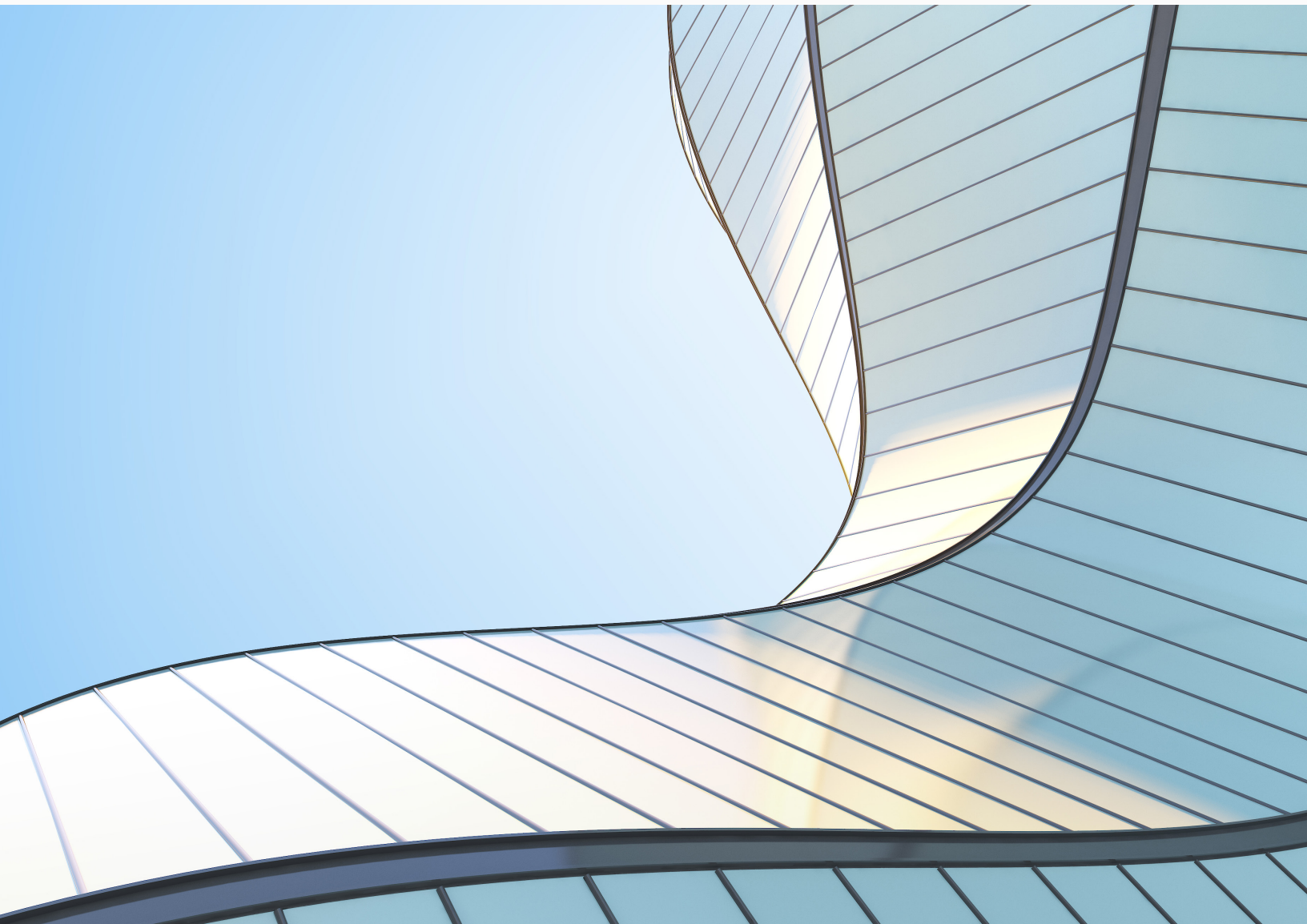
Fixed Annuities for Simple, Fixed Rate Growth and Protection

A “hitting singles” approach to preserving retirement assets that provides protection of premium and guaranteed rates.



What are fixed annuities?

A fixed annuity is a tax-deferred contract issued by an insurance company. It is designed for the long term and may offer the contract owner:

Protection of premium invested

A fixed interest rate for a specific period of time

Tax deferred accumulation of interest

Fixed annuities can be described as the insurance industry's version of a Certificate of Deposit (CD). When investors buy CDs, they give the bank money for a specific period and the bank pays them interest on that money each year. The bank guarantees all the money back at maturity, but there is typically a penalty if the CD is redeemed prior to that.

With fixed annuities, investors give their money to an insurance company and in return, the insurance company pays them interest annually at a guaranteed rate for 1 – 7 years. They can withdraw a "free annual withdrawal amount," typically up to 10% of their fixed annuity account value, each year without incurring any withdrawal penalties should they need to access some of the funds. However, withdrawals exceeding the free annual withdrawal amount during the surrender charge period (which typically ranges from 3 – 10 years), will generally carry an early withdrawal charge called a "surrender charge."

There are a few key differences between fixed annuities and CDs:

FDIC insurance	Bank CDs are FDIC insured while fixed annuities are guaranteed by the issuing insurance company. However, there may be state guaranteed in the event of an insurance company's failure.
Holding period	Fixed annuities are typically held for a much longer duration than CDs. While CDs can be bought in maturities of five years or less. Fixed annuities, on the other hand, are designed to be held for 3-10 years and early withdrawals may incur charges.
Rate differential	Fixed annuities generally offer a higher interest rate than CDs.
Maturity	Unlike CDs, fixed annuities don't actually mature. While withdrawals exceeding the free annual withdrawal amount will be subject to an early withdrawal charge during the surrender charge period, an investor can leave their money in the annuity even after the surrender period ends and continue to earn interest at a fixed rate.
Tax treatment	Annuities are tax deferred, which means an investor doesn't pay income on the interest earned until they withdraw funds. In contrast, the interest credited to a CD each year is taxable as ordinary income in that particular year, even if the investor chooses to leave the interest in the CD to earn additional interest.

Types of fixed annuities

Fixed annuities typically fall into one of two categories:

- Annuities that credit interest one year at a time, with the carrier setting a new fixed rate each year
- Annuities that guarantee a specific interest rate for the entire length of the surrender charge period

Traditional fixed annuities that guarantee a rate one year at a time

If an investor buys an annuity that guarantees an interest rate for only one year, the 1-year rate will usually be higher than a 1-year CD, but the carrier has the ability to reset the rate each year. This gives the insurance company the option to pay the investor a higher rate if rates go up and a lower rate if rates go down (subject to a minimum rate that is specified in the contract). Fixed annuity contracts with 1-year rates also have a surrender charge period, typically 7 – 10 years, during which any withdrawals from the annuity contract that exceed the free annual withdrawal amount will be subject to a surrender charge.

> It is very important that investors who buy a fixed annuity with this design be comfortable with the history of the insurance company's renewal rates.

Multi-year guaranteed annuities (MYGA)

In response to concerns about what future renewal rates would be, the industry introduced fixed annuities that guarantee a rate for the entire length of the surrender charge period. These contracts typically come in 3-, 5-, and 7- year terms. Within the insurance industry, these are referred to as Multi-Year Guaranteed Annuities, or MYGAs. These contracts are straightforward. If an investor puts $100,000 in a 3-year fixed annuity paying 2.25% for each of the three years, the investor knows that at the end of the 3-year period, there will be exactly $106,903 in the account. At that point, the investor can either elect to renew for a new term at the rate offered by the carrier, move the money to another tax-deferred annuity, or receive the money and pay taxes owed.

Remember, however, that annuities, unlike CDs, don't actually mature. Should an investor elect to leave the money in the existing annuity, one of two things could generally occur: the carrier will either automatically renew for a 1-year period or a multi-year period matching the investor's previous interest guarantee period. An investor should refer to the contract for further details.

Market value adjustments and how they can impact annuity values

If an investor buys a MYGA, the rate guarantee will most likely come with a market value adjustment (MVA) that will be assessed if the investor withdraws funds that exceed the annual free withdrawal amount from the annuity prior to the end of the surrender charge period. An MVA is in addition to any surrender charges and exists to protect the insurance company against an increase in interest rates in the event of early withdrawal.

One important concept to understand about a MVA is that if interest rates have increased since the annuity was purchased, it will further reduce the account value of the annuity, and any withdrawal amount received. If interest rates have fallen, it will increase the account value and any withdrawal amount the investor receives.

This MVA calculation is only assessed if an investor withdraws funds prior to the end of the surrender charge period that was selected. If a 5-year surrender charge period was selected and the investor waits to withdrawal funds until the term is over, no MVA would be assessed.

Tradeoffs when buying a fixed annuity

Fixed annuities may be an attractive addition to a portfolio for investors who seek:

- Protection of premium invested
- Predictability without exposure to market risk
- Simplicity with a guaranteed rate of return over a defined period
- Competitive, tax-deferred rates compared with a bank CD, however holding periods for fixed annuities can range from 3 –10 years, depending on the type of fixed annuity

However, there are several important considerations to understand, including:

- When interest rates are renewed, they are at the discretion of the insurance company and may be lower or higher than the previous guaranteed rate.
- Early withdrawals that exceed the free annual withdrawal amount during the surrender charge period may trigger surrender charges, fees, and/or tax penalties, and may be subject to negative adjustments, which could be substantial. Early withdrawals that exceed the free annual withdrawal amount may also be subject to a market valuation adjustment, or MVA, which can reduce the account value or the actual withdrawal amount. For this reason, an investor should be prepared and able to hold an annuity through the full length of the surrender charge period which is typically between 3-10 years.

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- Withdrawals and distributions of taxable amounts are subject to ordinary income tax and, if made prior to age 59½, may be subject to an additional 10% federal income tax penalty.
- Fixed annuities are not FDIC-insured. All references to guarantees arising under the annuity contract, including optional benefits, are subject to the claims-paying ability of the carrier.

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