Understanding Annuities: The Basics

Will your savings last a lifetime? Many pre-retirees and retirees are uncertain whether the nest egg they have built will let them live comfortably for the rest of their lives without running out of money. With the rising cost of living and the fact that people are living longer, an annuity could be a solution to help provide a steady stream of income in retirement; potentially one that cannot be outlived.

What is an annuity?

Annuities are long-term financial vehicles that allow you to accumulate money tax-deferred for retirement. An annuity is a contract between you—the investor—and an insurance company. Annuities can also help you create a steady stream of income to live on in retirement.

Types of Annuities

There are two main types of annuities—fixed and variable. Fixed annuities provide a rate of return at a fixed rate set and guaranteed by the insurance company for a certain period of time. A variable annuity offers a wide range of investment options and entails more risk in exchange for greater growth potential.

Annuities are also categorized based on when you take income, *immediate* or *deferred*, and how you make payments, *single* premium or *flexible* premium. Many deferred annuities have a surrender period. This is the amount of time an investor must wait until they can liquidate the entire annuity contract without facing a penalty from the insurance company.

Benefits of an Annuity

Annuities offer a number of benefits including:
Tax Deferred Growth Earnings from an annuity grow on a tax-deferred basis.

Income for Life Annuities offer several income options for receiving payments. These payments may last a lifetime.

Penalty Free Withdrawals Annuities generally permit penalty-free withdrawals, subject to limitations and restrictions.

Probate Avoidance By simply naming a beneficiary, the assets of your annuity are transferred directly to your beneficiaries, and may bypass probate.

Reallocating Investments You may reallocate or transfer among the investment options in variable annuities without paying fees or taxes.

Optional Benefits Principal protection, lifetime income and guaranteed death benefits may be offered for an additional cost.

Annuity Contract Parties

There are three parties to an annuity contract: the owner, annuitant and the beneficiary. The owner makes the initial investment, decides when to begin taking income and can change the beneficiary designation at will. The annuitant's life is used to determine the benefits to be paid out under the contract. Typically, the owner and the annuitant are the same person. Finally, the beneficiary is entitled to the annuity death benefit.

A Reliable Income Stream with Immediate Annuities

With a Single Premium Immediate Annuity (SPIA) you may begin receiving income immediately with the confidence of knowing payouts will continue for a period of time designated by you (typically lifetime). When a SPIA is purchased with non-qualified (after-tax) money, only a portion of each payout is taxable creating a tax-efficient income vehicle.

How does a SPIA work?

A SPIA contract is purchased by providing a lump sum payment to an insurance company. In return, you receive a guaranteed stream of income for a specific period of time or for the rest of your life (and even your spouse's life, or both of your lives, if you choose)—no matter how long you live, subject to the claims paying ability of the insurer. The amount of income you receive is based on several factors:

- The amount of money (premium)
- Your life expectancy—based on current age and gender
- The current interest rate
- The payout option along with any additional features (e.g., cost of living adjustments)

What are my SPIA payout options?

SPIA's offer a number of different payout options including:

Guaranteed Period Certain You or your surviving beneficiary receives income payments for a specific period of time.

Single Lifetime Income You receive income payments until death. There is no payout to your beneficiary. These payouts are typically the largest and riskiest.

Single Lifetime Income with a Guaranteed Period Certain You receive payments as long as you live. If death occurs before the guarantee period ends, payments will continue to your beneficiary through the end of the period.

Joint Lifetime Income When one spouse dies, the other gets a percentage of the previous payment for the rest of their life. There is no payment to a beneficiary once both spouses die.

Joint Lifetime Income with a Guaranteed Period Certain You receive payments as long as you or your spouse lives. If both you and your spouse die before the guarantee period ends, payments will continue to your beneficiary through the end of the period.

Lifetime Income Annuity with Refund You receive payments until death. If the total amount of income you have received at death is less than the premium you paid, your beneficiary will receive a refund of the difference (either as a lump sum or in installments).

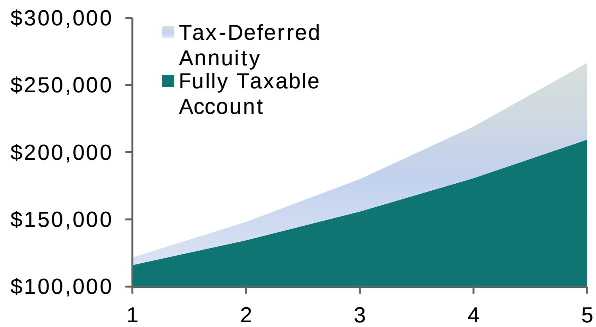
Preparing for Retirement with Fixed Annuities

A fixed annuity can provide a sense of security to you with a guaranteed, fixed rate of return over a specified period of time.

Why consider a fixed annuity?

Like all deferred annuities, fixed annuities offer tax-deferred treatment of earnings. In other words, you do not pay taxes each year on the interest earned. The example below shows the benefits of tax deferral and compounding interest on an investment of $100,000 over a period of 25 years and assumes no withdrawals. It assumes an interest rate of 4% and a federal tax rate of 25%.

Year	Tax-Deferred Annuity	Fully Taxable Account	Tax-Deferred Advantage
5	$121,665	$115,927	$5,738
10	$148,024	$134,392	$13,632
15	$180,094	$155,797	$24,297
20	$219,112	$180,611	$38,501
25	$266,583	$209,378	$57,205



This example is for illustrative purposes only, and is not indicative of any actual investment. The comparison is between a tax-deferred fixed annuity and a fully taxable investment. Any fees (if applicable) would have a negative effect on this example. Withdrawals may be subject to withdrawal charges and interest adjustment. Withdrawals of taxable amounts are subject to ordinary income tax and if made before age 59½, may be subject to a 10% Federal income tax penalty.

Additionally, a fixed annuity offers a death benefit that passes to your beneficiaries without the cost and potential delay of probate. Finally, fixed annuities may be annuitized, providing a potentially tax-advantaged guaranteed income that cannot be outlived. The earnings portions of withdrawals taken from a deferred annuity are subject to ordinary income tax.

What happens at the end of the guaranteed period?

At the end of each period, you can elect a new guarantee period. Generally, if no action is taken, you will typically renew into the same guarantee period at the current interest offered. Most contracts have a guaranteed minimum rate for the life of the contract.

What if I need my money before the end of the guaranteed period?

Generally, a surrender charge (penalty) may apply to early withdrawals. Some contracts allow withdrawals within certain guidelines penalty-free (e.g., up to 10% of contract value each year). A Market Value Adjustment (MVA) may also apply. An MVA could increase or decrease the value of the penalty-free withdrawal. Many contracts also offer withdrawals free of surrender charges in the event there is an emergency (e.g., nursing home). Be sure to check the terms and conditions of each fixed annuity.

Preparing for Retirement with Variable Annuities

A variable annuity is a long-term investment primarily designed for retirement or other long-range purposes.

Variable annuity types

There are four main types of variable annuities, including:

- **B-Share**—typically offer a six to eight year surrender period and have the lowest costs.
- **Bonus**—usually has a surrender period in excess of seven years; however, they contain annuity investment credits or bonuses. For example, if you invest $100,000 and the bonus is 4%, the annuity contract will be issued with a contract value of $104,000.
- **L-Share**—this annuity offers a shorter surrender period in exchange for a higher cost.
- **C-Share**—variable products that offer full liquidity but may restrict benefit offerings and charge higher fees.

Variable annuities and their unique benefits

Variable annuities offer additional features typically not found in other types of investment products, including:

- Death benefit protection options
- Living benefit options
- Tax-free transfers among a variety of professionally managed investment options

Death benefits explained

Most contracts include a standard death benefit where your named beneficiary is guaranteed to receive a specified amount—typically the greater of the contract value at the time of death or the amount of your purchase payments, adjusted for any withdrawals.

Some contracts also offer "enhanced" death benefits for an additional charge. An example of this type of benefit includes the allowance to periodically "lock-in" your investment performance and/or guarantee a minimum rate of return on the value of your account. Generally, when the owner (or annuitant, as specified in the prospectus or contract) of the annuity dies, the beneficiary is taxed on all appreciation when the death benefit is received.

Principal protection and lifetime income with living benefits

Annuities have been characterized by their ability to provide retirement income that cannot be outlived during the payout phase. Today, annuity products offer living benefits that provide principal and income guarantees to protect your retirement income from declining markets. There are three basic types of living benefits, each with a distinct objective: GMAB, GMIB, and GMWB. The chart on the next page provides a summary and some additional considerations.

A closer look at variable annuity living benefits

Living Benefits Options	Benefit Description
Guaranteed Minimum Accumulation Benefit (GMAB)	Generally this benefit guarantees the return of your purchase payments or a higher stepped-up value at the end of a waiting period, typically ten years from issue or the last step-up, regardless of your investment performance. If your contract value is below the guaranteed amount at the end of the waiting period, the insurance company will increase your contract value to equal the guaranteed amount (adjusted by any withdrawals).
Guaranteed Minimum Income Benefit (GMIB)	This benefit typically guarantees a lifetime income stream when you annuitize the GMIB amount, after a specific holding period (e.g., 10 years), regardless of your investment performance. Most insurance companies provide GMIBs with some flexibility for taking earlier withdrawals under certain guidelines. Withdrawals reduce the value of the benefit. A GMIB can provide income protection for an individual or a couple.
Guaranteed Minimum Withdrawal Benefit (GMWB)	Generally these benefits guarantee a return of your purchase payments over a specified number of years, or over a lifetime. The lifetime GMWB can provide annual income over a lifetime of an individual or a couple. Certain benefits may provide for a higher stepped-up benefit base via a roll-up percentage and/or positive market performance.

The actual guarantees and corresponding fees will vary by contract. These benefits are optional and carry an additional cost. Minimum holding periods and investment restrictions may apply.

Solution to volatility

Variable annuities offer a potential solution to volatility through benefits designed to help you stay invested in the markets while guaranteeing a baseline level of income in retirement. With these optional benefits, you are guaranteed a minimum income even when market values decrease. Furthermore, you enjoy the potential for an increase to your income if the value of the underlying investment increases. These features may allow you to invest confidently, knowing that an up market offers benefits, while a down market won't erode your guaranteed minimum income.

Variable annuity charges and fees

There are charges and fees that are unique to variable annuity products. These charges may include mortality and expense risk charges, surrender charges, administrative fees, portfolio management and optional insurance benefits.

Choosing an Annuity Company

Your Baird financial professional can help determine if an annuity is right for you. When selecting an annuity, remember to review some important factors, including:

- Independent Ratings—A number of rating organizations measure the financial strength of insurance companies. A.M. Best Co., Standard & Poor's, Moody's and Fitch are the primary rating organizations. It is important to consider the financial strength of the insurance company as all guarantees are subject to the claims paying ability of the insurer. Also, the insurance company ratings do not apply to the investment options within a variable annuity.
- Service Quality—You should also consider a company that provides high-quality service.

Annuities are investment vehicles designed for long-term planning. Variable annuities are subject to risk, including the loss of principal. All guarantees are based on the claims-paying ability of the insurance company. Withdrawals of taxable amounts are subject to income tax, and if taken prior to age 59 ½, a 10% federal tax penalty may apply. Neither Robert W. Baird & Co., Incorporated nor its Financial Advisors offer legal or tax advice.

Investors should carefully consider the investment objectives, risks, charges, and expenses of variable annuities and their underlying investment options before investing. This and other information can be found in the prospectus or summary prospectus for the variable annuity and the prospectuses or summary prospectuses for the underlying investment options, which can be obtained by contacting Robert W. Baird & Co. Please read them carefully before you invest.

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