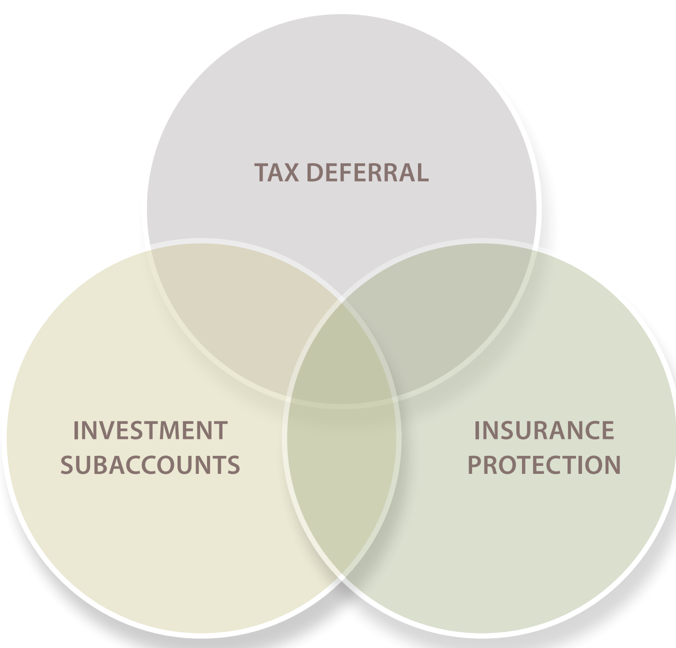
Are Variable Annuities Right For Your Retirement?

A variable annuity is a contract between you and an issuer whereby you agree to give the issuer principal and in return the issuer guarantees you payments over time. Variable annuities are tax-deferred contracts where account values and income payments may vary, and are based on the investment performance of professionally managed subaccounts that are selected by the policy owner. While annuities are not insurance policies, they are issued by insurance companies, and have certain insurance-related guarantee options, such as living benefits and death benefits.



Market Gains and Downside Insurance Protection … at a Cost

Variable annuities can be very attractive to investors for several reasons. They enable you to potentially benefit from market upside by investing in sub-accounts. They also could provide protection in a down market, and most products have various optional annuity riders (available for additional fees)—such as death benefits to provide for your heirs, guaranteed minimum income benefits that guarantee a minimum rate of growth (to the benefit base), and lifetime income benefits in which the annuity company can guarantee you a regular income for your lifetime, even if your account balance goes to zero. At a minimum, typically with this benefit you can get your initial investment, in the form of monthly payments, beginning at some point after your age 59 1/2 (an age set by law). Any withdrawals prior to age 59 1/2 may be subject to additional fees and penalties.

Adding a variable annuity to your portfolio could help hedge against a significant market downturn, if structured properly with policy riders. The issue facing many investors considering variable annuities is assessing whether the additional cost of these riders is worth the benefit and sense of well-being they might receive.

How Variable Annuities Work

Unlike some other investments, variable annuities offer tax deferred accumulation. This means that you can let your money grow without paying taxes until you begin to take income, or withdrawals, from the contract. With tax-free growth, instead of paying tax on the returns of an investment, tax is paid only at a later date, leaving the investment to grow unhindered. Another benefit of tax deferral is that investments are usually made when a person is earning higher income and is taxed at a higher tax rate. Withdrawals from a variable annuity are usually made in retirement when a person has little or no earned income and is taxed at a lower rate.

Two Phases: It is important for potential investors to learn about the two phases of a variable annuity; the Accumulation Phase and the Income Phase; and the contract provisions available in each phase, when determining if a variable annuity is a suitable investment for them.

Accumulation Phase

During the accumulation phase, payments made into the annuity can be allocated to a number of investment options via sub-accounts. The money you have allocated to each investment sub-account will increase or decrease over time, depending on the sub-account's performance. While most are invested in variable accounts, some variable annuities offer a fixed account option that will guarantee both principal and interest. Some variable annuities have living benefits that can benefit the policy owner while alive, even if the policy has poor investment performance, but how these benefits are calculated can be very confusing. One of the most confusing aspects of some variable annuities is distinguishing between the account value and the guaranteed income benefit base.

Account Value vs. Guaranteed Income Benefit Base

Account value

This is the actual value of the investment sub-accounts where the money is invested and grows tax deferred. Consider this to be the value paid to the policy owner if the contract is surrendered (minus any applicable surrender charge and penalties if taken before 59 1/2) prior to death. It is important to remember that the cash value of the policy will fluctuate over the life of the policy and could be lower than the initial investment.

Guaranteed Income Benefit Base

The Guaranteed Income Benefit Base is often considered a "shadow" account on which your actual income payments could possibly be based. These optional living benefit riders, in some cases, can guarantee a minimum rate of return on the benefit base (3%-7%), regardless of market performance of the underlying investment sub-accounts. If the market performance of the investments produces a rate of return that is higher than the guaranteed minimum rate of return, many contracts will "step-up" the guaranteed income benefit base to lock in gains, typically on the policy anniversary date. Keep in mind, there are additional fees (typically .75% to 1.5% annually) for these living benefit features and the guaranteed income benefit base has no cash value. If you wish to surrender the contract, the account value, which may be substantially less than the guaranteed benefit base is the value returned to you, less any surrender changes and penalties.

Income Phase

After the Accumulation Phase comes the Income Phase. The Income Phase is the point in the contract where regular income payments begin, either through withdrawals or annuitization. Currently annuities are the only financial product that could provide a person an assured income for life, regardless of how long they live. This can be achieved through annuitization. Annuitization is the conversion of the accumulated value of an annuity contract into a series of periodic income payments, for as long as the annuitant(s) are living or for a specific number of years. Typically annuitization is irreversible, access to cash is highly restricted, and a death benefit may not be available to beneficiaries. As a result, insurance companies have developed living income benefit riders such as the Guaranteed Minimum Withdrawal Benefit (GMWB) and Guaranteed Minimum Income Benefit (GMIB) that, when compared to annuitization, offers additional liquidity and flexibility.

Guaranteed Minimum Withdrawal Benefit (GMWB)

The GMWB living benefit rider usually provides a guaranteed minimum withdrawal amount from the annuity. Usually the minimum withdrawal amount is established based on your initial investment, and cannot be reduced, even if the account value of the annuity is reduced by investment losses. Generally, the percentage rate of withdrawal stays the same over time (4%-7%), while the actual dollar amount may increase if the value of the annuity rises. The annual cost for this rider typically will range between .80% and 1.5% of the benefit base or account value.

Guaranteed Minimum Income Benefit (GMIB)

Guaranteed Minimum Income Benefit riders provide guaranteed, consistent income payments in retirement for a set number of years or for life. The guaranteed income benefit base amount is the figure used to calculate the minimum stream of income that is guaranteed to be paid from the contract. The GMIB does require you to annuitize the contract, which means you would turn in your contract for a stream of income. Typically this income option is irrevocable. The annual cost for this rider typically will range between .75% and 1.00% of the benefit base or account value.

Guaranteed Minimum Accumulation Benefits (GMAB)

Guaranteed Minimum Accumulation Benefits (GMAB) protect the invested amount from market loss, by guaranteeing that at a specified time in the future, the entire principal will be returned to the policy owner if the then-current value is less than the original investment. This rider allows the policy owner to be invested investment subaccounts and participate in market gains, while protecting the principal on the downside. The cost for this rider generally ranges between .50% and .95% of the benefit base or account value.

Long-term Care Rider

Some contracts offer the option of purchasing a Long-term Care rider (subject to medical underwriting) which could provide a multiple amount of the contract value to pay for qualified long term care expenses whether in a facility or in the home. Any qualified LTC benefits received would typically be income tax-free* if needed for care, however the cost of the rider may reduce the cost basis of the non-qualified annuity contract. Rider costs are deducted from the contract value and will vary based on the specific contract, provisions, and age of the policy owner.

**Long-term care reimbursements are generally income tax-free under IRC Section 104(a)(3). Nonqualified assets represent your after-tax investments.*

Nursing Home Enhancements

Nursing home waivers are available on some contracts to allow access to contract values without the surrender charge being assessed, in the event the policy owner needs nursing home care. In addition, some contracts that have GMWB riders that allow an additional withdrawal percentage if nursing home care is needed by the policy owner. Medical underwriting is typically not required for these benefits, however there may be specific contract restrictions.

Death Benefit

With a variable annuity, the policyowner can name a direct beneficiary to receive the annuity death benefit upon death of the annuitant. There are usually several death benefit options which can be chosen at policy issue.

- **Guaranteed Minimum Death Benefit (GMDB):** The GMDB will typically ensure that named beneficiaries will receive, at a minimum, the amount invested into the annuity with no additional charge. Keep in mind that any distributions will reduce the death benefit by either a dollar-for-dollar or percentage basis.
- **Annual Step-up Death Benefit Rider:** If the policy has an annual step-up rider, then on the policy anniversary date, the insurance company takes a snapshot of your account value, either the account value or the highest anniversary value, less any withdrawals. The annual cost for this rider will typically range from .20%-40%.
- **Enhanced Death Benefit Rider:** The enhanced death benefit rider allows the beneficiaries to receive a death benefit equal to the greater purchase payments compounded annually at a fixed rate-of-return, or the highest anniversary value, less any withdrawals. The annual cost for this rider will typically range from .60%-1.30%.

Fees and Charges

Because of their insurance features, variable annuities generally have higher costs than traditional investments that do not have insurance features. It is important to understand the charges before you invest. These charges will reduce the value of the account and the return on your investment. Fees and charges vary by contract, and you should review the contract's prospectus for details. Following is a discussion of some of the typical charges that you may encounter when purchasing an annuity.

Surrender charges

If you withdraw money from a variable annuity within a certain period after a purchase payment (typically within four to eight years, but sometimes as long as ten years), the insurance company usually will assess a "surrender" charge, which is also called a contingent deferred sales charge. The first year percentage charge often equals the number of years (surrender period) the charge is in effect with the percentage decreasing each year consistent with the number of years left in the surrender period. For example a variable annuity with a 7-year surrender period, may have a first-year charge of 7%, a second year charge of 6% a third year charge of 5%, and so on until the surrender charge is 0%. Typically, contracts will allow you to withdraw 10% of your account value without paying a surrender charge.

Mortality and expense risk charge

This charge compensates the insurance company for insurance risks it assumes under the annuity contract. This charge is equal to a 1% to 2% per year of your account value.

Administrative fees

The insurer may deduct charges to cover record-keeping and other administrative expenses. These fees may be charged as a dollar amount (perhaps $25 or $30 per year) or as an expense ratio (typically around 0.15% per year).

Underlying Fund Expenses

You will also indirectly pay the fees and expenses imposed by the subaccount investment options for your variable annuity.

Fees and Charges for Other Features

Special features and optional riders offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges. See the companies policy prospectus for details.

The Right Mix

When considering a variable annuity, think about how your money is invested, and whether or not you're finding the right balance for retirement. Certificate of Deposits and savings accounts can provide you with the protection against risk, but their rate of return may not keep up with inflation, especially if you end up living a long life. Conversely, mutual funds and brokerage accounts may deliver better returns, but how much of your assets are you willing to expose to market volatility? Simply put, for additional fees, variable annuities may offer protection, growth potential, and can generate lifetime income to help meet the challenges of a long-term retirement. Many times, the appropriate choice involves using a combination of various strategies and investments. Factors such as your investment objectives, risk tolerance, time horizon, and liquidity needs should all be included in the decision on whether or not annuities, as well as other investment vehicles, make sense for you. Your Benjamin F. Edwards Financial Advisor, along with your other tax and legal advisors, can help you consider if an annuity fits your financial situation.

Guarantees are backed by the claims paying ability of the insurance company.

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One North Brentwood Boulevard, Suite 850 | St. Louis, Missouri 63105 | 314-726-1600 | benjaminfedwards.com