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Equity-Index Annuities

What is an Equity-Index Annuity?

While technically classified as a fixed annuity, an equity-indexed annuity (EIA) can be described as a hybrid of a fixed annuity and a variable annuity, having some characteristics of both, and falling in between regarding the potential for return and level of risk.

With a traditional fixed annuity, the annuity issuer guarantees both the rate of return and the payout. Investors in fixed annuities elect safety of principal and guaranteed returns over market risks and the potential for higher returns.

With a variable annuity, on the other hand, the rate of return varies according to the performance of the investments you choose from those offered by the issuer (these investments are often called subaccounts). With the exception of a guaranteed subaccount, variable annuities don't offer any guarantees on the performance of the subaccounts. You assume all the risk related to those investments including the risk that you may lose principal. In return for assuming a greater amount of risk, investors in variable annuities have a greater potential for growth in earnings.

EIAs take the middle ground, offering limited downside risk balanced by limited upside potential for returns. They offer safety of principal, and generally a minimum rate of return (provided the EIA is held for the full term). EIAs also offer the potential for higher

returns by tying interest paid to the performance of a stock index.

Caution: Guarantees are subject to the claims-paying ability of the annuity issuer.

How do EIAs work?

In general

As with fixed and variable annuities, an EIA is a contract between you and an insurance company, in which you pay premiums and the issuer promises to make periodic payments to you in the future. You can pay premiums by making one lump-sum payment or by paying in installments over time. The periodic payments to you from the issuer can begin immediately (an immediate annuity) or be deferred (a deferred annuity) until a later date.

What makes EIAs unique is that they offer a minimum guaranteed interest rate (typically 3 percent), but allow for the possibility of higher earnings by linking the interest rate calculation to the performance of an equity index. Interest is calculated using a formula based on changes in the index. The terms of the EIA contract dictate how interest is calculated and when it is credited.

Tip: An index tracks the performance of a specific group of stocks or bonds in a specific segment of the market or in the entire market. Some well-known indexes include the New York Stock Exchange

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Composite Index, S&P 500, American Stock Exchange Composite Index, and Dow Jones Industrial Average.

Caution: Unlike with variable annuities where the buyer's money is directly invested in the subaccount portfolios, buyers of EIAs are not directly invested in the index or the equities comprising the index. The index is merely the instrument used to measure the gain or loss in the market, and that measurement is used to calculate the interest rate.

Many variations

Today, there are many variations on the EIA concept. Many new EIA types have developed since the original EIA was introduced. Each type has its own (sometimes subtly unique) features, all of which can affect your return. Key features (discussed in greater detail below) include:

- Term
- Participation rate
- Interest rate cap
- Administration or asset fee (also known as margin or spread)
- Indexing method

It's important that you understand the individual features of an EIA if you want to compare the returns among different EIAs, and choose the one that best meets your needs.

Key EIA features

Term

The term refers to the holding period or the period over which interest is calculated. Terms vary from one to several years. Some EIAs offer

single terms while others offer multiple, consecutive terms. Some EIAs credit interest at the end of a term only. With others, a percentage of the interest is vested or credited annually or periodically. Further, some EIAs pay simple interest while others pay compound interest. These features are important not only because they affect the amount of your return, but also because having interest vested or credited to your EIA periodically instead of at the end of the term increases the likelihood that you'll receive at least some interest if you surrender your EIA before maturity.

Tip: Multiple term EIAs usually allow you 30 days at the end of each term to withdraw your money without penalty.

Participation rate

The participation rate determines how much of the associated index's gain will be used to calculate the interest rate. For example, if the participation rate is 90 percent and the index the EIA tracks increases 8 percent, the interest rate would be 7.2 percent ($8 \times .9 = 7.2$).

Participation rates vary among EIAs, but rates of 70 percent to 90 percent are typical. You should consider the participation rate in light of other features offered by a particular EIA; a lower or higher participation rate may be offset by other features.

Interest rate caps

The interest rate cap, or cap rate, is the maximum rate of interest the EIA can earn. If in the above example the cap rate was 6.5 percent, the interest rate would be 6.5 percent, not 7.2 percent. Not all EIAs have interest rate caps, and again, you should consider any

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interest rate cap in light of other features offered by the EIA.

Administration or asset fees (margin or spread)

Some EIAs have an administration or asset fee (sometimes called margin or spread) instead of, or in addition to, the participation rate. The administration fee is a percentage that is subtracted from the index's gain. For example, if the administration fee is 2 percent and the index increases 8 percent, the interest rate would be 6 percent ($8 - 2 = 6$). If there is also a participation rate of 90 percent, the interest rate would be 5.4 percent ($[(8 - 2) \times .9 = 5.4]$).

Caution: Most EIAs count index gains from market price changes only and do not include dividends.

Caution: When considering an EIA, you should note whether the issuer is allowed to change the participation rate, interest rate cap, and/or administration fee. A decrease in your participation rate or interest rate cap, or an increase in the administration fee could result in lower returns.

Indexing methods

In general

The indexing method is the approach used to measure the gain (or loss), or change, in an index.

The point-to-point or European method

The point-to-point or European method compares the value of the index at the beginning of the term to its value at the end of the term, disregarding fluctuations in between. This is the simplest method. With this method, interest may not be credited to your annuity until the end of the term. If you surrender your EIA early, you may not receive any interest for that term.

Example(s): John buys an EIA linked to the S&P 500 that uses the point-to-point method. The term is seven years. On the date of issue, the index is at 1,000. On the maturity date, the index is at 1,100. A gain of 10 percent is realized ($[(1,100 - 1,000) \div 1,000 = .10]$). Assuming a 90 percent participation rate and no other variables, John's EIA earns a rate of interest of 9 percent ($[.10 \times .9 = 9 \text{ percent}]$), which is credited at maturity.

The high-water-mark or look-back method

The high-water-mark or look-back method looks at the index at specific points during the term (e.g., each anniversary date). The highest of these is then used as the end-of-term index level and compared with the index value at the beginning of the term. This could result in a higher interest rate than the point-to-point method if the index has moved downward towards the end of the term. With this method, interest is added to the value of your annuity at the end of the term. If you surrender your EIA early, you may not receive any interest for that term.

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Example(s): John buys an EIA linked to the S&P 500 that uses the high-water-mark method. The term is seven years. On the date of issue, the index is at 1,000. The index on the EIA's anniversary date for the next six years is as follows: Year 1 = 1,050, Year 2 = 1,150, Year 3 = 1,050, Year 4 = 1,000, Year 5 = 950, Year 6 = 900, and on the seventh anniversary, at maturity, the index is at 850. The index at the high water mark is 1,150. A gain of 15 percent is realized ($[1,150 - 1,000] \div 1,000 = .15$). Assuming a 90 percent participation rate and no other variables, John's EIA earns a rate of interest of 13.5 percent ($.15 \times .9 = 13.5$ percent).

Annual reset or ratchet method

This method compares the index from the beginning to the end of each year. Interest is added to the value of your annuity at the end of each year. Once credited to your annuity, the interest is locked in. The beginning index value is reset at the end of each year, so future decreases do not affect the interest already earned. With this method, you are more likely to receive some interest in the event you surrender your EIA early. However, you are also more likely to have a lower participation rate, and/or a participation rate that changes annually.

Example(s): John buys a \$100,000 EIA linked to the S&P 500 that uses the annual reset method. The term is three years. On the date of issue, the index is at 1,000. The index on the EIA's first anniversary is 1,100. A gain of 10 percent is realized ($[1,100 - 1,000] \div 1,000 = .10$). Assuming a 90 percent participation rate and no other

variables, John's EIA earns a rate of interest of 9 percent (10 percent $\times .9 = 9$ percent), which is credited at the end of the first year. At the beginning of Year 2, John's EIA is valued at \$109,000 ($\$100,000 + .9 (\$100,000) = \$109,000$) and the index resets to 1,100. The index on the EIA's second anniversary is 1,150. A gain of 4.5 percent is realized ($[1,150 - 1,100] \div 1,100 = .045$). Assuming a 90 percent participation rate and no other variables, John's EIA earns a rate of interest of approximately 4 percent (4.5 percent $\times .9 = 4.05$ percent), which is credited at the end of Year 2. At the beginning of Year 3, John's EIA is valued at approximately \$113,360 ($\$109,000 + .4 (\$109,000) = \$113,360$) and the index resets to 1,150. At the end of Year 3, the maturity date, the index is at 1,050. No gain is realized ($1,050 - 1,150 = 0$ gain) and no interest is credited to John's EIA. Over three years, John's EIA has earned \$13,360 or 13.36 percent.

Averaging or Asian method

The averaging or Asian method involves averaging several points of the index to establish the beginning and/or ending index value. For example, the index's value at the end of each month for 12 months may be added together and divided by 12. Averaging can protect you against sudden declines in the index, but may also reduce returns if the market increases.

Example(s): John buys an EIA linked to the S&P 500 that uses the averaging method. The term is seven years. On the date of issue, the index is at 1,000. The index on the EIA's anniversary date for the next six years

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is as follows: Year 1 = 1,050, Year 2 = 1,100, Year 3 = 1,050, Year 4 = 1,100, Year 5 = 1,150, Year 6 = 1,150, and on the seventh anniversary, at maturity, the index is at 1,150. The index's average over the seven-year term is 1107 $([1,050 + 1,100 + 1,050 + 1,100 + 1,150 + 1,150 + 1,150] \div 7 = 1107)$. The interest rate used will be 11.07 percent

What are the advantages of EIAs

EIAs offer the same benefits as traditional fixed annuities, including:

- Tax-deferred growth
- No annual contribution limits
- Guaranteed death benefits for beneficiaries
- No mandatory distributions after age 70½
- Option of guaranteed income for life through annuitization
- Limited penalty-free annual withdrawal potential
- Avoidance of probate
- EIAs also offer other benefits, including:
- Safety of principal and guaranteed minimum returns (provided the EIA is held for the full term). Combined with
- Potential for higher index-linked returns

Caution: Guarantees are subject to the claims-paying ability of the issuer.

What are the disadvantages of EIAs?

EIAs generally have the same disadvantages as traditional fixed annuities, including:

- You pay premiums with after-tax dollars (a disadvantage when compared to deductible traditional IRA contributions and pretax contributions to employer-sponsored retirement plans)
- When withdrawn, earnings are taxed at ordinary income tax rates; lower capital gains tax rates won't apply
- Withdrawals made prior to age 59½ are generally subject to a 10 percent penalty tax
- Surrender fees charges in the early years of the annuity
- Further, EIAs have these additional disadvantages:
- Participation in market increases is limited
- Feature variations can make comparisons among EIAs challenging

Questions and answers

When are annuities particularly appropriate?

Generally, EIAs may be appropriate if you are planning for retirement and you:

- Have contributed the maximum to your employer-sponsored retirement plan (e.g., 401(k) plan) and IRA and want additional tax-deferred investments
- Desire death benefits
- Can keep the annuity long-term
- Expect to be in a lower income tax bracket when you retire
- Desire a guaranteed income in retirement

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Can I get my money early?

Getting out of your EIA early may mean taking a loss, especially if your annuity does not credit interest until the end of the term. Many EIAs have surrender charges in the early years of the contract, which can be a percentage of your withdrawal or a reduction in interest rate. Further, like any annuity, withdrawals made before you reach age 59½ are generally subject to a 10 percent penalty tax. You should only consider an annuity as part of a long-term accumulation strategy.

How are EIAs taxed?

As with any nonqualified annuity, your premiums are paid with after-tax dollars, which is why you should generally consider them only if you have contributed the maximum to your 401(k) plan and IRA. However, interest earned is tax deferred until it is withdrawn (but is taxed as ordinary income when taken).

Disclosures – Important – Please Review

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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