UNDERSTANDING THE INSURANCE INDUSTRY

KAPLAN FINANCIAL EDUCATION

The Insurance Industry

The insurance industry plays an important role in society. The majority of American households own some form of life insurance. In 2010, the average face amount of a newly purchased individual life insurance policy was $165,291. In that same year, purchases of life insurance, both individual and group, equaled $2.9 trillion. Most new life insurance policies are purchased by individuals from life insurance agents. According to the American Council of Life Insurers 2011 Life Insurers Fact Book, life insurance in force in the United States at the end of 2010 totaled $18.4 trillion, a 2% increase over 2009. In addition, the underwriting of annuities is receiving ever-increasing emphasis by many insurance companies. Measured by premiums written in 2010 by the life and health insurance industry, annuities led the way, accounting for 51% of the total, followed by accident and health insurance with 30%, and life insurance with 18%.

Insurance Products and the Consumers

Until the late 1970s, life insurance was a two-product world. Determining which product a consumer needed was easy: whole life was for lifelong needs, while term was for needs of limited duration. Then everything changed. During the late 1970s and early 1980s, in response to an increasingly sophisticated consumer base, an inflationary economy and the perception that life insurance was out of step, the industry created new products with greater market appeal in response to the criticisms leveled against the two-product life insurance world. An impressive lineup of new and innovative insurance products emerged and forever changed the marketing and sales of life insurance.

Consumers no longer need to settle for an either/or choice for life insurance protection. Universal life, variable life, variable-universal life, and numerous variations of whole life and term life now provide great flexibility. At the same time, these options complicate the decision to be made by the consumer, whose timeline or ability to pay a premium no longer determines the protection needed. Today's products demand more input from the consumer and more guidance from the agent in selecting the right plan of protection and making sure that plan is suitable. In fact, suitability has emerged as perhaps the most significant aspect of the agent's market conduct.

Licensure

Insurance sales agents must obtain a license in the states where they plan to work. Separate licenses are required for agents to sell life and health insurance and property and casualty insurance. In most states, licenses are issued only to applicants who complete specified prelicensing courses and who pass state examinations covering insurance fundamentals and state insurance laws. The insurance industry is increasingly moving toward uniform state licensing standards and reciprocal licensing, allowing agents who earn a license in one state to become licensed in other states more easily. Most state licensing authorities also have mandatory continuing education requirements focusing on insurance laws, consumer protection, ethics, and the technical details of various insurance policies. As the demand for financial products and financial planning increases, many insurance agents, especially those involved in life insurance, are choosing to gain the proper licensing and certification to sell securities and other financial products. Doing so, however, requires substantial study and passing an additional examination—either the Series 6 or Series 7 licensing exam—both of which are administered by the Financial Industry Regulatory Authority (FINRA). The Series 6 exam is for individuals who wish to sell only mutual funds and variable annuities, whereas the Series 7 exam is the main FINRA series license that qualifies agents as general securities sales representatives.

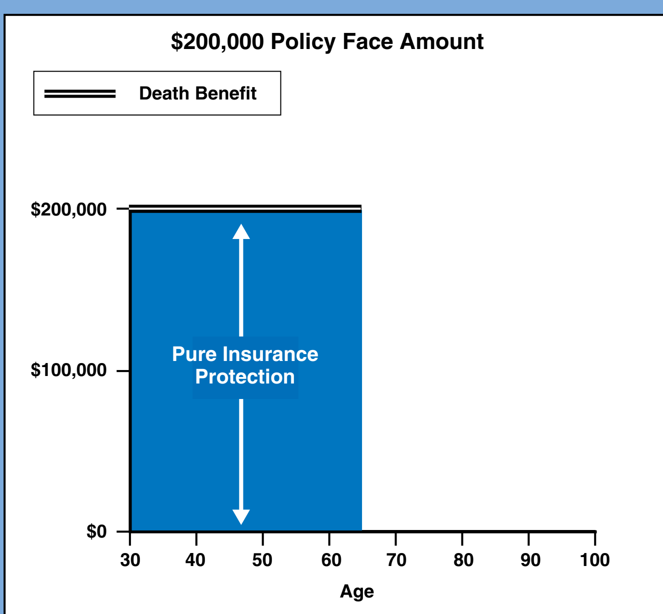
What is Term Life?

Term life insurance provides insurance protection for a specified period of time and pays the face amount as a benefit, only if the insured dies during that period. Generally, term is the least expensive and least complicated life insurance policy. It is "pure" insurance protection. It does not have a cash value, which explains the low cost of term relative to permanent life insurance.

Term life insurance is fairly easy to understand. Assume, for example, Larry purchases a five-year, $100,000-level term policy on his life, naming his sister, Loretta, the beneficiary. If Larry dies at any time during the policy's five-year period, Loretta will receive the $100,000 death benefit. If Larry lives beyond the five-year period, nothing is payable; the policy's term has expired. There is no residual value or cash value. When the coverage period expires, so does the protection.

Term insurance is similar to renting a home. When renting, an individual can use the home and everything that goes with it but only for as long as the lease allows. At the end of the lease, the renter may have the option to renew, but usually for a higher price. The renter does not build equity in the home and the lease has no value when it ends.

ILL. 2.1 ▪ Level Term Life Insurance



The term insurance plan illustrated is a $200,000 term to age 65 policy. The insured has a level $200,000 worth of coverage until age 65, after which the policy—and its benefits—expire.

Term of Coverage

The period for which term policies are issued may be defined by a number of years (one-year term, 10-year term, 15-year term, 20-year term) or it can be issued in relation to the insured's age (term to age 45, term to age 50, term to age 65). The selection of the proper period depends on how long the individual needs the protection.

Type of Death Benefit

Term insurance is also available with various death benefits or face amount options. A term policy can provide a level, decreasing or increasing, face amount.

Level Death Benefit. Level term insurance provides level death benefit protection for a specified period, after which the policy expires. A $100,000, 10-year level term policy provides exactly that: $100,000 of coverage for 10 years. A $250,000 term-to-age-65 policy provides $250,000 of coverage until the insured reaches age 65. If the insured under the $100,000 policy dies at any time within those 10 years, or if the insured under the $250,000 policy dies before age 65, their beneficiaries will receive the specified face amounts. If the insured live beyond the 10-year period, or past age 65, respectively, the policies expire and no benefits are payable.

Decreasing Death Benefit. Also available are term insurance policies that provide a death benefit that decreases gradually over the term of protection. They are used to cover needs that decline over time. A 20-year, $100,000 decreasing term policy, for example, will pay a death benefit of $100,000 at the beginning of the term; that amount gradually declines over the 20-year term and reaches zero at the term's end.

Decreasing term insurance is best used when the need for protection declines from year to year. For example, a family breadwinner who has a $100,000, 30-year mortgage could purchase decreasing term insurance that would retire the mortgage balance should the insured die during the 30-year mortgage paying period. A decreasing amount of life insurance coverage matches the similarly decreasing amount of the debt so that if the insured dies at any point during this period, the amount of insurance in force should equal the balance left on the mortgage. Decreasing term life that protects mortgages and loans is commonly known as "credit life insurance."

Increasing Death Benefit. Increasing term insurance provides a death benefit that increases at periodic intervals over the policy's term. The amount of increase is usually stated as specific amounts or as a percentage of the original amount. It also may be tied to a cost of living index, such as the Consumer Price Index (CPI). Increasing term may be sold as a separate policy but is usually purchased as a rider.

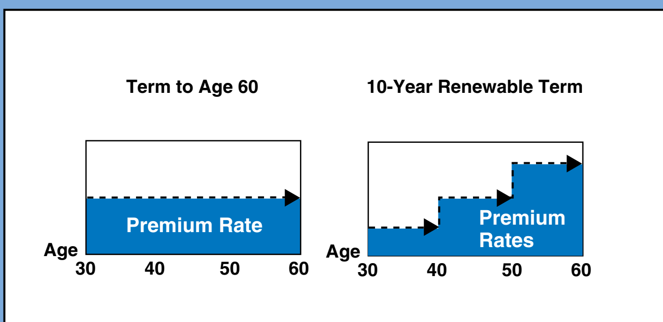
Increasing term is used to provide the death benefit increases that arise through so-called cost-of-living-adjustment riders. The rider is frequently supported by an increasing term policy, piggybacked onto an underlying permanent life insurance policy.

Renewability and Convertibility

All term policies are issued with an expiration date. However, almost all insurers offer term plans that allow the policyowner to lock in the ability to continue coverage for another term or under a different policy without having to provide evidence of insurability. Clients often overlook the critical fact that their insurability could change. If a term policy is allowed to expire and there is no renewal or conversion feature, then the policyowner would have to reapply for coverage. If the policyowner is found to be uninsurable, coverage will be denied.

The capability to extend the coverage of a term policy is available through two options: the option to renew and the option to convert. Some term policies may offer both; others may offer only one.

ILL. 2.2 ■ Level Term Premium vs. Renewable Term Premium



A term to age 60 policy, issued at the insured's age 30, has premiums that are fixed and level over the 30-year term period. A 10-year renewable policy of the same amount, issued at the insured's age 30, will have premium increases at each of the renewal periods.

Option to Renew

A term policy's option to renew allows the policyowner to renew the coverage—usually for the same face amount—for another term of protection. This can be done regardless of the insured's health at the time of renewal. Typically, a policy's renewal option sets a limit on the number of renewals a policyowner may use or an age at which the option to renew will cease. Policyowners who underestimated the length of time for which they need protection or who had intended to convert but find themselves financially unable or unwilling to do so can continue their protection under the renewal option.

The renewal of a term policy requires the policyowner to pay the premium appropriate for the age attained upon renewal.

Option to Convert

A term policy that contains an option to convert allows the insured to convert or exchange the term insurance for permanent life insurance, without evidence of insurability. Thus, if the insured develops an illness or faces a situation that would prevent him or her from obtaining insurance altogether, he or she can opt to convert to coverage that cannot be canceled and will not expire. The conversion involves the issuance of a permanent policy at a premium rate reflecting the insured's age at either the time of conversion or the time when the original policy was purchased.

The option to convert generally specifies a time limit for converting, such as three or five years before the policy expires.

Term Life Premiums

Compared to other types of life insurance policies, term represents the lowest cost per $1,000 of face amount and, at least at younger ages, it carries the lowest premium. One reason is that it is pure insurance only. However, the cost of that pure insurance increases steadily with age, because the premium amount for any insurance plan reflects, in part, the degree of risk the insurer accepts when it issues a policy and age is a significant risk factor (the higher the age, the more likely death becomes). Term premiums reflect this rising cost.

The price of any insurance policy is based, in part, on the insured's age at issue. The older the insured, the higher the cost. At younger ages, term insurance has the lowest premiums and can provide more coverage for the same premium outlay than whole life insurance. However—and this is a critical factor that clients must understand—the cost of term insurance increases with each renewal. Though level for the duration of each term, it can become unaffordable at older ages.

Advantages of Term Life

- Term insurance plans are easily explained and understood.
- Term insurance carries the lowest cost per $1,000 of face amount at issue.
- Because it is pure insurance protection only, it is simple, basic, and to the point.
- Initially, premiums are lower than those of permanent insurance plans, which allows purchase of greater amounts of coverage at younger ages. For many people, this is when their need for protection is greatest.
- If the policy offers a renewal or a conversion feature (which most do), the policyowner's insurability is locked in.
- It provides an economical and sure way to supplement other coverages when financial responsibilities loom largest. This would include, for example, while the mortgage is still being paid, while children are young, before college tuitions have been paid, and when a family faces large debts.
- Because it is available for limited and specified periods, it offers a good way to cover specific needs that will disappear in time (such as the mortgage or college tuition).
- As with all insurance plans, death proceeds paid to the insured's beneficiaries are income tax-free.

Disadvantages of Term Life

- Premiums generally increase with age. For many, term insurance is unaffordable later in life.
- There is no cash value element with term insurance so there is no tax-advantaged savings or accumulation associated with the product.
- Once the policy's term expires (unless the product is renewed or converted), the insurance coverage ceases and the policy has no further value.

A term policy would be hard pressed to cover the protection needs of an individual and his or her family for their entire lives. While term may be perfectly suitable early on, its increasing cost could make it prohibitive down the road. Clearly, discovering at age 60 or 65 that one can no longer afford life insurance presents a serious problem. Just as the need for life insurance coverage becomes most apparent, it falls out of reach of many budgets.

When is Term Life Suitable?

By providing pure protection against death only, term insurance can fill an essential need when properly used. Many situations exist where term insurance may offer the most appropriate solution, notably in cases where the need for protection is of short duration and funds are limited. Some common examples of personal needs include:

- when you do not have a need (or desire) for anything other than pure insurance protection;
- when you have only a temporary need for life insurance protection and will have no other insurance need after the term period expires;
- when permanent insurance is preferable but not feasible (maybe you are just beginning a career or family and can't afford the cost of permanent protection but could benefit by purchasing term with the ability to convert to a permanent plan at a later point;
- when you need a large amount of insurance but only for a specified period of time;
- when you need to protect a yet-to-be-realized savings or accumulation goal (this might include saving for a child's education, paying off the mortgage, or settling some other large debt);
- you need coverage until you can build enough assets to meet your obligations on their own;
- you need additional coverage to supplement an existing plan at the lowest possible cost; and
- you are willing to pay a higher premium to extend coverage beyond the initial term period.

Term life insurance may also be suitable for certain business or business-related needs. These might include:

- covering speculative business enterprises that would absorb much of the client's available resources for a finite period of time;
- covering the life of a key employee (owner or nonowner) until the employee retires;
- providing a business owner's heirs with the financial resources to buy back the owner's stock at his or her death;
- covering outstanding business loans or other short-term obligations; and
- providing an attractive employee benefit.

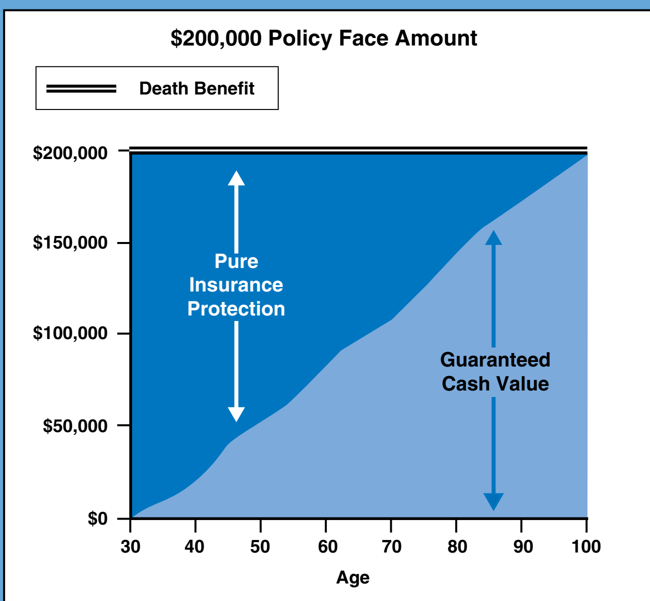
You Must Understand . . .

- Coverage may expire before death occurs.
- Future coverage may not be available without an insurability option.
- The entire premium represents payment for pure insurance.
- There is no cash value accumulation and that, once the policy expires, it has no more value.
- There is no savings element from which a loan or withdrawal can be taken.
- The option to renew or convert must be exercised to continue coverage beyond the original term.
- A renewed or converted policy will require an increase in premium.

What is Whole Life?

Whole life insurance provides permanent protection for the "whole of life": from the date of issue to the date of the insured's death, provided premiums are paid. The death benefit payable is the face amount of the policy, which remains constant throughout the policy's life. Premiums are set at the time of policy issue and they, too, remain level and fixed for the policy's life.

ILL. 3.1 ▪ Whole Life Insurance



In a whole life policy, the level death benefit equals the face amount from the time the policy is issued. The cash value is guaranteed to grow at a specified rate throughout the policy's life. When the insured reaches age 100, the cash value equals the face amount.

Features of Whole Life

Whole life insurance policies provide the following "living benefits":

Cash Values

Whole life insurance combines pure insurance protection with an accumulation element—the policy's cash value, which builds over the life of the policy. With whole life, the cash value is credited with a rate of interest that is fixed and guaranteed within the contract.

Maturity at Age 100

A whole life policy matures when the cash value has grown to completely replace the pure insurance protection: at policy maturity, the cash value equals the face amount. Whole life insurance is actuarially designed to mature at age 100.

Level Premiums

Reflecting the cost for mortality, an assumed rate of interest and insurer expenses, the premium for a whole life insurance policy is actuarially calculated (in part) on the basis of the number of years between the insured's age at issue and age 100. Not all whole life insurance plans require lifetime premium payments; most insurers offer limited pay policies that reduce the premium paying period to one that suits the policyowner's needs and circumstances.

Dividends

Many life insurers (most notably mutual companies that are owned by their policyholders rather than stockholders) issue a form of whole life insurance that features a return of "excess" premium as a policy dividend. Premiums for these kinds of policies are generally higher; policy dividends reflect this increase plus a share of any gain the insurer might have experienced in its operation or claims experience. In this way, owners of these kinds of policies "participate" in the operation of the company and may receive a partial return of premium when there is a surplus. Accordingly, these types of policies are often referred to as participating (or par) policies. Policy dividends are never guaranteed.

Whole Life Options

Whole life policies contain options called nonforfeiture, limited payment, loan, and exchange options and, for some policies, an accelerated death benefit option.

Nonforfeiture Options

A whole life policy's cash value belongs to the policyowner. A whole life policy's nonforfeiture provision spells out the options the owner has with regard to these values if he or she cancels or surrenders the contract. If a policy is canceled or surrendered, the owner may take or apply the cash value in any of the following ways: in cash; to purchase a reduced amount of paid-up whole life insurance, payable upon the same conditions as the original policy; or to provide term coverage in the same amount as the original policy.

Loan Options

Most whole life policies contain a provision that allows policyowners to use their cash value as collateral for loans from the insurer. The insurer will loan, at a rate specified in the policy, an amount up to the accumulated cash value. The money does not have to be repaid; the loan will never be "called" by the insurer. Policy loans do not require credit checks or impose other restrictions. However, any outstanding loan amounts, plus interest, would be deducted from the death benefit before it is paid out. If ever the indebtedness exceeds the policy's cash value, the policy is terminated.

Limited Payment Options

Most insurers offer whole life insurance plans on a limited payment basis, where the premium payment period is less than the insured's lifespan. In other words, a limited pay life policy adjusts premiums to fit a specified payment period. The names assigned to limited pay policies denote their premium paying period. For example, a 30-year-old client who purchases a "life paid-up at 65" policy will pay premiums for 35 years (until age 65) and then have a paid-up policy.

Exchange of Plan Option

Many whole life policies contain a provision that allows the owner to exchange the policy for another form of permanent insurance.

Accelerated Death Benefit Option

The accelerated death benefit option allows for the "early payment" of a certain portion of the death benefit to the insured if he or she is struck by a catastrophic illness, enters a nursing home, or is diagnosed as terminally ill. Under these circumstances, up to a specified amount of the policy's face will be paid to the insured while he or she is alive; at death, the balance is paid as a death benefit to the beneficiaries.

Advantages of Whole Life

- It offers guaranteed, lifetime insurance protection. As long as the insured lives, no matter the state of his or her health, the protection is available.
- It eliminates the problem of future uninsurability.
- Premiums are fixed, level, and guaranteed; they will not increase with age.
- Over time, whole life may be more economical than term because premiums do not increase and it builds a cash value.
- The death benefit is guaranteed.
- The cash value account is guaranteed to grow at a specified rate.
- The cash value is accessible to the policyowner during life and can be used for any purpose. After a certain point, if there is no longer a need for insurance coverage, the values can be taken in cash. If insurance protection is still needed, the values can be used to provide continued coverage (in a different form or amount) and relieve the owner of further premium payments.
- Cash value accumulations are not subject to income tax.
- The policy's cash value can serve as a source of low-cost loans for any need.
- It can be purchased with a premium-paying period that conforms to the policyowner's needs and capabilities.
- The death benefit may be accessible during life if the insured is faced with catastrophic or terminal illness.
- Of permanent life insurance plans, it is the most basic. As long as the policyowner understands the product and is committed to its long-term guarantees, there's little to manage.
- Of permanent life insurance plans, it contains the most guarantees. With traditional whole life, there are no surprises.

Disadvantages of Whole Life

- It is probably the least flexible permanent life insurance plan.
- It is more expensive than term, at least initially.
- If the policy is cashed in within the first few years, the result is economic waste.
- There is no opportunity to adjust the face amount or the premium payment (unless the policy is surrendered and a nonforfeiture option is elected).
- The premium commitment is fixed. Premiums must be paid in the scheduled amount, by the scheduled due date, to avoid policy lapse.
- The rate of return on cash values, because of the long-term guarantees, is usually lower than that available with pure investment products or other kinds of permanent life insurance plans (universal life or variable life, for example).
- It requires the owner to understand and accept the long-term nature of its financial guarantees and commitments.
- Any loans or unpaid loan interest would be deducted from the policy's proceeds at death, which might leave beneficiaries unprotected.

When is Whole Life Suitable?

Once an insurance need is established, the next step is to analyze that need: is it temporary or permanent? If the need for protection will exist for a relatively short period of time (for example, 10 years or less), it's doubtful that anything but a term policy would be suitable. For longer periods, the situation becomes less clear. As the length or duration of the insurance need increases, an argument in favor of whole life gains increasing credibility. This is where the detail from the fact-finder will help. What are the client's objectives? What other goals could be supported by whole life insurance? Again, if protection is the only need, a level term policy—even of long duration—is suitable. But if the client has other needs, a whole life policy might prove to be the better answer. This is especially true for the upper-income client who could benefit from the product's unique planning applications and its structured guarantees and stability.

Though the following list is by no means inclusive or exact, a whole life policy might be a suitable insurance option:

- when the client wants or needs lifetime protection;
- when the client wants assurance of coverage whether he or she dies at a ripe old age or next week;
- when the client wants or needs fixed, unchanging premium payments;
- when the client prefers the safety and the assurance of the product's guarantees;
- when the client wants or needs a policy with the ability to build cash values steadily at an assured rate;
- when the client anticipates a specific need at a specific future point;
- when the client likes the idea that premiums will never increase;
- when the client likes the idea that the cash values represent a source of ready funds;
- when the client will have the need for additional income during retirement;
- when the client's protection needs will not diminish over time and the client will need money for estate settlement costs and taxes;
- when the client's protection needs will continue late in life or when the purchase of term might not be feasible (due to cost or insurability);
- when the client wants to leave an estate to heirs;

- when the client has other long-term financial goals that can be supported by the policy's cash value (college funding, for example);
- when the client needs permanent protection but does not want or desire to "manage" the policies or coverage;
- when the client needs permanent protection but does not want the proceeds dependent on the ups and downs of the market;
- when the client's only existing coverage is term life through an employer, which may not be available after retirement; and
- when the client is attracted to the idea of the insurance premiums pulling "double duty" (that is, providing guaranteed insurance protection and contributing to a guaranteed future cash accumulation fund).

Combination Plans

For many individuals, the most suitable product for their insurance needs will turn out to be whole life, but the cost may be more than they can afford. In these cases, the practitioner could recommend a combination of term and whole life or the purchase of term that could be converted gradually into whole life. An individual who needs $300,000 worth of insurance, for example, could purchase a term policy for that amount and later convert $50,000 or $75,000 of it into whole life, keeping the remainder of the term coverage for conversion.

You Must Understand . . .

- The primary reason a client would be making the purchase is for insurance protection.
- The commitment is long-term and the product is not designed (or priced) for short-term needs.
- Continued payment of premiums is required to keep the insurance in force.
- The cost of the protection, at least initially, is more expensive than term.
- A portion of each premium payment funds the net amount at risk or pure insurance protection element.
- A portion of each premium payment funds the cash value.
- The decision to purchase should not be made on a rate-of-return basis.
- The premiums and face amount are fixed.
- The policy's cash value and face amount are not the same.
- The interest rate credited to the cash value account, though guaranteed, is unlikely to match what could be earned with a pure investment product.
- Dividends, if payable, are not guaranteed.
- Dividends, if illustrated, are based on the insurer's current dividend scale and reflect values that are merely projected, not guaranteed.
- A full surrender of the policy in the early years would produce little economic benefit.
- Taking advantage of the loan option would reduce the amount of death benefit unless and until the loan plus interest is paid back.

What is Universal Life?

Universal life is distinguished from whole life by a number of factors. From the consumer's perspective, the most notable difference is premium flexibility. Unlike whole life, universal life does not require a fixed schedule of unchanging premium payments; they are completely flexible. The only time a fixed level of premiums is required is during the first one or two policy years (effectively setting up the "prefunding" needed to initiate the policy); after that, the timing and amount of premium payments is up to the policyowner.

This is made possible by the seemingly simple concept on which universal life relies. Universal life separates the two components of a whole life policy's benefit—the pure insurance net amount at risk and the cash values—and administers them separately. Unlike whole life's guaranteed level death benefit, a universal life policy makes no attempt to maintain a guaranteed death benefit or contractually scheduled cash value accumulation. It permits the pure insurance component to be funded independently of the cash value component.

How a Universal Life Policy Works

A UL policy's operation can be described in simple terms. Here's how a UL policy works.

1. The policyowner selects an initial insurance amount and the type of death benefit option. This option can be either:

– a level death benefit, or

– a death benefit that rises in relation to the policy's cash value.

After a certain period of time from policy issue, the amount of insurance or death benefit option can be changed.

2. Based on the insurance amount and the death benefit option selected, a premium amount and payment schedule is established. A "minimum" premium is required only for the first year or two. Though the insurer recommends a "target" premium level after the initial period, the amount and timing of premium payments are completely flexible. The premium is directed into the policy's cash value or accumulation account.
3. Each month, the insurer credits the funds in the accumulation account with interest. The amount of interest so credited is the "current declared rate" determined by the insurer. This amount fluctuates, based on the current investment and economic environment. In this way, it more closely reflects market rates. Current UL interest rates will vary from crediting period to crediting period, but will never be lower than a minimum guaranteed rate (typically 3 percent to 4 percent).
4. Each month, a charge for the cost of the pure insurance (term) component of the policy plus an expense charge is deducted from the cash accumulation account. To the extent the cash value is sufficient to support these monthly deductions, the insurance remains in force. Consequently, the policy's funding is directly dependent not on the payment of premiums but on the amount in the cash value account. In turn, the amount in the cash value account is dependent on the level and frequency of premium payments and interest crediting. Cash value amounts in excess of the insurance costs and expense deductions continue to earn interest at the rate declared by the insurer.
5. Due to the separation of the pure insurance element and the cash value accumulation element, universal life policies can support partial withdrawals of funds from the cash value account. This is not possible with whole life insurance; accumulated funds in a whole life policy can be accessed only through a loan (with interest) or through complete surrender of the policy. With UL, money can be withdrawn from the cash value without incurring interest and with no obligation to repay the amount.
6. Within specified limits, policyowners can pay more than the target premium.

On a regular basis, the policyowner receives a statement from the insurer outlining the status of his or her policy: premiums paid, expenses charged, interest credited, insurance costs deducted, and cash values accumulated. This full disclosure is unique to universal life and should play a role in the on-going determination of product suitability. The practitioner should take the time to review these statements periodically with policyowners and explain how they illustrate whether the policy continues to provide the benefits and values intended when the product was first purchased.

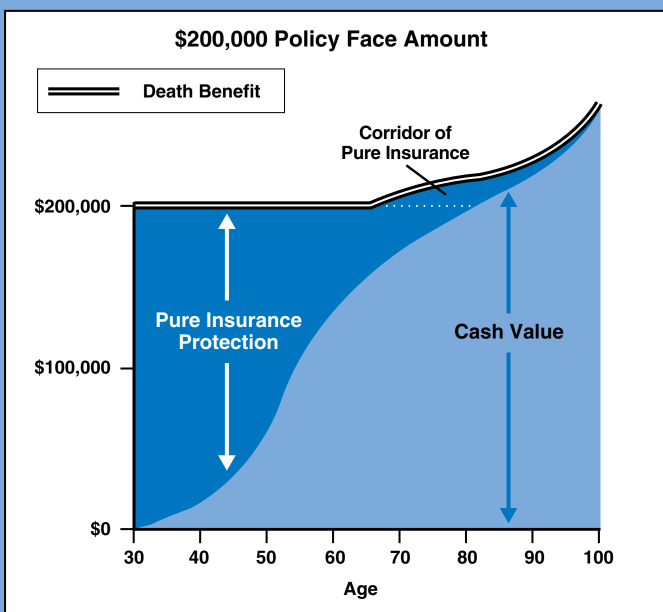
The flexibility of UL offers consumers options that are not available with traditional whole life insurance. The policyowner can adjust the death benefit or premium payments to fit his or her situation. As financial priorities come and go and as different situations present themselves, the flexibility of a universal life policy allows the coverage and cost components to adapt to the owner's needs. This flexibility is one of UL's chief benefits. However, with this flexibility come fewer guarantees. This, in turn, requires the UL buyer to assume a level of risk absent from traditional whole life. Consequently, when evaluating the suitability of a UL policy, it is important to consider a client's understanding of the product's operation and his or her ability to manage the product. Specifically, the practitioner should make sure that the client understands the policy's target premium.

Target Premium

A UL's target premium amount is based, in part, on the insurer's mortality costs and expenses. It also includes an assumption of future investment returns. The higher the return the insurer earns, the greater the amount it will be able to credit to its UL policies. If the actual investment return credited to the policy is in line with what was assumed in determining the target premium and if the target premium is paid consistently, the policy will perform as anticipated. On the other hand, if the actual investment return credited to the policy falls short of what was assumed in determining the target premium, the cash value may not be sufficiently funded to carry the policy, even if targeted premiums are paid. In this case, additional premiums—above and beyond the targeted amount—would be required to keep the insurance in force.

This aspect of universal life is very often misunderstood or its significance overlooked. Suitability standards require that the practitioner makes clear to the customer the effect that changing market conditions may have on a UL policy's premiums. Overall, most insurers take a conservative path when establishing target premiums for their UL policies and the majority represent levels that are sufficient to keep these policies in force for life.

ILL. 4.1 ▪ Universal Life Insurance (Option I)



Under universal life's Option I, the policyowner designates a specified face amount of coverage. The death benefit equals the cash value plus the remaining pure insurance (which is decreasing term). If the cash value approaches the face amount before the policy matures, the insurer will raise the death benefit by increasing the amount of pure insurance—this additional pure insurance is called a "corridor."

Adjustable Benefit

Universal life also offers flexibility with regard to the death benefit. First, the owner selects one of two options at purchase: a benefit that remains level throughout the policy's term (Option I), or one that increases gradually over time in relation to the cash value growth (Option II). Second, after policy issue, that benefit can be increased or decreased at the owner's discretion, with very few limitations. The decision to increase or decrease the benefit amount does not require issuance of a new policy; the insurer simply modifies the existing policy. Third, in most cases, a policyowner can switch from one death benefit option to the other. Consequently, a single UL policy can accommodate changing protection needs without requiring the owner to purchase additional policies. (It should be noted that almost all insurers require the insured to submit evidence of insurability if an increase in the death benefit is requested.)

To differentiate between the two options, consider the following example. Suppose an individual purchases a universal life policy with a face amount of $200,000. Under Option I, the death benefit payable will remain at (or close to) $200,000, as long as target premiums are paid. If the individual chooses Option II, the death benefit will rise in relation to the cash value. If the cash value increases to $15,000, the death benefit will equal $215,000; if the cash value increases to $25,000, the death benefit will be $225,000; and so on.

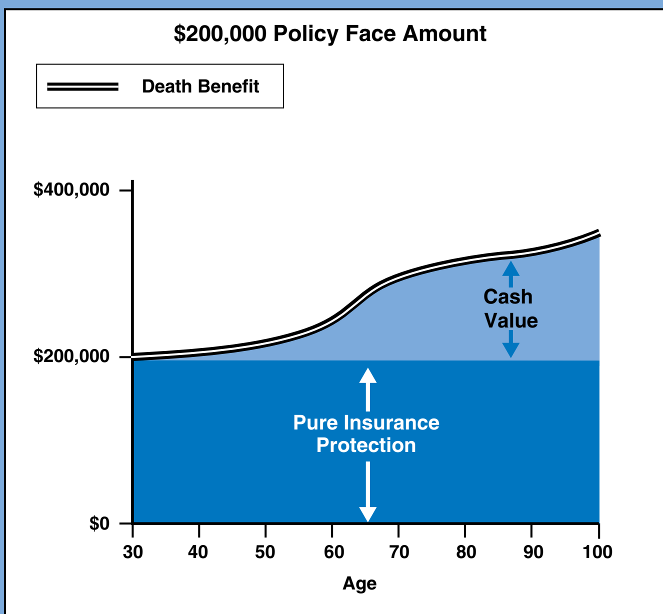
Under either option, the death benefit amount can be increased or decreased as the owner desires. If, for example, a temporary need expires, the policy can be adjusted downward to provide lower benefits. If there is a need for greater protection—after a home has been purchased, for example—the death benefit can be increased (usually after providing evidence of insurability) for as long as needed. An increase or decrease in protection will adjust the amount deducted from the cash value account, but again, as long as the account is sufficient to cover these costs, the insurance remains in force. Consequently, a temporary increase in coverage may not require additional premium payments; in fact, payments might even be suspended for a period of time even after coverage has been increased.

Advantages of Universal Life

- The policy's flexible provisions give owners considerable control over policy values.
- As a permanent plan, coverage extends for the whole of the insured's life.
- Flexible premiums allow owners to adjust payments to fit changing needs and goals.
- Due to flexible funding, policyowners have some control over the growth of cash values.
- As cash values grow, policyowners can decrease or skip premiums as circumstances require.
- Premiums in excess of the cost of insurance contribute fully to the cash value accumulation.
- Cash values grow tax deferred and are easy to access.
- Interest credited to UL cash values is reflective of current (conservative) market conditions.
- A minimum rate of return is guaranteed with most policies.
- Coverage can be adjusted—up or down—as needs change. The death benefit option can be changed to accommodate the desire for greater cash accumulation or an increased death benefit.
- The premium for the policy's protection element is generally lower than whole life.
- Tax-advantaged withdrawals can be taken without interest or the requirement to repay them.
- The ability to take partial withdrawals provides for more flexible liquidity than whole life.

- Policy statements provide full disclosure of costs, coverage, and accumulated values.

ILL. 4.2 ■ Universal Life Insurance (Option II)



Under universal life's Option II, the policyowner designates a specified amount of insurance. The death benefit equals the level amount at risk (pure insurance) plus the cash value.

Disadvantages of Universal Life

- Premiums are more costly than term, at least initially.
- Because premiums are payable at the policyowner's discretion, the amount of the death benefit cannot be guaranteed for the life of the policy.
- Additional premiums may be required to maintain the coverage if current interest rates fall below initial assumptions.
- Nonguaranteed values mean that the policy might not meet protection needs;
- some of the risk of policy performance is assumed by the policyowner.
- Increases in coverage amounts generally require the insured to submit evidence of insurability.
- The policy's flexibility—and the responsibility the consumer must assume in funding the benefits—may seem complex and hard to understand.

When is Universal Life Suitable?

Flexible, interest-sensitive, adjustable, permanent—the features of universal life make it seem as if it would be a suitable option for just about anyone who needs a permanent plan of life insurance protection. For many, it is. It represents a viable alternative for the "buy term and invest the rest" client or one who is reluctant to commit to the relative rigidity of a traditional whole life policy. The following describes prospects for whom a UL product may be suitable:

- A client who needs permanent life insurance protection but can't afford the cost of whole life
- A young family whose insurance needs are likely to grow and change
- A new business owner who anticipates changing stages of growth and development
- A client who is attracted to the flexibility of unstructured premiums
- A client who prefers to earn current short-term rates rather than the longer term rates associated with whole life
- A client who wants a policy that can adapt to changing circumstances
- A client who is attracted to the concept that a single, versatile policy can serve insurance needs over a lifetime
- A client who likes the idea of being able to prefund policy values

You Must Understand . . .

The client should understand the following with regard to a universal life policy.

- The primary purpose of the policy is long-term protection.
- Though premiums are flexible, the policy requires the buyer's long-term commitment.
- The target premium amounts could be affected by adverse market conditions.
- Additional premium payments above the targeted schedule might be necessary to keep the insurance in force—that is, if not paid, the policy would lapse.
- The primary purpose of the policy's cash value is to fund the cost of the insurance protection.
- The guaranteed minimum rate and the current declared rate are not the same.
- If current interest rates decline, the rate at which the cash value grows may be less than expected.
- Partial withdrawals would affect the policy's death benefit, mortality cost and the amount in the cash value available to earn interest.
- An increase in the policy's benefit will likely require the insured to submit evidence of insurability.
- The policy's annual statement must be reviewed carefully to determine how the product is performing and whether some adjustment might be required.
- Early surrender of the policy may be subject to surrender charges.

Universal life is suitable when the client needs adjustable coverage, desires a policy that can grow, is capable of understanding the policy, and seeks flexible funding and is willing to forego some guarantees to obtain this flexibility.

What is Indexed Universal Life?

To understand indexed universal life insurance you must first understand universal life insurance. Universal life is distinguished from whole life by a number of factors. From the consumer's perspective, the most notable difference is premium flexibility. Unlike whole life, universal life does not require a fixed schedule of unchanging premium payments; they are completely flexible. The only time a fixed level of premiums is required is during the first one or two policy years (effectively setting up the "prefunding" needed to initiate the policy); after that, the timing and amount of premium payments is up to the policyowner.

This is made possible by the seemingly simple concept on which universal life relies. Universal life separates the two components of a whole life policy's benefit—the pure insurance net amount at risk and the cash values—and administers them separately. Unlike whole life's guaranteed level death benefit, a universal life policy makes no attempt to maintain a guaranteed death benefit or contractually scheduled cash value accumulation. It permits the pure insurance component to be funded independently of the cash value component.

How a Universal Life Policy Works

A UL policy's operation can be described in simple terms. Here's how a UL policy works.

1. The policyowner selects an initial insurance amount and the type of death benefit option. This option can be either:
   - a level death benefit, or
   - a death benefit that rises in relation to the policy's cash value.

   After a certain period of time from policy issue, the amount of insurance or death benefit option can be changed.
2. Based on the insurance amount and the death benefit option selected, a premium amount and payment schedule is established. A "minimum" premium is required only for the first year or two. Though the insurer recommends a "target" premium level after the initial period, the amount and timing of premium payments are completely flexible. The premium is directed into the policy's cash value or accumulation account.
3. Each month, the insurer credits the funds in the accumulation account with interest. The amount of interest so credited is the "current declared rate" determined by the insurer. This amount fluctuates, based on the current investment and economic environment. In this way, it more closely reflects market rates. Current UL interest rates will vary from crediting period to crediting period, but will never be lower than a minimum guaranteed rate (typically 3 percent to 4 percent).
4. Each month, a charge for the cost of the pure insurance (term) component of the policy plus an expense charge is deducted from the cash accumulation account. To the extent the cash value is sufficient to support these monthly deductions, the insurance remains in force. Consequently, the policy's funding is directly dependent not on the payment of premiums but on the amount in the cash value account. In turn, the amount in the cash value account is dependent on the level and frequency of premium payments and interest crediting. Cash value amounts in excess of the insurance costs and expense deductions continue to earn interest at the rate declared by the insurer.
5. Due to the separation of the pure insurance element and the cash value accumulation element, universal life policies can support partial withdrawals of funds from the cash value account. This is not possible with whole life insurance; accumulated funds in a whole life policy can be accessed only through a loan (with interest) or through complete surrender of the policy. With UL, money can be withdrawn from the cash value without incurring interest and with no obligation to repay the amount.
6. Within specified limits, policyowners can pay more than the target premium.

On a regular basis, the policyowner receives a statement from the insurer outlining the status of his or her policy: premiums paid, expenses charged, interest credited, insurance costs deducted and cash values accumulated. This full disclosure is unique to universal life and should play a role in the on-going determination of product suitability. The practitioner should take the time to review these statements periodically with policyowners and explain how they illustrate whether the policy continues to provide the benefits and values intended when the product was first purchased.

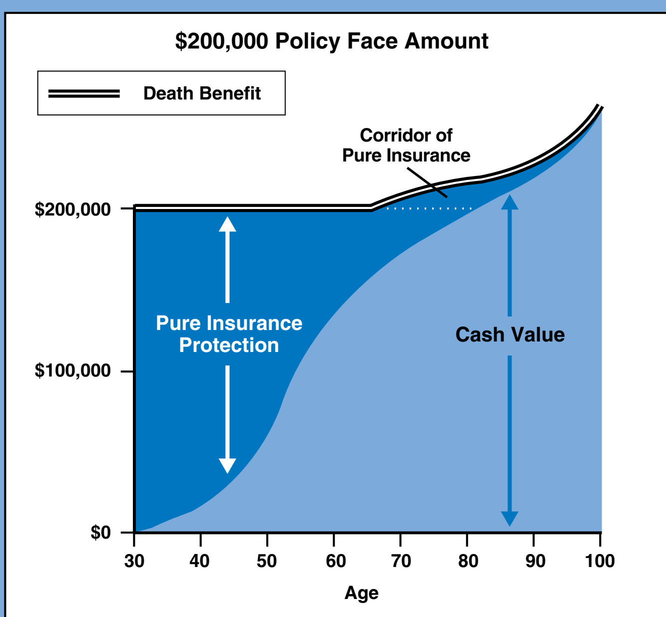
The flexibility of UL offers consumers options that are not available with traditional whole life insurance. The policyowner can adjust the death benefit or premium payments to fit his or her situation. As financial priorities come and go and as different situations present themselves, the flexibility of a universal life policy allows the coverage and cost components to adapt to the owner's needs. This flexibility is one of UL's chief benefits. However, with this flexibility come fewer guarantees. This, in turn, requires the UL buyer to assume a level of risk absent from traditional whole life. Consequently, when evaluating the suitability of a UL policy, it is important to consider a client's understanding of the product's operation and his or her ability to manage the product. Specifically, the practitioner should make sure that the client understands the policy's target premium.

Target Premium

A UL's target premium amount is based, in part, on the insurer's mortality costs and expenses. It also includes an assumption of future investment returns. The higher the return the insurer earns, the greater the amount it will be able to credit to its UL policies. If the actual investment return credited to the policy is in line with what was assumed in determining the target premium and if the target premium is paid consistently, the policy will perform as anticipated. On the other hand, if the actual investment return credited to the policy falls short of what was assumed in determining the target premium, the cash value may not be sufficiently funded to carry the policy, even if targeted premiums are paid. In this case, additional premiums—above and beyond the targeted amount—would be required to keep the insurance in force.

This aspect of universal life is very often misunderstood or its significance overlooked. Suitability standards require that the practitioner makes clear to the customer the effect that changing market conditions may have on a UL policy's premiums. Overall, most insurers take a conservative path when establishing target premiums for their UL policies and the majority represent levels that are sufficient to keep these policies in force for life.

ILL. 4.1 ■ Universal Life Insurance (Option I)



Under universal life's Option I, the policyowner designates a specified face amount of coverage. The death benefit equals the cash value plus the remaining pure insurance (which is decreasing term). If the cash value approaches the face amount before the policy matures, the insurer will raise the death benefit by increasing the amount of pure insurance—this additional pure insurance is called a "corridor."

Adjustable Benefit

Universal life also offers flexibility with regard to the death benefit. First, the owner selects one of two options at purchase: a benefit that remains level throughout the policy's term (Option I), or one that increases gradually over time in relation to the cash value growth (Option II). Second, after policy issue, that benefit can be increased or decreased at the owner's discretion, with very few limitations. The decision to increase or decrease the benefit amount does not require issuance of a new policy; the insurer simply modifies the existing policy. Third, in most cases, a policyowner can switch from one death benefit option to the other. Consequently, a single UL policy can accommodate changing protection needs without requiring the owner to purchase additional policies. (It should be noted that almost all insurers require the insured to submit evidence of insurability if an increase in the death benefit is requested.)

To differentiate between the two options, consider the following example. Suppose an individual purchases a universal life policy with a face amount of $200,000. Under Option I, the death benefit payable will remain at (or close to) $200,000, as long as target premiums are paid. If the individual chooses Option II, the death benefit will rise in relation to the cash value. If the cash value increases to $15,000, the death benefit will equal $215,000; if the cash value increases to $25,000, the death benefit will be $225,000; and so on.

Under either option, the death benefit amount can be increased or decreased as the owner desires. If, for example, a temporary need expires, the policy can be adjusted downward to provide lower benefits. If there is a need for greater protection—after a home has been purchased, for example—the death benefit can be increased (usually after providing evidence of insurability) for as long as needed. An increase or decrease in protection will adjust the amount deducted from the cash value account, but again, as long as the account is sufficient to cover these costs, the insurance remains in force. Consequently, a temporary increase in coverage may not require additional premium payments; in fact, payments might even be suspended for a period of time even after coverage has been increased.

Indexed Universal Life Insurance

Indexed universal life insurance offers all of the benefits of a universal life insurance policy, while crediting a guaranteed minimum interest rate and linking the excess interest rate to the upward movement of a particular equity index, such as the Standard & Poor's 500. Policyowners don't know in advance what excess interest their policies will earn, but they do know that if the equity index increases in value, the excess interest credited to their policies will be a stated percentage of that increase. If the equity index decreases in value, their policies will be credited with the guaranteed minimum rate.

The impact of negative index returns is limited by a growth floor (typically 0% to 2%), and the maximum interest crediting rate is limited by a growth cap. The cap varies among insurers from 7% to 12%. Each index is made up of different companies and measures a slightly different mix of industries. The policyowner should examine and select the index account that meets his overall objectives. The major advantage of an indexed universal life insurance policy is the option to participate indirectly in the upward movement of a stock index without assuming any of the risks involved in investing in the stock market.

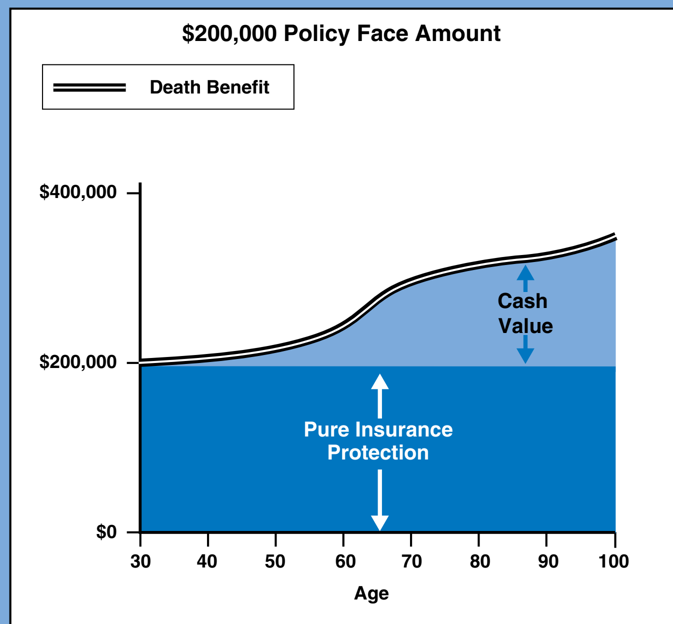
Advantages of Universal Life

- The policy's flexible provisions give owners considerable control over policy values.
- As a permanent plan, coverage extends for the whole of the insured's life.
- Flexible premiums allow owners to adjust payments to fit changing needs and goals.
- Due to flexible funding, policyowners have some control over the growth of cash values.
- As cash values grow, policyowners can decrease or skip premiums as circumstances require.
- Premiums in excess of the cost of insurance contribute fully to the cash value accumulation.
- Cash values grow tax deferred and are easy to access.
- Interest credited to UL cash values is reflective of current (conservative) market conditions.
- A minimum rate of return is guaranteed with most policies.
- Coverage can be adjusted—up or down—as needs change. The death benefit option can be changed to accommodate the desire for greater cash accumulation or an increased death benefit.
- The premium for the policy's protection element is generally lower than whole life.
- Tax-advantaged withdrawals can be taken without interest or the requirement to repay them.
- The ability to take partial withdrawals provides for more flexible liquidity than whole life.
- Policy statements provide full disclosure of costs, coverage and accumulated values.
- An indexed universal life insurance policy offers the option to participate indirectly in the upward movement of a stock index without assuming any of the risks involved in investing in the stock market.

Disadvantages of Universal Life

- Premiums are more costly than term, at least initially.
- Because premiums are payable at the policyowner's discretion, the amount of the death benefit cannot be guaranteed for the life of the policy.
- Additional premiums may be required to maintain the coverage if current interest rates fall below initial assumptions.
- Nonguaranteed values mean that the policy might not meet protection needs; some of the risk of policy performance is assumed by the policyowner.
- Increases in coverage amounts generally require the insured to submit evidence of insurability.
- The policy's flexibility—and the responsibility the consumer must assume in funding the benefits—may seem complex and hard to understand.

ILL. 4.2 ■ Universal Life Insurance (Option II)



Under universal life's Option II, the policyowner designates a specified amount of insurance. The death benefit equals the level amount at risk (pure insurance) plus the cash value.

When is Universal Life Suitable?

Flexible, interest-sensitive, adjustable, permanent—the features of universal life make it seem as if it would be a suitable option for just about anyone who needs a permanent plan of life insurance protection. For many, it is. It represents a viable alternative for the "buy term and invest the rest" client or one who is reluctant to commit to the relative rigidity of a traditional whole life policy. The following describe prospects for whom a UL product may be suitable:

- a client who needs permanent life insurance protection but can't afford the cost of whole life;
- a young family whose insurance needs are likely to grow and change;
- a new business owner who anticipates changing stages of growth and development;
- a client who is attracted to the flexibility of unstructured premiums;
- a client who prefers to earn current short-term rates rather than the longer term rates associated with whole life;
- a client who wants a policy that can adapt to changing circumstances;
- a client who is attracted to the concept that a single, versatile policy can serve insurance needs over a lifetime; and

- a client who likes the idea of being able to prefund policy values.

You Must Understand . . .

The client should understand the following with regard to a universal life policy:

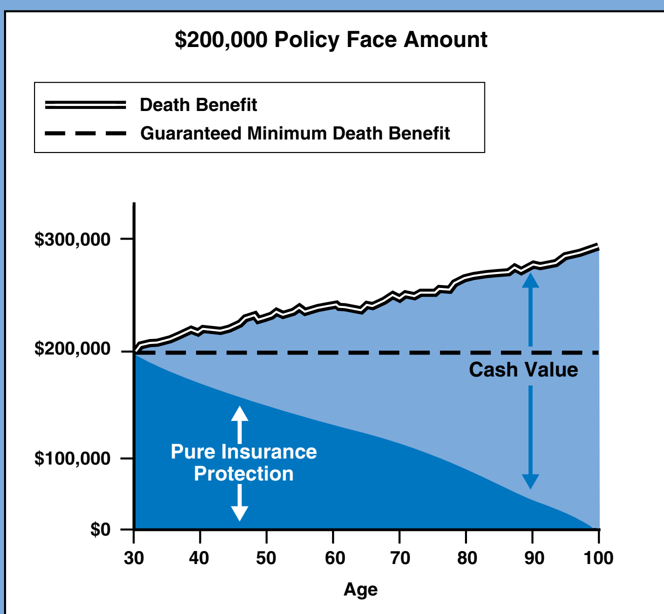
- The primary purpose of the policy is long-term protection.
- Though premiums are flexible, the policy requires the buyer's long-term commitment.
- The target premium amounts could be affected by adverse market conditions.
- Additional premium payments above the targeted schedule might be necessary to keep the insurance in force—that is, if not paid, the policy would lapse.
- The primary purpose of the policy's cash value is to fund the cost of the insurance protection.
- The guaranteed minimum rate and the current declared rate are not the same.
- If current interest rates decline, the rate at which the cash value grows may be less than expected.
- Partial withdrawals would affect the policy's death benefit, mortality cost and the amount in the cash value available to earn interest.
- An increase in the policy's benefit will likely require the insured to submit evidence of insurability.
- The policy's annual statement must be reviewed carefully to determine how the product is performing and whether some adjustment might be required.
- Early surrender of the policy may be subject to surrender charges.

Universal life is suitable when the client needs adjustable coverage, desires a policy that can grow, is capable of understanding the policy, seeks flexible funding and is willing to forego some guarantees to obtain this flexibility.

What is Variable Life?

Variable life is a form of permanent life insurance that operates in many ways like traditional whole life. Premiums are fixed, a death benefit equal to the face amount at issue is guaranteed, and the net amount at risk within the policy—the difference between the cash value and the death benefit—is designed to decrease progressively over time. As long as premiums are paid, the insured is covered and the cost of the coverage never increases. The main difference between traditional whole life and variable life is the manner in which the policy's values are invested and who assumes the risk of the investment performance.

ILL. 5.1 ▪ Variable Life Insurance



In a variable life insurance policy, the death benefit increase each year that the separate account's actual return exceeds the assumed interest rate (AIR). In years where the actual return or growth is less than the AIR, the effect is to decrease the death benefit from any previously attained levels. Note, however, that the death benefit will never drop below the face amount guaranteed at policy issue.

General vs. Separate Accounts

Traditional whole life cash values are managed in the insurer's general account and invested in conservative vehicles (such as long-term quality bonds) to match its contractual promises and liabilities.

By contrast, variable life insurance policy values are placed in separate accounts that contain stock, bond, money market, and other securities instruments. These instruments are riskier but potentially higher yielding than those in the general account. In exchange for the benefit of higher returns, the policyowner—not the insurer—assumes the investment risk associated with these values. The actual value of the policy's cash value is based on the separate account funds that make up the policy's portfolio; the results of their investment performance—up or down—are credited to the policy's cash value. In turn, because the funding of the death benefit relies, in part, on the cash value accumulation, the actual death benefit will also vary in relation to the cash value performance. The insurer is not obligated to pay out more than a base amount, which is the policy's face amount at issue.

How a Variable Life Policy Works

The concept of variable life is not complicated. It is best explained through a discussion of its premiums, fees, separate accounts and death benefit.

Premium Payments

Like conventional whole life, variable life requires the payment of scheduled premiums of a fixed amount. These premiums fund the minimum guaranteed death benefit (explained below); failure to pay a scheduled premium by the end of the policy's grace period—usually 30 or 31 days after the premium due date—causes the policy to lapse.

From the premium, a charge for policy costs and expenses is deducted. The balance is directed into the insurer's separate accounts.

Separate Account Funding

An insurer's separate accounts are similar to mutual fund portfolios. They might include, for example, a variety of stock funds (growth, income, balanced, international), bond funds (large corporations, small corporations, federal and state government) balanced funds, indexed funds, and money market or treasury funds. (Many VL policies also include a "fixed account" option that invests in conservative vehicles and often provides for a guaranteed minimum rate of return, such as 3 percent or 4 percent.) The policyowner determines how his or her premium deposits are to be allocated among these funds; the values associated with each allocated portion of the premium grow in relation to the fund's performance. The policyowner benefits directly when his or her selected funds do well; he or she bears the loss when they don't. The insurer does not guarantee any rate of return on funds invested in its separate accounts.

Fluctuating Death Benefit

The death benefit associated with a VL policy, as with any permanent insurance product, relies on the cash value. The policy's cash value (generally increasing) plus the insurer's net amount at risk (usually decreasing) equals the death benefit. With conventional whole life plans, the two components of the policy are calculated (and guaranteed) to equal a certain level amount (the face amount) for the life of the policy. With VL policies, given the fluctuating nature of the policy's cash value as it rises and falls in relation to the performance of the underlying funds, the death benefit will rise and fall.

Marketing Variable Life: Disclosure and Risk Assessment

By its very nature, variable life entails volatility and unpredictability—

risks that the policyowner absorbs. To have the potential for better than projected returns, the owner must assume the downside as well. This risk positions variable life insurance as a "securities" product, regulated by the Securities and Exchange Commission (as well as state insurance laws). Variable insurance products must be registered with the SEC, as must those that issue and those who sell these products. (Practitioners who sell variable insurance must be licensed as both life insurance and securities agents.) SEC registration also means that selling activity must conform to certain requirements. Chief among them is providing a policy prospectus and assessing the client's risk tolerance.

Policy Prospectus

Variable life insurance is sold by prospectus, which means that a product presentation or proposal must be accompanied by a formal informational document that provides full disclosure about the product's provisions and operation: expenses, costs, investment options, benefits surrender charges, and nonforfeiture rights. The prospectus describes each of the separate account investment funds into which a policyowner can allocate the premium payments, noting their investment objective and historical performance.

Risk Tolerance

Certainly, one of the most important aspects of determining the suitability of a variable life insurance product is the client's risk tolerance. A VL policy is subject to market risk—the risk that the ups and downs of the market in general will affect the value of the policy—and it is incumbent upon the practitioner to assess how much "downside" a client can comfortably withstand. With that information, the practitioner is in a better position to determine whether, in fact, a variable insurance policy is a suitable recommendation and, if so, how a client might want to allocate premium payments.

Advantages of Variable Life

- The coverage is permanent and the policy's original face amount is guaranteed. As long as premiums are paid, the protection is assured for the insured's life.
- Premiums are fixed, stable, and predictable.
- The policyowner controls how his or her premiums are invested.
- The policy provides for growth that is potentially greater than whole life.
- The policyowner can participate directly in favorable investment returns, which can produce higher policy values at a faster pace than those associated with whole life.
- The product allows an allocation mix that matches the policyowner's risk tolerance and long-term investment goals.
- Proper asset allocation within the policy provides diversification.
- A minimum death benefit is guaranteed, regardless of how the investments underlying the policy may perform.
- If investment results are favorable, the policy automatically provides higher death benefits without an increase in premium.
- Cash values accumulate on a tax-deferred basis, which fuels the power of compounding.
- Assets can be transferred among the policy's separate account options without current income tax consequences.
- The (potentially) larger cash values that will accumulate later in life will be available to fund other late-life needs, such as retirement income and long-term care costs.
- An insurer's separate account funds are professionally managed.

Disadvantages of Variable Life

- Initially, VL is more expensive than term. VL premiums support its permanence and therefore are higher.
- There is no guarantee associated with the contract's cash values; the policyowner assumes the risk of investment performance.
- The death benefit is not guaranteed to be any more than the original amount at issue.
- The product inherently entails unpredictability, something many do not associate with life insurance.
- A significant shift in the market could result in loss of contract values.
- The policyowner must assume responsibility for the "management" of his or her policy by selecting the premium investment accounts and periodically reviewing the allocation mix. (It should be noted that some might consider this an advantage.)
- Partial withdrawals are not available (though loans are available).
- A "double tier" of due diligence and education is required: the professional must assess the insurer underwriting the policy as well as the funds supporting the product.
- Policyowners might be concerned with short-term separate account performances and take consequent action.

When is Variable Life Suitable?

The following, though by no means complete or exact, point out when a VL policy might be a suitable option:

- When the prospect needs permanent protection to provide for future income, education funding, supplemental retirement income and/or estate preservation
- When the prospect needs permanent insurance protection, but is not satisfied with the conservative, guaranteed rate of return associated with whole life
- When the prospect is knowledgeable of and comfortable with the benefits and drawbacks of investing
- When the prospect understands—and accepts—the risk of tying a portion of his or her insurance coverage to the performance of nonguaranteed investment accounts
- When the prospect has the time to weather the ups and downs of the market
- When the prospect desires control over how and where premium dollars are invested
- For younger families who can afford permanent protection and are willing to rely on market forces to help propel the amount of coverage they have

- For those with a combination of protection and long-term accumulation needs
- For those who are drawn to the potential for higher, tax-deferred cash value growth and are willing to accept greater risk
- For those in the advanced markets—business owners and those with large estates—who may be more comfortable and experienced with fund management and the risks it entails

You Must Understand . . .

A client should understand the following with regard to a variable life insurance policy:

- The primary reason to purchase the product is for its protection element and the underlying chassis for the product is life insurance.
- Premiums are fixed and payable over the life of the policy.
- There is risk associated with the policy's values, which the owner—not the insurer—assumes.
- The amount of the death benefit (and the ability of the product to generate cash values and living benefits such as loans, for example) depends, in part, on how well fund managers manage the separate accounts.
- Benefits and values will vary from year to year.
- The commitment is long-term and any prior stock market performance must be kept in perspective; a significant and sustained market downturn could affect the policy's values and coverage.
- A complete assessment of the policy should involve more than a review of the separate accounts' historical performances.
- The death benefit has the potential to increase, but will never drop below the policy's initial face amount.
- A portion of the premium is absorbed by policy fees and the cost of providing the insurance protection.
- The growth of the cash value will never be the same as the growth of noninsurance products invested in similar assets.
- Surrender charges may apply if the owner cancels the policy during the early years.

Variable life is suitable when the client needs or wants long-term, cash value protection with predictable premiums, the potential for better-than-expected returns on policy value—and when he or she is willing to accept the risk associated with this potential. For those who want greater flexibility with regard to funding their policies, a variable universal life product might be suitable.

What is Variable Universal Life?

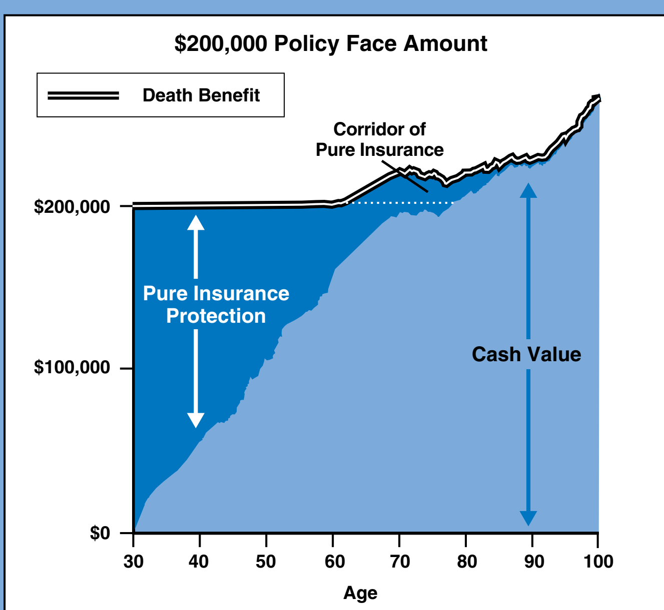
Those who understand *universal life insurance* and *variable life insurance* are prepared to grasp the full scope and operation of variable universal life insurance. In brief, variable universal life, or VUL, combines the policy structure and flexibility of universal life insurance with the investment choices, potential, and risks of variable life. Many see it as the life insurance industry's own response to "buy term and invest the rest." With a single product, an individual has permanent life insurance protection, the opportunity to direct premium investments, the potential for market rates of returns on cash values and the flexibility to adjust the amount and frequency of premium payments and death benefits to meet his or her changing needs. This combination makes VUL a powerful—and increasingly popular—form of life insurance. In fact, according to LIMRA, VUL now has the highest premium market share of all nontraditional permanent plans. It also raises the issue of suitability to the highest level.

With VUL, the policyowner has ultimate control and flexibility. He or she also assumes responsibility for two crucial aspects of the policy's operation.

1. Managing the policy's funding
2. Directing cash value investment and absorbing the consequent investment risk

This control and flexibility can benefit policyowners so long as they understand the product and their responsibilities.

ILL. 5.4 ■ Variable Universal Life Insurance (Option I)



Under variable universal life's level death benefit (Option I), the policyowner specifies the total death benefit in the policy. This amount remains constant and does not fluctuate as the cash value increases or decreases. Instead, cash value builds up within the policy until it reaches the corridor, at which time the death benefit will increase to corresponding increases in the cash value.

Death Benefit Options

The death benefit options in a VUL policy mirror those available with universal life. The policyowner can select a level death benefit (with the cash value added to a decreasing amount at risk) or an increasing death benefit (with the cash value added to a level amount at risk). With VUL, if the policyowner wants a death benefit that varies with the performance of the funds in which the contract is invested, he or she should select the increasing death benefit option. Generally speaking, the increasing death benefit option provides a hedge against inflation and allows the forces of the market (i.e., the underlying separate accounts) to increase coverage gradually.

Under the level benefit design, the death benefit remains the same, regardless of increases in the policy's investment accounts. Typically, the premium charges are lower for a level death benefit VUL policy than for one that offers an increasing death benefit. Under both plans, however, the owner pays a higher cost of insurance as he or she ages.

(Many of the newer VUL policies, like some UL policies, contain a provision that guarantees a minimum death benefit as long as the policyowner pays target premiums. The minimums typically equate to a stipulated percentage of the cash value or a percentage of the face amount. Often the policyowner is allowed to select the duration of the guarantee period. Another trend in VUL policies, aimed specifically at the split-dollar market, makes provisions for a third death benefit option, in which the death benefit equals the policy's face amount plus premiums paid.) Coverage under VUL can be increased or decreased at the owner's discretion. Usually, an increase in coverage requires evidence of the insured's good health.

Premiums

Every VUL policy is issued with a minimum schedule premium based on an initial specified death benefit. This initial premium establishes the plan, meets first-year expenses, and provides funding to cover the cost of insurance protection. Once this initial premium has been paid, policyowners can pay whatever premium amount they wish, with certain limitations. Provided that adequate cash value is available to cover monthly expenses and the cost of the pure insurance component, out-of-pocket premium payments may be reduced or even suspended. As is the case with UL, however, the drawback to contributing too little to a VUL policy is potential lapse. There is no guarantee that the cash value will ever sustain the policy. If the policy is to stay in force, the policyowner must be committed to more than minimum funding.

Conversely, policyowners wishing to increase death benefits or take advantage of tax-deferred accumulation of cash values can pay additional premiums. Clients who have the wherewithal to fund their policies more heavily in the early years will help create significant accumulation value for the later years when they might want to access the policy's funds and/or have the policy support itself. Market-driven returns, fueled by tax-deferral and the power of compounding, can produce significant results over time. However, most policies contain maximum funding or premium limits to maintain the required "corridor" between the cash value and the death benefit so that the policy continues to retain its status as life insurance.

Cash Value Investment Options

Like variable life, VUL allows owners to determine how their premiums are invested and allocated from a menu of separate account options. This menu typically includes a variety of stock, bond, balanced and money-market accounts, the choice of which can—and should—coincide with the owner's risk tolerance and investment objectives. (Some of the newer products might offer as many as 20 different funds and fund manager options as well as fixed accounts.) As with variable life, the upside with VUL is the potential to earn higher rates of return on invested values (at a faster pace than whole life or universal life); the downside is that the policyowner—not the insurer—assumes the risk associated with each separate account. To the extent that the investments perform better than what is required to cover the cost of the policy's death benefit and expenses, the cash values grow.

Conversely, should these investments lose enough value that the cash value account can no longer support the policy's monthly costs and fees, the policy could lapse. Again, many VUL issuers provide for a contractually guaranteed death benefit, no matter how the separate accounts perform, as long as a certain level of premium is paid. This guarantee is offered as a standard policy provision or by rider. (Of course, the premium rate for such VUL contracts would reflect this guarantee.)

One of the benefits of VUL, like VL, is the ability for the owner to transfer funds among the various separate accounts without tax consequences. Doing so allows the product to provide a constant and appropriate asset allocation mix. The restrictions placed on account transfers vary from product to product and from insurer to insurer. The most liberal policies allow unlimited free transfers; others place restrictions on the number of transfers that may be made during a single year, the amount that may be transferred and/or impose a fee on transfers. Practitioners must be able to explain to clients the specific requirements of the policies they represent.

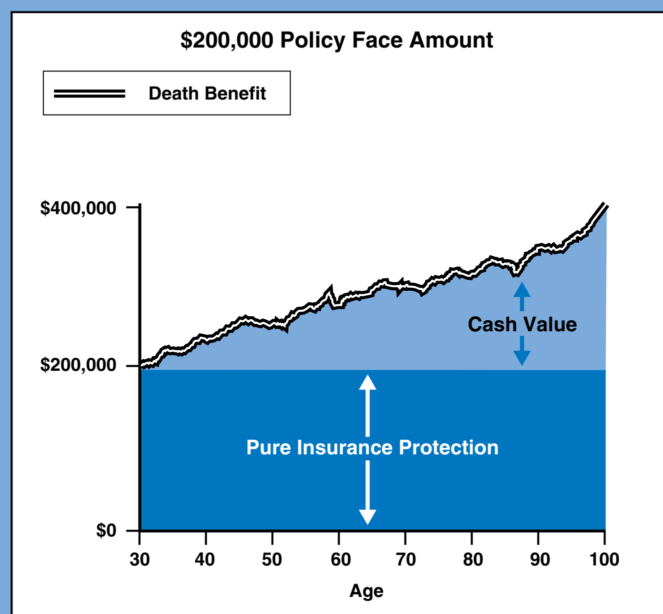
Withdrawals and Loans

Like universal life policies, VUL policies permit partial withdrawals, allowing owners to tap the cash value without incurring any indebtedness. These funds do not have to be repaid and no interest is charged on the amount withdrawn. Withdrawals, however, do affect the policy's future earnings and, depending on the option selected, may affect the death benefit. Partial withdrawals taken in the policy's early years are likely subject to surrender charges.

With withdrawals (and surrenders), if the amount received exceeds the policyowner's net investment in the contract, the excess will be treated as ordinary income and subject to tax. For this reason, a loan may be preferable. Any loan amount (plus interest) not repaid at the time of the insured's death is subtracted from the death benefit amount; however, there is no requirement that these loans be repaid. As long as the policy is not a modified endowment contract, a policy loan is not taxable; therefore, it should be considered an option in the event the owner wants to access the contract's values if and when the need for protection has diminished.

The ability to access the policy's values through loans and withdrawals is one advantage that VUL has over VL, which only allows loans. This allows for more flexible planning and application.

ILL. 5.5 ■ Variable Universal Life Insurance (Option II)



Under variable universal life's variable death benefit (Option II), the policyowner selects a specified amount of pure insurance coverage. This specified amount remains constant. The death benefit payable at any time is a combination of the specified (or face) amount and the cash value within the policy. That is, the cash value plus the specified amount equals the total death benefit.

Fees and Expenses

Variable universal life carries certain expense charges and fees that are not applicable to other forms of life insurance. Like variable life, VUL entails costs associated with the management of its separate account funds; some policies include fees for account transfers. There is also the mortality expense and the sales load expense.

Withdrawal and surrender charges are typical with VUL policies when these transactions take place during the early policy years. For competitive purposes, some insurers allow for what is known as "free withdrawals," meaning that up to a certain amount of the policy's value (typically 10 percent) can be taken each year without surrender charges. Again, it's important for the practitioner to know the provisions of the policies he or she represents and to explain them to clients. As consumers grow increasingly sophisticated and more comfortable with financial matters, they require more information. Agents must be able to offer full disclosure as to a product's mortality, expense, and administrative and surrender charges.

Policy Prospectus

Like variable life, VUL policies are considered securities. They must be registered with the SEC (as well as filed with state insurance departments) and those who market them must have a securities license in addition to a life insurance license. Because VUL policies are registered securities products, they must be sold by prospectus. The same level of risk and suitability assessment that the SEC requires for the sale of variable life also applies to variable universal life.

Advantages and Disadvantages of Variable Universal Life

The advantages and disadvantages of VUL are similar to those of universal life and variable life combined. This product offers the policyowner control and flexibility over death benefits and premiums with the concurrent benefits and drawbacks of policyowner-directed investment options. The policyowner selects the amount and type of death benefit and, for the first year or two, follows a set schedule of premium payments. After that initial period, as needs and goals change, the amount of coverage can be adjusted and premium payments can be increased, decreased or skipped. The funding must be enough to create a cash value that can support the insurance costs (which are comparable to yearly renewable term) but not so much as to force the cash value above the required ceiling. The policyowner decides how his or her premium payments are invested among myriad investment fund options and, to the extent that the investment returns exceed the amount required to cover the insurance protection and policy expenses, the cash value grows. By the same token, if funding options perform poorly and the policyowner has not maintained an adequate level of premium payments, the death benefit can decrease and/or the policy could lapse.

With its flexible funding, VUL can also be used to accumulate funds for the long-term on a self-directed, tax-advantaged basis. Those who want to build a fund for college tuition or to supplement their IRA, 401(k) or other qualified retirement plan—especially when they have contributed the maximum amount allowed to such plans—can contribute accordingly to a VUL policy. Spurred by market-linked rates of return and tax-deferred compounding, a VUL's cash value can contribute significantly to an individual's long-term accumulation goals. However, with its flexible funding and potential high cash value configuration, a VUL policy (perhaps more than any other type of policy) can run afoul of the seven-pay test and/or the corridor requirement. The practitioner should advise the client as to possible tax implications of discretionary or forced withdrawals and loans if funding levels and or cash values exceed specified levels. No adverse tax consequences result as long as the values remain intact in the policy.

Conflicting Needs and Objectives

To the extent that a life insurance buyer wants a great deal of control over his or her coverage, VUL can fit the bill. It also requires a greater degree of policyowner responsibility with regard to funding the product and allocating the premium deposits so that the product is able to generate the desired benefit and the allocation mix best represents the client's long-term goals. Whereas no life insurance policy should be purchased only for its investment potential, it's likely that many VUL buyers are attracted to this potential—and the policy's living benefits—as much as they are to its death benefit element. For this reason, the practitioner needs to be sensitive to a potential conflict.

Protection vs. Accumulation

As life insurance, VUL provides financial protection for the insured's beneficiaries; the primary reason for the purchase of the product should be the death benefit. Fulfilling this objective would indicate a conservative investment strategy. On the other hand, VUL's tax-deferred accumulation potential could encourage aggressive investment positions. This inherent "conflict of interest" should be explored before a VUL policy is placed. The practitioner should advise the client to assess and weigh the death benefit need vs. the accumulation need. This will help define, for any particular client, the appropriate funding level and allocation mix. Keep in mind that most people fear loss more than they desire gain.

When is Variable Universal Life Suitable?

Determining the suitability of a VUL placement begins by asking four questions:

1. Does the client need long-term life insurance?
2. Does the client desire flexible death benefits and premium payments?
3. Does the client want the ability to invest his or her cash values so that they have the growth potential of a diversified investment portfolio?
4. Does the client have a risk tolerance (and a time horizon) that will allow him or her to ride the ups and downs of the market?

If the answers to all these questions are "yes," the first step in determining suitability has been accomplished. (A "no" to the first question would certainly raise doubts about suitability, while a "no" to the second, third, or fourth questions suggests that an alternate product might be preferable.) Though by no means complete, the following could be used as general guidelines to further assess the suitability of a VUL placement:

- When the client has indicated that he or she believes in "buy term and invest the rest"

- When the client is familiar with investing; the fact-finder reveals that he or she owns mutual funds or other securities and understands—and is comfortable with—the inherent risks of market volatility
- When in addition to life insurance protection, the client wants other benefits from his or her policy, such as tax-advantaged capital growth
- When the client has contributed fully to other tax-favored vehicles (IRA, 401(k), SEP, etc.)
- When the client's needs are complex and subject to change; he or she owns a business and/or has a large estate
- When the client is an older, high net worth individual who has already provided for his or her retirement needs and wants to set funds aside for heirs or a charity
- When the client is willing to forego guarantees to achieve flexibility
- When the client wants the potential of being able to use the cash values to cover the cost of insurance
- When the client wants a product that can offer the maximum potential for living benefits as well as death benefits
- When the client anticipates needing funds for estate liquidity
- When the client has a fairly long-term investment horizon

The more complex or diverse the client's needs, the more flexible and accommodating the solution should be. For many, this will be a variable universal life policy. Certain market niches—the business planning, succession planning and estate planning areas, for example—may present the most opportunity for VUL placements.

Clients in these markets tend to have a variety of financial needs and typically are familiar with sophisticated financial products and investment principles. They also tend to have significant assets that need to be protected and/or maximized.

The application of VUL is not limited to the advanced markets, however. It can also be suitable for young families who want a product that can keep pace with their changing needs. While obligations are relatively low, a couple can contribute more to their policy; as the family's requirements grow, the amount and frequency of premium payments can be lessened. Then, as the couple ages and as life insurance needs decline, the amount of coverage can be reduced with the same level of premium funding to support the looming need for retirement income. Unlike any other kind of policy, VUL allows for a changing mix of coverage amounts, premium payments and investment options to reflect an ever-changing insurance need.

You Must Understand . . .

Of the various forms of life insurance, variable universal life offers the most flexibility. A client can customize VUL to fit situations and needs by selecting the death benefit amount and option, the level and frequency of premium payments and the funding options for cash value accumulation. At the same time, a VUL policy shifts a significant amount of risk to the policyowner. Before placing a VUL product, the practitioner should make sure that the client understands the following regarding VUL.

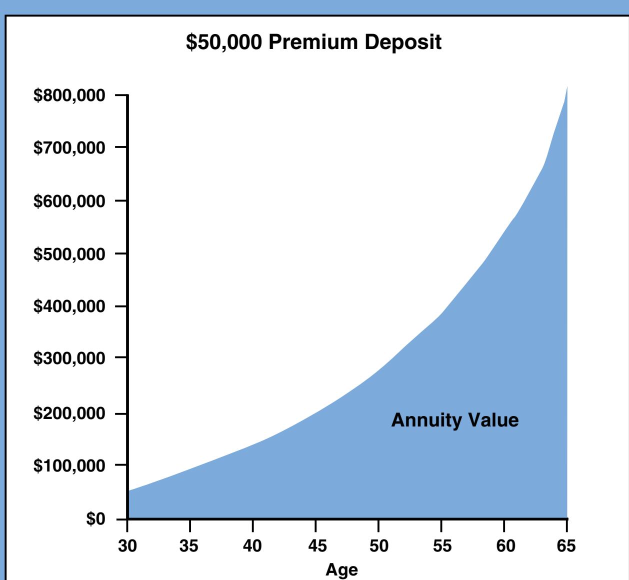
- The product is primarily a long-term life insurance plan, enhanced by a market-linked accumulation component.
- The policyowner assumes the risk of keeping the product properly funded.
- Depending on market conditions, additional premiums above and beyond the target amount could be necessary to keep the policy in force.
- There are no guaranteed rates of return and no guaranteed cash values.
- If the cash value grows to the point that it can begin to carry the policy, there is no guarantee that it will be able to do so continually.
- The product is primarily life insurance—it should not be used as a short-term investment vehicle.
- Because a portion of the policy's values is absorbed by the cost of the pure insurance protection element, the net rate of return on the policy will not be the same as a non-insurance product backed by similar investments.
- Withdrawals may trigger surrender charges, if taken during the early years of a policy.
- The policy may impose a ceiling on how much premium can be deposited.
- Many of the product's tax advantages could disappear if premium payments or withdrawals exceed IRS limits or restrictions.
- The owner and financial professional should review the product regularly to determine that its premiums, values and benefits continue to support the client's needs.

What are Fixed Annuities?

An annuity is the "mirror image" of a life insurance policy. Whereas a life insurance policy is designed to create a principal sum of money, an annuity is designed to liquidate a principal sum. It creates an income stream, payable over a defined period of time, by distributing the principal amount invested plus returns on principal. Each annuity payment comprises principal and return. In a traditional annuity, interest accrued on the yet-to-be-distributed principal amount makes the total sum of annuity payments larger than the initial amount of money deposited in the annuity.

A fixed annuity invests its premium deposits in the insurer's general accounts and is guaranteed to be credited with at least a minimum rate of return over the contract's life. Above and beyond the minimum, insurers credit a "current rate," a rate that fluctuates based on current market conditions. Fixed annuities appeal to those who are willing to accept lower rates of return in exchange for the guarantees the contract provides. Renewal rates (although varying and subject to the insurer's discretion) are guaranteed for some duration and a certain minimum rate of return underlies the contract for its life. These guarantees protect the annuity owner's principal. Furthermore, because values are not currently taxed while they remain within the contract, the product's ability to accumulate funds is greatly enhanced.

ILL. 6.1 ■ Deferred Annuity Accumulation Phase



In a deferred annuity, premiums grow for a certain length of time (usually years or decades) before payouts are scheduled to begin. This time period is known as the "accumulation phase," during which funds are deposited into the contract to accumulate in one of several ways. This illustration shows a fixed, deferred annuity.

Common Annuity Features and Contract Provisions

Tax Deferral

One of the chief features of a fixed annuity contract is tax deferral. The use of annuities as accumulation vehicles is one of the few ways individuals have to save money on a tax-favored basis outside a qualified plan and it is one of the primary reasons why annuities are so popular. Interest earnings compounded on a tax-deferred basis can add significantly to one's investments over the long haul. However, in exchange for this favorable tax treatment, annuities are considered long-term investment products.

Annuitization

All annuities are issued with a maturity date or annuity start date. This is the date upon which the contract is scheduled to annuitize and the annuity fund converted to an income stream. The contract owner usually has a number of options as to how payments will be received. The contract owner also determines the payout period by specifying straight life annuitization, joint and survivor annuitization, term certain or term certain with a life contingency.

Death Benefit

Annuities provide for the payment of a death benefit in the event the contract owner (or the annuitant, if different) dies before the contract is annuitized. Under most contracts, the death benefit is defined as the greater of:

1. the total of premium deposits made (less prior withdrawals and surrender charges); or

2. the contract's value as of the date of death.

Contracts that had already annuitized prior to the owner or annuitant's death would follow the provisions of the payout option already in place. In the event the contract owner or annuitant dies before the annuity date, the contract's values are usually paid out to the beneficiary under one of the following options:

1. As a lump sum

2. Over a 5-year period following death

3. As a life annuity based on the beneficiary's life expectancy

Surrender Charges

Surrender charges apply for the first seven to ten years after contract issue; the charges are usually a percentage of the amount invested or of the contract's accumulated value. These charges can be quite substantial.

Free Withdrawals

To minimize the lack of liquidity that characterizes the annuity in its early years, most deferred contracts include a provision that offers limited access to the contract's funds during the surrender charge period.

Commonly referred to as a free withdrawal, this provision allows the owner to withdraw up to a certain amount of the contract's value, usually one time per year.

Charges and Fees

In addition to the surrender charge, other charges and fees are associated with an annuity. Among these is the mortality and expense charge. As a life insurance product, an annuity carries a cost—inherent or expressed—associated with covering the product's death benefit guarantee and the risk the insurer assumes if mortality and expenses vary from its assumptions. Under a fixed annuity, this mortality cost is effectively covered by the way the insurer invests its fixed annuity premiums, the level of interest it credits to these contracts and its underwriting requirements (i.e., placing age limits, such as 70 or 80, on contract issue). This cost would not be apparent to the buyer but it should be explained.

When is an Annuity Suitable?

What kinds of needs indicate an annuity solution?

That question is best answered by recalling the fundamental purpose an annuity can serve: it can be used to accumulate a sum of money on a tax-deferred basis for distribution at a future date. Therefore, an annuity can address a savings and accumulation need and a distribution need.

The Distribution Need

Fixed Annuitization

Most retirees are financially conservative; while they might want to maximize the return on their assets, they are also risk-averse. Generally speaking, they tend to limit the number of investments they hold and prefer less complicated, more liquid investments. Loss of principal is a concern. For many, a fixed payout is most suitable. There is something to be said for a set income stream, with payments guaranteed to be the same every month for as long as the owner wants them. The rate earned on the annuity account is fixed at the point of annuitization and is usually lower than current rates.

Funds annuitized at a fixed rate and payable for what could amount to 20 or 25 years or longer will be affected by inflation and will experience a loss of purchasing power. This is the trade-off a fixed annuity stream requires.

The Accumulation Need

The other need annuities address—and the one for which most annuities are purchased today—is tax-deferred accumulation.

Assessing the Accumulation Need

Determining the suitability of a fixed annuity requires more than the client's acknowledgment that he or she wants tax-deferred accumulation. Specifically, the practitioner needs to assess certain issues.

- The accumulation need must be long-term.
- The long-term accumulation need should also entail the use of the assets.
- The client should intend to make use of the annuity funds or liquidate the contract during his or her life. If the accumulation goal is to pass assets on to one's heirs, then a life insurance solution—which would provide tax-free benefits to beneficiaries—is more suitable.
- How does the client feel about a portion of his or her premium deposits being used to cover the product's death benefit? No annuity product puts the full amount of the client's premium payments toward growth or accumulation. There is a cost for the death benefit and other expenses.
- If the annuity is to fund a tax-qualified retirement plan such as a traditional or rollover IRA, the age of the buyer must be considered. Generally speaking, minimum distribution tax rules require that withdrawals from IRAs begin when the owner turns 70½.
- If the client's desire is to fund a tax-qualified plan, the use of an annuity must be thoroughly scrutinized. Though certainly allowed and commonly employed, the use of either a fixed or variable annuity to fund a tax-qualified plan is often alleged to be unsuitable because (1) such plans, by their nature, provide for tax deferral and (2) the fees associated with annuities (notably the death benefit cost) are not associated with other financial products, such as mutual funds. In many cases, this allegation has merit.
- What are the possible implications of the ordinary tax treatment of the annuity's distributed earnings and interest? While annuity funds accumulate tax-deferred within the contract, upon withdrawal or distribution, their earnings are subject to tax as ordinary income, not capital gains. The tax bracket of the buyer should be considered as should that of his or her beneficiary who would be responsible for the income tax due on the annuity earnings if the contract owner or annuitant were to die before annuitized payouts begin.
- What qualified retirement plan options are available to the client? Generally speaking, an individual should be encouraged to take full advantage of any employer-sponsored retirement plan (such as a 401(k) or 403(b) plan) or any tax-deductible IRA contributions he or she could make as a first retirement funding option. An annuity should be used to complement, not replace, those options. In addition to offering tax deferral, an annuity does not impose contribution maximums as do qualified plans.

If a deferred annuity is a suitable option for the client's long-term savings and accumulation needs, then the next question is how to invest it—fixed, variable or indexed? Ultimately, this question must be answered in light of the client's risk tolerance, desire for growth vs. need for safety and—most importantly—his or her ability to understand the product's provisions. Each option has advantages and disadvantages.

Fixed Annuities: Advantages and Disadvantages

- A fixed deferred annuity offers two key guarantees: the guaranteed safety of principal and a guaranteed rate of return. These guarantees appeal to individuals who seek a safe, sure, tax-deferred investment option for their long-term retirement funds. Because it promises no unpleasant surprises, a fixed deferred annuity is a suitable option for the investment of all or a portion of a client's long-term "safe money" and, with no market risk, could be a substitute for bonds or CDs. Fixed annuities are fairly easy for clients to understand; there is no "managing" of the product required on the part of the owner.

- The fixed deferred annuity's greatest disadvantage is the conservative return it generates, which subjects its funds to inflation risk. Though a minimum rate is guaranteed for the life of the contract, the declared interest crediting rates are usually lower than current market rates. Furthermore, a fixed deferred annuity's declared rate is usually payable for a limited period of time (such as one year), after which it is subject to change. During the surrender charge period, a fixed annuity buyer may have little recourse if he or she is not happy with the rate of return the insurer declares upon contract renewal.

You Must Understand . . .

Annuities can be ideal retirement planning tools. For the accumulation and/or distribution of funds, they offer distinct options and opportunities. However, before the practitioner closes the book on an annuity sale, he or she should make sure the client understands the following regarding annuities.

- The purchase of a fixed annuity is a long-term commitment and the need or objective it addresses must have a distant horizon point.
- Early surrender of or withdrawal from an annuity could trigger a surrender charge and possibly an IRS penalty.
- Upon distribution, income taxes are due on the product's cumulative returns; this applies not only to the annuitant but also to the beneficiary if the annuitant dies while there are funds left in the contract.
- There are charges associated with the death benefit, which means that less will be invested for accumulation purposes.
- Once annuitization begins, it is irrevocable.

Annuity Payout Options

When it comes time to convert a deferred annuity into a flow of income, the contract holder has a variety of options. Because each option provides different measures of income guarantees, the owner can select the one that best matches his or her needs and objectives.

Straight Life Annuity

This option guarantees to make income payments for the duration of the annuitant's life, no matter how long or short that period may be. When the annuitant dies, all payments cease.

Term Certain Annuity

This option is not based on a life contingency but simply guarantees income payments for a certain period of time (such as 10 or 15 years), whether or not the annuitant is living. If the annuitant dies before the end of the term, the same payments will continue to his or her beneficiary for the remainder of the term. If the annuitant lives beyond the specified term, no more payments are made.

Life with Term (or Period) Certain Annuity

This option guarantees to make income payments for the duration of the annuitant's life, but for no less than a specified period of time (such as 10 or 15 years). If the annuitant lives beyond the specified term, payments continue until his or her death; if the annuitant dies before the end of the term, payments continue to a beneficiary for the remainder of the term.

Life with Refund Annuity

This option pays the annuitant an income for life and guarantees that if death occurs before the premiums paid into the contract have been fully recouped, any premiums not yet liquidated will be "refunded" to a beneficiary (either in cash or through continuing annuity benefit payments until the principal is fully paid out). If the annuitant lives long enough to recover the full amount paid into the contract, however, no payments will be made to a beneficiary at the annuitant's death.

Joint Life Annuity

This option provides payments as long as either of two people (typically a husband and wife) is alive. It can be structured in a number of ways. A joint and full survivor payout would provide income payments to two people and, upon the death of the first, would continue the same (full) amount to the survivor as long as he or she lived. A joint and one-half survivor payout would, upon the death of the first individual, make payments to the survivor of one-half the original amount as long as the survivor lives. A joint and two-thirds survivor payout would make payments to the survivor equal to two thirds of the original amount.

What are Variable Annuities?

An annuity is the "mirror image" of a life insurance policy. Whereas a life insurance policy is designed to create a principal sum of money, an annuity is designed to liquidate a principal sum. It creates an income stream, payable over a defined period of time, by distributing the principal amount invested plus returns on principal. Each annuity payment comprises principal and return. In a traditional annuity, interest accrued on the yet-to-be-distributed principal amount makes the total sum of annuity payments larger than the initial amount of money deposited in the annuity.

A variable annuity, or VA, invests its funds in the insurer's separate accounts, which are nonguaranteed investment options supported by stock, bond and money-market funds. These investment accounts hold the potential for higher rates of return, but have no guarantees. To the extent that annuity values are invested in these accounts, the annuity owner assumes the risk for the contract's investment performance: all gains and losses these accounts experience are passed on to the contract holder. This is the fundamental difference between a fixed annuity and a variable annuity.

Each variable annuity premium payment purchases "accumulation units." A contract's accumulation unit has a given value when the contract is issued, and the initial premium deposit purchases accumulation units at that price. (A $5,000 premium deposit in a variable annuity contract in which accumulation units are valued at $5 would purchase 1,000 accumulation units.) The units represent the purchaser's ownership of the particular subaccount or subaccounts in which his or her premiums are invested. From that point on, the value of an accumulation unit fluctuates in response to the underlying funds in which the contract's values are invested; the insurer regularly—usually monthly—revalues the units accordingly. Each revaluation reflects the gains or losses the investment accounts experienced. Future premium deposits, after deductions are taken for expenses and fees, are applied to purchase additional accumulation units at their current value. Like fixed annuities, variable annuities accumulate tax deferred.

Variable annuities allow the contract owner to direct how his or her premium deposits are allocated among the separate account fund options. Often 20 or more different subaccount funds will support a single VA product. Many variable annuities also offer a fixed account option, which earns a fixed interest rate, backed by the assets of the insurer's general accounts.

Because of the risk they entail, variable annuities are considered securities as well as life insurance. Consequently, they must be registered with the SEC and their sellers must be FINRA-licensed as well as life licensed. They must be sold by prospectus and their sale must comply with suitability and market conduct standards established by FINRA as well as state insurance laws. The agent must make reasonable efforts to determine the buyer's financial position, tax status, and investment objectives and to recommend products in light of the buyer's goals and needs.

Common Annuity Features and Contract Provisions

Tax Deferral

One of the chief features of a variable annuity contract is tax deferral. In exchange for this favorable tax treatment, annuities are considered long-term investment products.

Annuitization

All annuities are issued with a maturity date or annuity start date. This is the date upon which the contract is scheduled to annuitize and the annuity fund converted to an income stream.

Death Benefit

Annuities provide for the payment of a death benefit in the event the contract owner (or the annuitant, if different) dies before the contract is annuitized.

Surrender Charges

Surrender charges apply for the first seven to ten years after contract issue; the charges are usually a percentage of the amount invested or of the contract's accumulated value. These charges can be quite substantial.

Free Withdrawals

To minimize the lack of liquidity that characterizes the annuity in its early years, most deferred contracts include a provision that offers limited access to the contract's funds during the surrender charge period. Commonly referred to as a free withdrawal, this provision allows the owner to withdraw up to a certain amount of the contract's value, usually one time per year.

Charges and Fees

In addition to the surrender charge, other charges and fees are associated with an annuity. Among these is the mortality and expense charge. As a life insurance product, an annuity carries a cost—inherent or expressed—associated with covering the product's death benefit guarantee and the risk the insurer assumes if mortality and expenses vary from its assumptions.

Under a variable annuity, the mortality cost is assessed directly against the separate account funds. The exact charge is stated in the contract and is usually stipulated not to increase for the contract's duration. However, the practitioner should not rely on the contract's prospectus and contract provisions to disclose this charge; it should be made clear to the client that a portion of his or her funds are applied to cover the contract's death benefit. A variable annuity valued at $100,000 might be charged about $1,250 or $1,350 in mortality and expense fees.

Variable contracts include other charges associated with the separate account investment options. In brief, these include:

Contract Maintenance Charge. This annual service charge covers the administrative expenses associated with the variable annuity contract. It is typically assessed on contract anniversary dates and when a contract is surrendered.

Administrative Service Charge. This fee compensates the insurer for the costs it incurs in operating the separate accounts and issuing and administering VA contracts.

Premium Taxes. A few states impose a tax on annuity premium deposits. Tax rates range from about 1 percent to 3 percent and are subject to change. Usually these taxes are collected from the insurer, which, in turn, will impose a similar charge against the owner's contract values.

Transfer Fees. Some VA contracts retain the right to impose a fee on transfers among the subaccounts.

Variable annuities, are often criticized for the charges they carry, including the mortality and expense fee. Critics suggest that these charges substantially undermine the value of the product as an accumulation and investment vehicle. The practitioner must deal with this issue responsibly. These costs should be disclosed and discussed. If it is apparent that the buyer does not want insurance protection or is not interested in a death benefit guarantee, a variable annuity may not be suitable. The cost of the death benefit should not be hidden or masked as "the cost of tax deferral." On the other hand, it is an advantage the annuity offers that the death benefit can help protect retirement savings. The producer should take the time to explain what annuity charges cover and then discuss with the buyer how these aspects of the product might support—or counter—the client's long-term goals.

When is an Annuity Suitable?

What kinds of needs indicate an annuity solution?

That question is best answered by recalling the fundamental purpose an annuity can serve: it can be used to accumulate a sum of money on a tax-deferred basis for distribution at a future date. Therefore, an annuity can address a savings and accumulation need and a distribution need.

The Distribution Need

Variable Annuitization

With variable annuitization, the monthly income payments rise and fall in response to the underlying funds in which the annuity monies are invested. Upon annuitization, the contract owner selects an assumed interest rate (AIR), which is the rate of investment growth assumed for the contract's future performance and the rate against which the contract's actual return is measured. If actual returns are less than the AIR, the payment amount decreases; if actual returns are greater, the payment amount increases.

Assume, for example, that Carl purchases an immediate life annuity for $100,000 and selects variable annuitization with a 5 percent AIR. This produces an initial monthly payment of $700, based on the assumed interest rate, the life payout term and expenses. If the value of the funds in which Carl's money is invested increases at a net rate of 5 percent, the next payment Carl receives will also be $700. If the net value increases more than 5 percent, Carl's next payment will be more than $700; if the net value increases less than 5 percent, Carl's next payment will be less than $700.

One of the important considerations with variable annuitization is the AIR, which the contract owner chooses. For this purpose, most contracts offer three or four rates, ranging from 4 percent to 7 or 8 percent. Selecting a lower assumed interest rate will likely assure the client of higher payouts in the future, but will generate a lower level of income initially. Conversely, the selection of a higher AIR will produce a high initial payout while creating a tougher benchmark for the contract's future performance. So which is better—a conservative AIR or a more aggressive projection? The answer depends on the contractholder's risk tolerance and his or her expectations for the future. If the client would not be satisfied with or could not accept a decrease in payment amounts, a conservative AIR projection such as 4 percent or 5 percent should be recommended. This minimizes the risk of monthly income payments decreasing and, in the event of a down market, "dips" will be less.

The Accumulation Need

The other need annuities address—and the one for which most annuities are purchased today—is tax-deferred accumulation.

Assessing the Accumulation Need

Determining the suitability of a fixed annuity requires more than the client's acknowledgment that he or she wants tax-deferred accumulation. Specifically, the practitioner needs to assess certain issues.

- The accumulation need must be long-term.
- The long-term accumulation need should also entail the use of the assets.

The client should intend to make use of the annuity funds or liquidate the contract during his or her life. If the accumulation goal is to pass assets on to one's heirs, then a life insurance solution—which would provide tax-free benefits to beneficiaries—is more suitable.

- How does the client feel about a portion of his or her premium deposits being used to cover the product's death benefit? No annuity product puts the full amount of the client's premium payments toward growth or accumulation. There is a cost for the death benefit and other expenses.
- If the annuity is to fund a tax-qualified retirement plan such as a traditional or rollover IRA, the age of the buyer must be considered. Generally speaking, minimum distribution tax rules require that withdrawals from IRAs begin when the owner turns 70½.
- If the client's desire is to fund a tax-qualified plan, the use of an

annuity must be thoroughly scrutinized. Though certainly allowed and commonly employed, the use of either a fixed or variable annuity to fund a tax-qualified plan is often alleged to be unsuitable because (1) such plans, by their nature, provide for tax deferral and (2) the fees associated with annuities (notably the death benefit cost) are not associated with other financial products, such as mutual funds. In many cases, this allegation has merit.

- What are the possible implications of the ordinary tax treatment of the annuity's distributed earnings and interest? While annuity funds accumulate tax-deferred within the contract, upon withdrawal or distribution, their earnings are subject to tax as ordinary income, not capital gains. The tax bracket of the buyer should be considered as should that of his or her beneficiary who would be responsible for the income tax due on the annuity earnings if the contract owner or annuitant were to die before annuitized payouts begin.
- What qualified retirement plan options are available to the client? Generally speaking, an individual should be encouraged to take full advantage of any employer-sponsored retirement plan (such as a 401(k) or 403(b) plan) or any tax-deductible IRA contributions he or she could make as a first retirement funding option. An annuity should be used to complement, not replace, those options. In addition to offering tax deferral, an annuity does not impose contribution maximums as do qualified plans.

If a deferred annuity is a suitable option for the client's long-term savings and accumulation needs, then the next question is how to invest it—fixed, variable, or indexed? Ultimately, this question must be answered in light of the client's risk tolerance, desire for growth vs. need for safety and—most importantly—his or her ability to understand the product's provisions. Each option has advantages and disadvantages.

Variable Annuities: Advantages and Disadvantages

- A variable deferred annuity offers the advantage of potentially higher rates of return on invested premium dollars and the ability to allocate these dollars among subaccount options that match the owner's long-term objectives. There is a great deal of investment choice and flexibility with these products and, within a single contract, the owner can achieve diversification. Tax deferred compounding adds to the product's ability to accumulate funds at a faster rate than taxable investments.
- Compared to a fixed annuity, the disadvantage of a VA is its lack of guarantees—the VA owner assumes the risk for both principal and rate of return. It's possible that an investor could lose some or all of the original premium deposit.
- Compared to other investment products, the primary disadvantage of a variable annuity is the additional fees, charges, and expenses attached to the product's invested values. This includes the contract's mortality and expense charge, which can be as much as 1.35 percent per year. In recent years, there has been an explosion of variable annuity product designs and the creation of new and innovative features, all of which offer some benefit to the consumer. However, these features and benefits do come with price tags and the upshot is that mortality and expense charges now vary considerably from product to product. It's imperative that the practitioner be familiar with the charges associated with the products he or she represents.

You Must Understand . . .

Annuities can be ideal retirement planning tools. For the accumulation and/or distribution of funds, they offer distinct options and opportunities. However, before the practitioner closes the book on an annuity sale, he or she should make sure the client understands the following regarding annuities.

- The purchase of a deferred annuity is a long-term commitment and the need or objective it addresses must have a distant horizon point.
- Early surrender of or withdrawal from an annuity could trigger a surrender charge and possibly an IRS penalty.
- With a variable annuity, there are no investment or growth guarantees—loss of principal is a possibility.
- With a variable annuity, protection of principal applies only if the owner or annuitant dies prior to annuitization.
- Upon distribution, income taxes are due on the product's cumulative returns; this applies not only to the annuitant but also to the beneficiary if the annuitant dies while there are funds left in the contract.
- There are charges associated with the death benefit, which means that less will be invested for accumulation purposes.
- Once annuitization begins, it is irrevocable.

Taxation of Annuities

The following is an overview of how annuities are taxed.

Taxation During Accumulation

One of the benefits deferred annuities offer is tax-deferred accumulation: while funds remain in the contract, no income tax is imposed on interest earnings credited to the contract nor on the values as they build within the contract. Taxes are due only upon withdrawal. This greatly enhances the build-up of funds. However, in exchange for this favorable tax treatment, the annuity is treated as a long-term retirement savings vehicle. If contract values are withdrawn before the owner is age 59½, a 10 percent penalty may be imposed on the interest portion of the withdrawal, in addition to ordinary income tax. Let's say, for example, that at the age of 40, Hal deposited $25,000 in a deferred annuity. Now, eight years later, he withdraws $10,000. What is Hal's tax liability? To the extent the $10,000 represents interest earnings, Hal would have to pay a penalty of 10 percent, or $1,000, in addition to ordinary income taxes.

Annuity withdrawals taken before a contract's maturity date are treated on a LIFO ("last-in, first-out") basis. In other words, withdrawals are considered to consist of interest earnings first. Only after all interest has been recovered is invested principal considered to be withdrawn, which of course is not taxable. Using the example above, let's assume that the value of Hal's annuity at the time he took the withdrawal was $40,000: $25,000 principal and $15,000 accumulated interest earnings. Consequently, the full amount of the $10,000 withdrawal would be deemed interest earnings, fully subject to the 10 percent penalty and ordinary income tax. This same tax treatment would apply to any and all amounts Hal might withdraw up to $15,000; above $15,000, withdrawals would be considered a nontaxable return of principal.

(The above example is based on the assumption that Hal's annuity is nonqualified. If it were a traditional IRA, the $25,000 in principal too would be subject to the 10 percent penalty and ordinary income tax, to the extent that any of it had previously been deducted as IRA contributions. There are, however, a number of exceptions to the 10 percent penalty for IRA withdrawals, including withdrawals due to death, disability, or when taken in substantially equal payments over life.)

Taxation of Annuitized Income

Income received from a (nonqualified) annuity under a structured annuitization option is taxed according to the exclusion ratio. The exclusion ratio treats each annuity payment as part principal and part interest and applies a formula that excludes the principal portion of the payment, taxing only the interest. The formula is the "investment in the contract" (i.e., the total of premiums paid, less withdrawals) divided by the "expected return" (i.e., the total amount of annuitized income the contract is expected to pay out). For example, let's say Betty invested a total of $20,000 in a fixed deferred annuity. Now at the age of 62, she opts to annuitize her contract and selects a single life payout, which will generate $160 a month for her for life. Based on Betty's life expectancy of 22.5 years, the total expected payout under the contract is $43,200. The nontaxable portion of her annuity income is calculated as follows:

$$\frac{\$20{,}000 \text{ (investment in the contract)}}{\$43{,}200 \text{ (expected payout)}} = 46.3\%$$

Consequently, $74.08 of each $160 annuity payment is excluded from income tax; the balance is taxable. This methodology applies until the entire investment in the contract has been paid out. If Betty lives beyond her life expectancy, the annuity payments will continue; however, at that point they will consist entirely of interest and will be fully taxable. (For contracts that annuitized prior to 1987, the exclusion ratio applies indefinitely, permanently excluding from tax a portion of all annuity payments.)

The exclusion ratio applies to fixed annuity payouts. Variable annuity payments require slightly different calculations and follow a special rule that determines the portion of each payment that is "an amount received as an annuity" and excluded from tax.

What are Equity-Indexed Annuities?

An annuity is the "mirror image" of a life insurance policy. Whereas a life insurance policy is designed to create a principal sum of money, an annuity is designed to liquidate a principal sum. It creates an income stream, payable over a defined period of time, by distributing the principal amount invested plus returns on principal. Each annuity payment comprises principal and return. In a traditional annuity, interest accrued on the yet-to-be-distributed principal amount makes the total sum of annuity payments larger than the initial amount of money deposited in the annuity.

Equity-indexed annuities are a type of fixed annuity that offer the potential for higher rates of growth. The interest credited to an equity-indexed annuity is tied to increases in a specified equity or stock index. Underlying the contract for the duration of its term is a minimum guaranteed rate so the contract owner's principal is protected and a certain rate of growth is guaranteed. When the growth of the index to which the annuity is linked produces gains that are greater than the minimum rate, that gain becomes the basis for the amount of interest that will be credited to the annuity. At the end of the contract's term, the annuity owner will be credited with the greater of the guaranteed minimum value or the indexed value. The index to which most EIAs are tied is the Standard & Poor's 500 Composite Stock Price Index.

It's easy to see why equity-indexed annuities have become popular. They offer potential for market-linked rates of return with a guarantee that principal will be protected. They bridge the gap between guaranteed, fixed, low-interest options (which are subject to inflation risk) and higher interest, nonguaranteed options (which are subject to market risk). With an EIA, investors who do not want to risk principal can still receive market-based earnings—which are likely to be higher than those offered by other guaranteed products—without risking principal.

Although no one can predict how the equity markets will perform in the future and history is no guarantee of future performance, equity-linked investments such as EIAs offer the potential to achieve a return higher than the rate of inflation.

There are a number of EIA designs on the market today, characterized by differing methods of calculating how the index gain is credited to the contract. Some designs are fairly straightforward; others are more complicated.

Furthermore, individual EIA designs will perform differently in different market environments. Some respond well to volatile markets; others do better in stable or rising markets. EIA contracts have introduced new terminology to the annuity arena: participation rates, caps, floors, interest vesting schedules, windows—all of these terms represent different features of EIA contracts, which can vary greatly from product to product.

Equity-indexed annuities can be complicated. It's imperative that the practitioner understands the product he or she represents and is able to explain its features, benefits and limitations to prospective buyers. Though most equity-indexed annuities are not registered securities products, those who represent these products must still meet a high level of due diligence.

Common Annuity Features and Contract Provisions

Tax Deferral

One of the chief features of a variable annuity contract is tax deferral. In exchange for this favorable tax treatment, annuities are considered long-term investment products.

Annuitization

All annuities are issued with a maturity date or annuity start date. This is the date upon which the contract is scheduled to annuitize and the annuity fund converted to an income stream.

Death Benefit

Annuities provide for the payment of a death benefit in the event the contract owner (or the annuitant, if different) dies before the contract is annuitized.

Surrender Charges

Surrender charges apply for the first seven to ten years after contract issue; the charges are usually a percentage of the amount invested or of the contract's accumulated value. These charges can be quite substantial.

Free Withdrawals

To minimize the lack of liquidity that characterizes the annuity in its early years, most deferred contracts include a provision that offers limited access to the contract's funds during the surrender charge period.

Charges and Fees

In addition to the surrender charge, other charges and fees are associated with an annuity. Among these is the mortality and expense charge. As a life insurance product, an annuity carries a cost—inherent or expressed—associated with covering the product's death benefit guarantee and the risk the insurer assumes if mortality and expenses vary from its assumptions.

When is an Annuity Suitable?

Commonly referred to as a free withdrawal, this provision allows the owner to withdraw up to a certain amount of the contract's value, usually one time per year.

What kinds of needs indicate an annuity solution?

That question is best answered by recalling the fundamental purposes an annuity can serve: it can be used to systematically liquidate an existing amount of money or it can be used to accumulate a sum of money on a tax-deferred basis for distribution at a future date. Therefore, an annuity can address a distribution need and/or a savings and accumulation need.

The Distribution Need

Most people look for returns on their investments that outpace inflation and show real growth. In periods of low interest rates, real returns—returns after accounting for inflation—are usually quite low, and the stock market becomes the investment vehicle of choice. This attitude favors an equity-indexed fixed annuity, whereby the client enjoys safety of principal, some guaranteed minimum returns, and some of the gains in the stock market.

The Accumulation Need

The other need annuities address—and the one for which most annuities are purchased today—is tax-deferred accumulation.

Assessing the Accumulation Need

Determining the suitability of a fixed annuity requires more than the client's acknowledgment that he or she wants tax-deferred accumulation. Specifically, the practitioner needs to assess certain issues.

- The accumulation need must be long-term.
- The long-term accumulation need should also entail the use of the assets.

The client should intend to make use of the annuity funds or liquidate the contract during his or her life. If the accumulation goal is to pass assets on to one's heirs, then a life insurance solution—which would provide tax-free benefits to beneficiaries—is more suitable.

- How does the client feel about a portion of his or her premium deposits being used to cover the product's death benefit? No annuity product puts the full amount of the client's premium payments toward growth or accumulation. There is a cost for the death benefit and other expenses.
- If the annuity is to fund a tax-qualified retirement plan such as a traditional or rollover IRA, the age of the buyer must be considered. Generally speaking, minimum distribution tax rules require that withdrawals from IRAs begin when the owner turns 70½.
- If the client's desire is to fund a tax-qualified plan, the use of an annuity must be thoroughly scrutinized. Though certainly allowed and commonly employed, the use of either a fixed or variable annuity to fund a tax-qualified plan is often alleged to be unsuitable because (1) such plans, by their nature, provide for tax deferral and (2) the fees associated with annuities (notably the death benefit cost) are not associated with other financial products, such as mutual funds. In many cases, this allegation has merit.
- What are the possible implications of the ordinary tax treatment of the annuity's distributed earnings and interest? While annuity funds accumulate tax-deferred within the contract, upon withdrawal or distribution, their earnings are subject to tax as ordinary income, not capital gains. The tax bracket of the buyer should be considered as should that of his or her beneficiary who would be responsible for the income tax due on the annuity earnings if the contract owner or annuitant were to die before annuitized payouts begin.
- What qualified retirement plan options are available to the client? Generally speaking, an individual should be encouraged to take full advantage of any employer-sponsored retirement plan (such as a 401(k) or 403(b) plan) or any tax-deductible IRA contributions he or she could make as a first retirement funding option. An annuity should be used to complement, not replace, those options. In addition to offering tax deferral, an annuity does not impose contribution maximums as do qualified plans.

If a deferred annuity is a suitable option for the client's long-term savings and accumulation needs, then the next question is how to invest it—fixed, variable, or indexed? Ultimately, this question must be answered in light of the client's risk tolerance, desire for growth vs. need for safety and—most importantly—his or her ability to understand the product's provisions. Each option has advantages and disadvantages.

Equity-Indexed Annuities: Advantages and Disadvantages

- Because it is a fixed product, an equity-indexed annuity guarantees a certain minimum return over the term of the contract, but offers the potential for higher, market-linked rates of return. Unlike a traditional fixed annuity, the actual interest rate credited to an EIA is not based directly on the insurer's investment experience and is not dependent on a rate declared by the insurer. Instead, it is tied to an independent stock index such as the S&P 500 and the movement of that index over the contract's term. Consequently, the EIA owner is guaranteed a certain rate of growth and preservation of principal but can also see accumulation that reflects current equity markets. EIAs allow investors to achieve some of the benefits of stock market investing but provide a safety net.
- The primary disadvantages to an EIA are the caps and restrictions the product imposes on the actual rate of return credited to the contract. Under most contracts, this rate is a specified percentage of the index's return, such as 60 percent or 75 percent, and it does not include dividends. Furthermore, EIA contracts can be extremely complex. If a client does not understand an equity-indexed annuity and all that the contract entails, it is not a suitable option.

You Must Understand . . .

Annuities can be ideal retirement planning tools. For the accumulation and/or distribution of funds, they offer distinct options and opportunities. However, before the practitioner closes the book on an annuity sale, he or she should make sure the client understands the following regarding annuities.

- The purchase of a deferred annuity is a long-term commitment and the need or objective it addresses must have a distant horizon point.

- Early surrender of or withdrawal from an annuity could trigger a surrender charge and possibly an IRS penalty.
- Upon distribution, income taxes are due on the product's cumulative returns; this applies not only to the annuitant but also to the beneficiary if the annuitant dies while there are funds left in the contract.
- There are charges associated with the death benefit, which means that less will be invested for accumulation purposes.
- Once annuitization begins, it is irrevocable.

What is a Mutual Fund?

Mutual funds and other investment companies provide the understanding and knowledge many investors lack. The complexities of investing in stocks require the ability and time to stay abreast of developments in the stock market. Many potential investors lack this ability. Many investors also lack the volume of money required to invest in a variety of individual stocks, and are therefore subject to the risk of a stock failing to perform as hoped. Investment companies provide a way for investors to establish their financial houses without becoming financial "experts."

For a fee, mutual funds and other investment companies choose stocks that will fulfill certain objectives such as growth, income, or stability. The people employed by investment companies to perform these functions presumably have the skills and abilities that the average person has neither the time nor opportunity to develop. Thus, the investor "buys," along with securities, the expertise of the investment company. Using investors' money, the investment company purchases a *diversified* (in most cases) portfolio of stocks based on its stated objectives. This diversification gives the investor still another benefit from purchasing securities through an investment company. That is, because the portfolio is widely diversified, poor performance in any one stock is unlikely to cause severe financial loss to any one investor. Instead, the investor's money continues to work through the many other stocks of the investment company's holdings, spreading the risk of loss. This is not to say that pooled investments provide guarantees. There is no guarantee that the amount invested will be safe from loss, nor that there will be any return on the investment. However, the chances of such a loss are considerably reduced by the wide diversification.

Although diversification is an important aspect of most investment companies, some investment companies are not diversified. In order to qualify as a diversified company, an investment company must invest at least 75 percent of its assets in such a way that it meets these two requirements:

1. No more than 5 percent of its assets are invested in one corporation.

2. It does not own more than 10 percent of the outstanding voting stock of any one corporation.

Any investment company that does not meet these qualifications is a nondiversified investment company. Because there is a corporate tax benefit for diversification, most investment companies are diversified. "Investment companies" refers to those companies that are registered with the Securities and Exchange Commission under the regulations of the Investment Company Act of 1940.

How They Work

The investment company invests the shareholders' pooled resources in a variety of securities, which together are called a **diversified portfolio**. The earnings and capital gains of the securities in this portfolio are returned to the investment company, which in turn distributes them (less fees and expenses) to each shareholder in proportion to the shareholder's investment.

A mutual fund is continuously offering its shares for sale. There is no limit to the number of shares it may offer, although it may choose to limit the number itself. Most, however, do make continuous offerings. In addition, the fund is always "open" to redeem the shares it has sold if a shareholder requests that it do so. The mutual fund is required by law to redeem its shares if requested.

Mutual fund shares differ from other securities in the way the investor purchases them. Whereas stock is sold per share at the current market price, and bonds generally are $1,000 face value, mutual fund shares are purchased in whatever dollar amount the investor chooses. This may result in the investor owning some full shares and a part of a share. For example, suppose a mutual fund share is selling at $7.40. An investor who has $150 to invest will receive 20.270 shares (note that the fractional share is usually calculated to three decimal points). These 20.270 shares are said to represent an *undivided interest* in the investment portfolio. That is, a single investor does not own all of any one security, but owns a part of every security in the portfolio.

Purchasing Mutual Funds

Determining the cost to purchase shares of a mutual fund is slightly more complex. First, two different figures are involved in arriving at the selling price. These are the **net asset value (NAV)** and the **public offering price**. The NAV of a mutual fund is determined at least once each business day. It is the fund's total assets minus its total liabilities. To determine the NAV *per share*, then, this total NAV is divided by the number of shares outstanding. For example, if the fund's NAV is $50,000,000 and it has 5,000,000 shares outstanding, the NAV *per share* is $10.00.

The NAV is also called the **bid price**. This is the price the fund will pay a shareholder who wishes to redeem shares. Now, mutual fund share prices do not respond to stock market changes as do regular stock and closed-end shares. Instead, the company uses the NAV as indicated to determine its value for redemption. In addition, to determine the price at which shares will be offered to the public, it is common for a *sales load* to be added to the NAV, resulting in the **asked price**, which is the same as the offering price. The sales load is like a commission that compensates the individual selling the fund for his or her financial advice.

Some mutual funds are known as **no-load funds**. This means that no sales charge is made when shares are purchased. These funds sell their shares directly, usually by mail, so there is no dealer or sales representative commission to pay. However, no-load funds may charge a *redemption fee* when the investor wants to sell the shares back to the investment company. Sales charges and other fees must be fully explained to the potential investor before any purchase is made.

Types of Investment Policies

Mutual funds and other investment companies are often labeled by the objectives they hope to accomplish, such as current income or growth. Mutual funds, especially, may have a number of different funds available to meet various objectives. Note, however, that there is no guarantee that any mutual fund will actually attain the desired objective. In any event, the funds can be loosely classified as one of these: (1) diversified common stock fund, (2) balanced fund, (3) bond and preferred stock fund, (4) municipal bond fund, and (5) money market fund.

Diversified common stock funds invest primarily, but not exclusively, in common stock. Their particular objectives may vary widely over, roughly, five areas. The type of common stock fund that seeks maximum capital appreciation is called, appropriately, a *maximum capital gains* fund, a *go-go* fund, a *performance* fund, or an *aggressive growth* fund. Such funds may pay little or no dividend. Their usual type of investment is one where growth potential seems good, such as a small, little-known company expected to advance rapidly. Occasionally, this particular type of common stock mutual fund might *not* be diversified, preferring instead to concentrate holdings in a particular area where growth is expected.

Another type of common stock fund is a *growth* fund, quite similar to the previous type, but slightly more conservative. Again, growth possibilities, rather than dividends, are the objective.

A third type of common stock fund, the *growth-income* fund, compromises slightly on the growth possibilities in order to attain some dividend income. This is even less risky than the growth fund.

The *income* fund, unlike the other common stock funds we've talked about, does look for dividend income. In search of a higher dividend yield, this type of fund may take more risks. The potential for capital growth, however, is limited.

A newer type of fund is the *index* fund. An index fund is not managed as other funds are, with a portfolio manager buying or selling stocks on the basis of his or her estimation of their value. Rather, the index fund is composed of the stocks of an existing index, such as the Standard & Poor's 500. An index fund seeks only to match the performance of the index.

Finally, *specialized* funds are likely to concentrate their holdings in some special area, such as a specific industry or geographical area. While these are no longer prolific, those that are in operation look for capital growth over income.

While the various common stock funds just mentioned seem somewhat lopsided in their unique emphases, **balanced** funds attempt to maintain a balance between the usually steady bonds and preferred stocks and the more volatile common stocks. As conditions in the financial market change, such a fund is likely to change the proportions of its holdings of these securities. A balanced fund is a conservative, defensive approach to investment.

A few **bond and preferred stock** funds exist, with concentration in bonds and preferred stocks, also known as senior securities. They are much like income funds, with more emphasis on safety of capital. They are safe and more conservative, and as such, provide a lower yield.

Municipal bond funds invest only in the munis discussed in the previous unit. They exist solely for the purpose of providing tax-exempt income for the investor, offering more flexibility than the individually purchased municipal bonds.

Money-market mutual funds invest in short-term money-market instruments. The advantages of the fund are the same as with the individual money market instruments—safety of principal, high liquidity, and relatively high yields. The yields fluctuate widely just as short-term interest rates do.

International and global investing has been growing in popularity, and various types of mutual funds can be an excellent way for investors to get into it. When dealing with foreign securities, the management expertise and diversification provided by mutual funds can be especially valuable and not otherwise easy for the average investor to obtain. International funds are distinguished from global funds in that international funds generally own securities issued only by non-US companies, while global funds own stocks of companies all over the world, including the United States. There are **international equity** and **global equity** funds, as well as **international bond** and **global bond** funds.

Comparing Mutual Funds

In comparing one mutual fund to another, it is important that both funds have a similar investment objective. For example, it would be fair to compare the expenses of one aggressive growth fund to another aggressive growth fund, or the expenses of one index fund to another index fund. To begin with, then, the investor has to determine which investment objective he or she wants to achieve, and then compare the funds that have that investment objective. Once an investor has determined his or her investment objective, there are three major factors by which mutual funds can be compared.

Performance

A record of successful growth or appreciation in the fund's capital value in the past is a positive sign, but it is no indication that the growth will continue in the future. Mutual fund dividend distributions may contain both stock dividends and interest earned by the portfolio. Some investors may think that a fund's income distribution, or current yield, is the best measure of performance. Investors must factor in the total return—capital appreciation as well as dividend and interest distributions—to get a true measure of the fund's performance.

Risk

Every investment involves risk. Investors hope that, if they are willing to take a greater risk, they will be rewarded with a greater return. Analysts use "risk-adjusted performance" to rank funds of a given type on their rate of return adjusted for risk, measuring a fund's performance in both up and down markets. A volatile fund may produce above-average gains when the market is up. But it may also lose value much faster than average in a falling market. Funds that have performed well in both good periods and bad may be ranked higher than more volatile funds with a greater return.

Cost

A final element for comparison between funds is cost. The expense ratio gives you the fund's operating expenses for the year expressed as a percentage of the fund's average net assets. In general, the lower the expenses, the greater the return to the investor.

Other Factors

Investors will find many features that cannot be compared statistically from fund to fund. These special features may weigh heavily with specific investors. The presence or absence of features like telephone transfers, exchange privileges, front-end or back-end loads, or minimum purchase amounts may override differences in performance with these investors.