




EXCHANGE

DEMYSTIFYING ANNUITIES



GSI EXCHANGE has developed this guide to help you better understand this popular form of investment. Our goal is to help you understand the complexities behind annuity products so that you can better decide for yourself whether its promised benefits are worth their hidden risks.

Investing is virtually synonymous with risk. If you seek returns from an investment, you will have to assume some degree of risk in order to gain exposure to its profit potential. Despite this necessary and **commonly-acknowledged** trade off, risk can still be a frightening prospect to most investors, as no investor enjoys seeing their portfolio values drop.

For many investors who feel a strong aversion towards risk, instruments that offer guaranteed income or returns with zero loss can sound very attractive. Hence, some investors choose to purchase annuities.

Annuities may seem like a near-perfect solution, one that can provide returns with little to no risk. The truth, however, is that annuities are complex instruments whose structure and rules are far more heavily weighted in favor of the provider rather than the investor.

Often with high fees and costs, and complex limitations and restrictions, annuities carry risks that not only offset the benefits they promote, but that also contradict the one singular characteristic for which they are sought: **safety**.

So, while most annuities tout the benefit of avoiding market risk and volatility, such risk avoidance comes at the cost of high fees that may ultimately drain the value of your “investment” while severely restricting access to and control of your own money.

GSI Exchange has developed this guide to help you better understand this popular form of investment. Our goal is to help you understand the complexities behind annuity products so that you can better decide for yourself whether its promised benefits are worth their **hidden** risks.

In this guide, we will answer 9 critical questions that you should ask yourself before signing an annuity contract.

- 1. Do I Seek Growth, Income, or Safe Haven?*
- 2. Do I Fully Understand the Terms of the Annuity Contract?*
- 3. How Much of Your Annuity Benefits Are Eaten Up by Costs?*
- 4. What Annuity Terms and Conditions Might Get in the Way of the Benefits?*
- 5. Will I Be Penalized if I Take Early Withdrawals from My Annuity?*
- 6. How Might Performance Floors and Caps Impact My Overall Returns?*
- 7. How Are Taxes Going to Affect My Annuity Income and Principal?*
- 8. How Will Inflation Impact My Annuity Income?*
- 9. How Might Annuities Impact My Beneficiaries When I Pass Away?*



Do I Seek Growth, Income, or Safe Haven?



There are generally three types of annuities. Each one comes with its own unique set of benefits and risks. Before you consider purchasing any type of annuity contract, it's important to have a balanced view as to how these instruments can both help and hurt your long-term investment goals.

Fixed Annuities: these instruments guarantee a fixed rate of return over a specified time period. Similar to certain “money market” instruments, the most popular of which are CDs (Certificates of Deposits), fixed annuities can shield you from loss as their returns are guaranteed. But they also can be highly restrictive and illiquid. Unlike investing in other forms of fixed income that can generate similar returns, you may be relinquishing access and control over your money when purchasing a fixed annuity contract.

Indexed Annuities: investors who seek market-based returns may consider investing in an indexed annuity. These annuities are often benchmarked to a given index such as the S&P 500. The downside is that many of these returns are capped to the upside. And although some indexed annuities are benchmarked to dividend-generating assets, most of them do not provide dividends, a limitation that can severely limit your potential returns.

Variable Annuities: if you want a mutual fund-style investment that provides a guaranteed minimum rate of return while avoiding downside in underperforming markets, then you may be attracted to the features offered by variable annuities. Just bear in mind that these guaranteed returns are typically counterbalanced by high fees that may ultimately erode your total return.

A Safe Haven to Shield Your Assets from Inflation

Some annuities provide inflation protection in the form of “riders.” Although we will discuss this later in the guide, it's important to understand that inflation riders come at an additional cost which can ultimately offset any protective benefits you receive, defeating the purpose of having the rider in the first place.

Think Twice about Your Trade-off Between Risk and Return

Whether you seek portfolio growth, income, or a “safe haven,” these three annuity types may seem like a good investments. In actuality, there may be simpler, more efficient, and much less restrictive ways to achieve your investment goals.

Do I Fully Understand the Terms of the Annuity Contract?

As an investor, you may be familiar with two important documents that are almost always presented to you before you decide on a particular financial product: *prospectus* and *risk disclosure*.

But have you ever tried to decipher the meaningful content hidden within the verbal complexities of these documents? Given the jargonistic way in which most of these documents are written, most investors would answer “no.”

In 2004, the Financial Industry Regulatory Authority (FINRA) published a **report** addressing complaints received from customers who were sold variable annuities without a full explanation of the details of each product. In each case, the lack of disclosure made it difficult for investors to understand whether these annuity products were appropriate for their financial goals.

It goes without saying that in order to fully understand the advantages and disadvantages of any annuity contract, you have to go beyond the promotional copy. You have to read and understand the terms of the contract which, unfortunately, can require hundreds of pages of reading.

If the devil is buried within the details, then it's often the case with variable annuities that the details are made impenetrable, often for purposes that are advantageous to for the provider, not the investor.

Indexed annuities, on the other hand, provide a “Statement of Understanding” which is a much shorter disclosure of contractual terms and obligations. Despite its brevity, it’s still neither simple nor easy to understand.

What investors often miss when reading a statement of understanding are the implications of three terms: namely, participation/index rate, performance floor (minimum return), and performance caps. We’ll provide a simple definition for each.

Participation/Index Rate is the percentage of return you are allowed to take in based on the average return of an underlying market index.

Performance Floor is the minimum rate of return that you may earn based on the average return of an underlying market index.

Performance Cap is the maximum return that you are allowed to earn based on the average return of an underlying market index.

To add more uncertainty to an already complicated context, annuity providers have the right to change the terms, which can work against you, severely impacting your financial prospects.

For instance, let’s suppose that you plan on receiving higher income benefits by making regular contributions to your annuity. The annuity provider can legally limit your future contributions so that your payments and overall benefits are reduced.

And since the provider reserves the “right” to change the terms—a detail which may be well buried within the provider’s thick volume of disclosure pages—*you likely have no legal recourse*, as you had technically agreed to it when signing the contract.

This also means that your annuity provider can change the terms of your fees, participation/index rates, performance floors and performance caps on an annual basis. Essentially, you are bound to contract terms that your annuity provider can legally change as frequently as each year.

This leaves your investment vulnerable to the profit-seeking interests of your provider.

The main point is that you should read and understand every bit of information furnished by your provider. Most providers don’t count on their customers analyzing the details of the prospectuses and disclosures. Signing an annuity contract that you haven’t fully read can put you in a very detrimental bind.

How Much of Your Annuity Benefits are Eaten Up by Costs?

It's unlikely you'll find a suitable annuity that offers a flat fee. Most annuity expenses involve complex layers of fees. The fees are typically stated in percentage terms which, if you were to add them up, can cost thousands of dollars each year.


Let's suppose that a \$100,000 annuity included fund expenses, riders (e.g. inflation protection, death benefit, etc.), and administrative fees that add up to 3.86%. Annually, that may cost you \$3,860.

Variable Annuity Expense (Hypothetical)	How Much You Pay Annually
Administrative Costs	0.19%
Expense for Underlying Funds in Annuity	0.97%
Cost of Living Rider	1.02%
Death Benefit Rider	0.65%
Mortality & Expense Risk	1.21%
Total Cost	(3.86% or \$3,860)

Over the long term, these annual costs can add up to a significant amount, eroding your total return and making it difficult for you to achieve your retirement goals.

Fortunately, there are other ways to achieve your objectives—ways to generate portfolio growth, income and capital preservation in a manner that also allows you to have immediate liquid access to your capital.





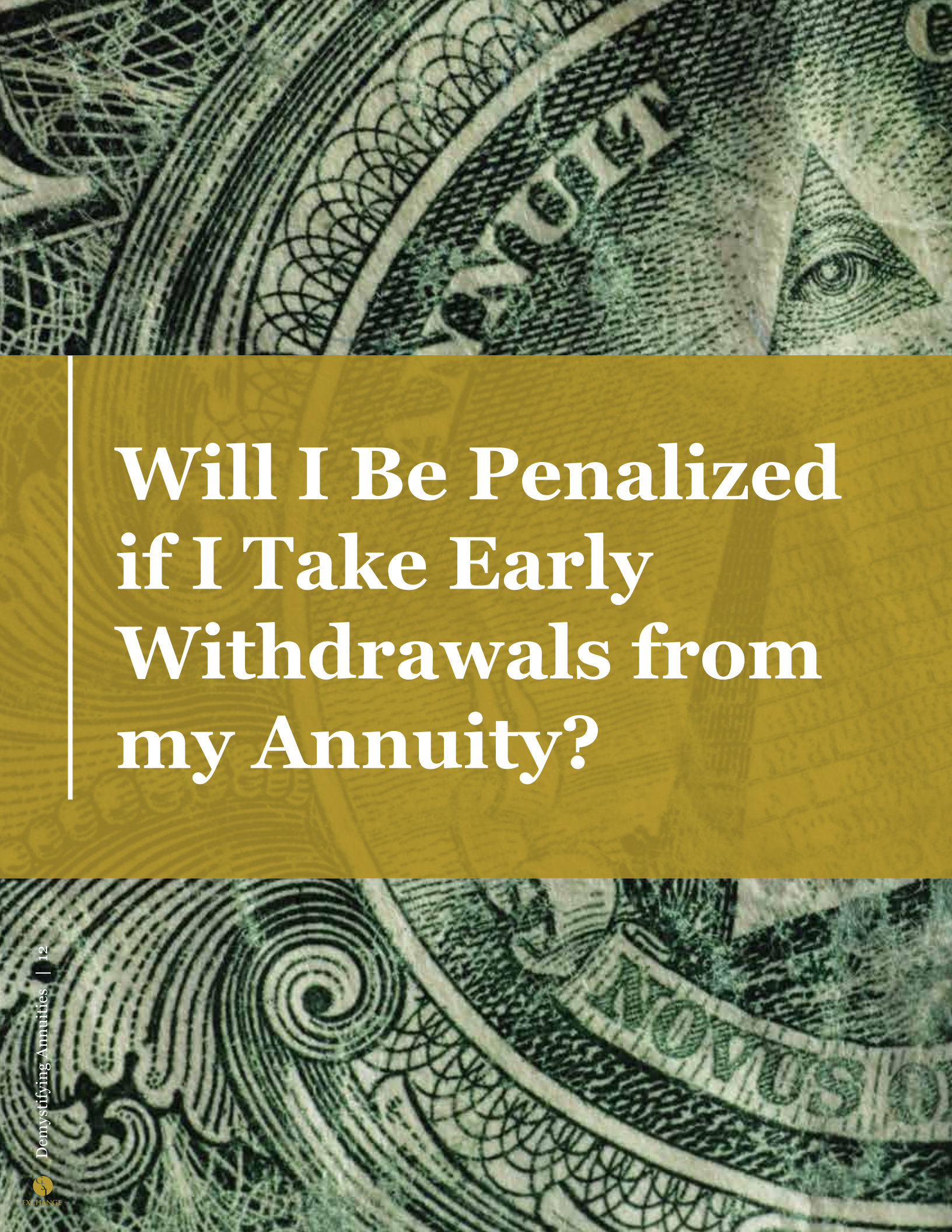
What Annuity Terms and Conditions Might Get In the Way of the Benefits?

Riders are additional benefits that annuities offer provide for an additional fee. The three most popular rider benefits guaranteeing lifetime withdrawals, income, and principal are the following:

01. **Guaranteed Lifetime Withdrawal Benefit:** The annuity holder receives a percentage of the total principal but the income can last the holder's entire lifespan.
02. **Guaranteed Minimum Withdrawal Benefit:** The annuity holder can receive guaranteed income payments over a specified period until the end of the contract's term or until the total payments are equivalent to the principal value.
03. **Guaranteed Minimum Income Benefit:** The annuity holder can receive a lifetime income stream but the balance of the principal is often forfeited upon reaching a specified maturity date.

The problem with these rider benefits is that a number of contractual terms or conditions can *prevent holders from actually receiving them*, despite having paid for them.

- **Waiting Period:** Waiting periods can be exceedingly long, some requiring you to wait as long as ten years. If you need your benefits sooner, say, in the case of a financial emergency, you might have forfeited your access to that money.
- **Annuitization:** Once you agree to convert your deposited funds into periodic payments, *you've virtually signed off your entire principal to your provider*. This is an irrevocable decision, one that finalizes the annuity provider's full control over your funds.
- **Limited Investment Options:** Although you may be paying for a living benefit rider—one that guarantees lifetime income while providing exposure to equities—*providers can significantly cut back their exposure to market, reducing the benefit that you are paying for*. As an annuity holder, you have no say as to how the provider allocates the investments within your annuity.



Will I Be Penalized if I Take Early Withdrawals from my Annuity?

Annuity contracts often come with *surrender fees* which can be quite sizeable, starting at around 7% or more. Although most annuity contracts allow you to withdraw a relatively small percentage each year penalty-free, the likelihood of experiencing unforeseen financial needs might not play well into this scenario.

If you need more than your allotted withdrawal, you cannot access the amount you need without being penalized. And if for any reason you need the *entire* amount of your annuity, or if you simply decided that the annuity was not a right match for you, the cost of unwinding your contract can be exorbitant. If you happened to purchase a fixed annuity, then in addition to penalty charges, your account value might be subject to a Market Value Adjustment which can negatively affect your account value during a period of rising interest rates.

Before you purchase an annuity, think twice whether you can truly commit to its contract length given your changing life circumstances, or if you are willing to absorb the high penalization costs of exiting your contract.

Surrender Periods and High Broker Commissions

A surrender period is the length of time you must wait until you can withdraw funds without penalty. And different annuities have varying annuity surrender periods, from as short as three years to as long as seven years or more.

On average, annuities with longer surrender periods are often incentivized with higher commissions. According to an SEC report, “High commissions, typically above 5% for variable annuities, help drive sales of these products.” In other words, if your financial advisor is incentivized to sell high-commission annuities, his or her motivation to sell them to you may not be geared toward your interests or financial needs.

How Might Performance Floors and Caps Impact My Overall Returns?

Certain annuities, particularly indexed annuities, come with both performance floors and performance caps. A performance floor sets the minimum rate of return that you can receive, while a performance cap sets a maximum rate of return that you can receive.

Another type of cap that you may see is called a “participation rate.” This determines the percentage of a market’s return that you can receive. So if your participation rate were, say 75%, and if the market had risen by 20%, then your return would only be 15%.

- Performance floors were intended to protect investors from taking too large a loss during a market decline.
- Performance caps, on the other hand, were set in place so that insurance companies can generate more profit (by not paying out too much to investors) in a rising market.

Perhaps this sounds like a fair deal—you risking less, and the provider, in exchange, making more. But is it really a good trade-off? Here are a few examples to consider:

If your participation rate is 75% and the market rises by 10%, then your total return is only 7.5%.

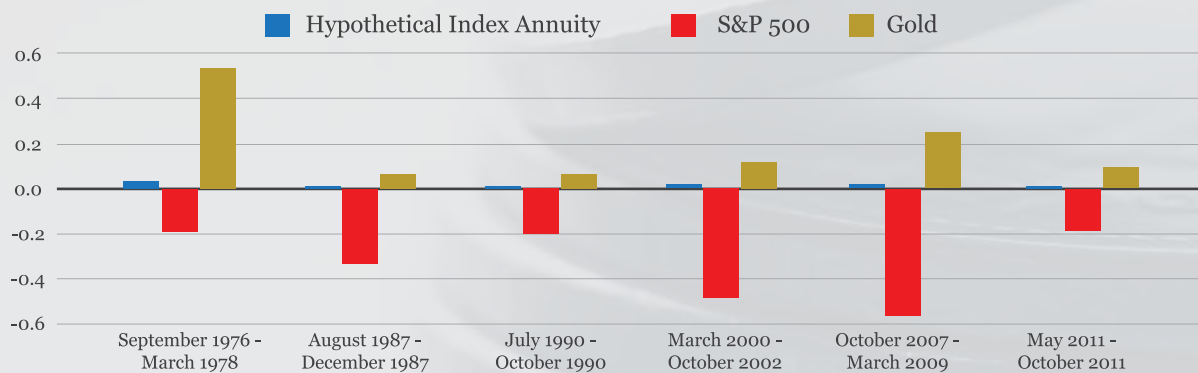
Supposing your participation rate is 100%, and your annuity has a floor of 1% and a cap of 5%:

- If the market gains less than 1% (your annuity floor) or loses value, your annuity will return 1%.

- If the market gains between 1% and 5%, your annuity return will match the market.
- If the market gains more than 5% (your annuity cap), your annuity will still return 5%.

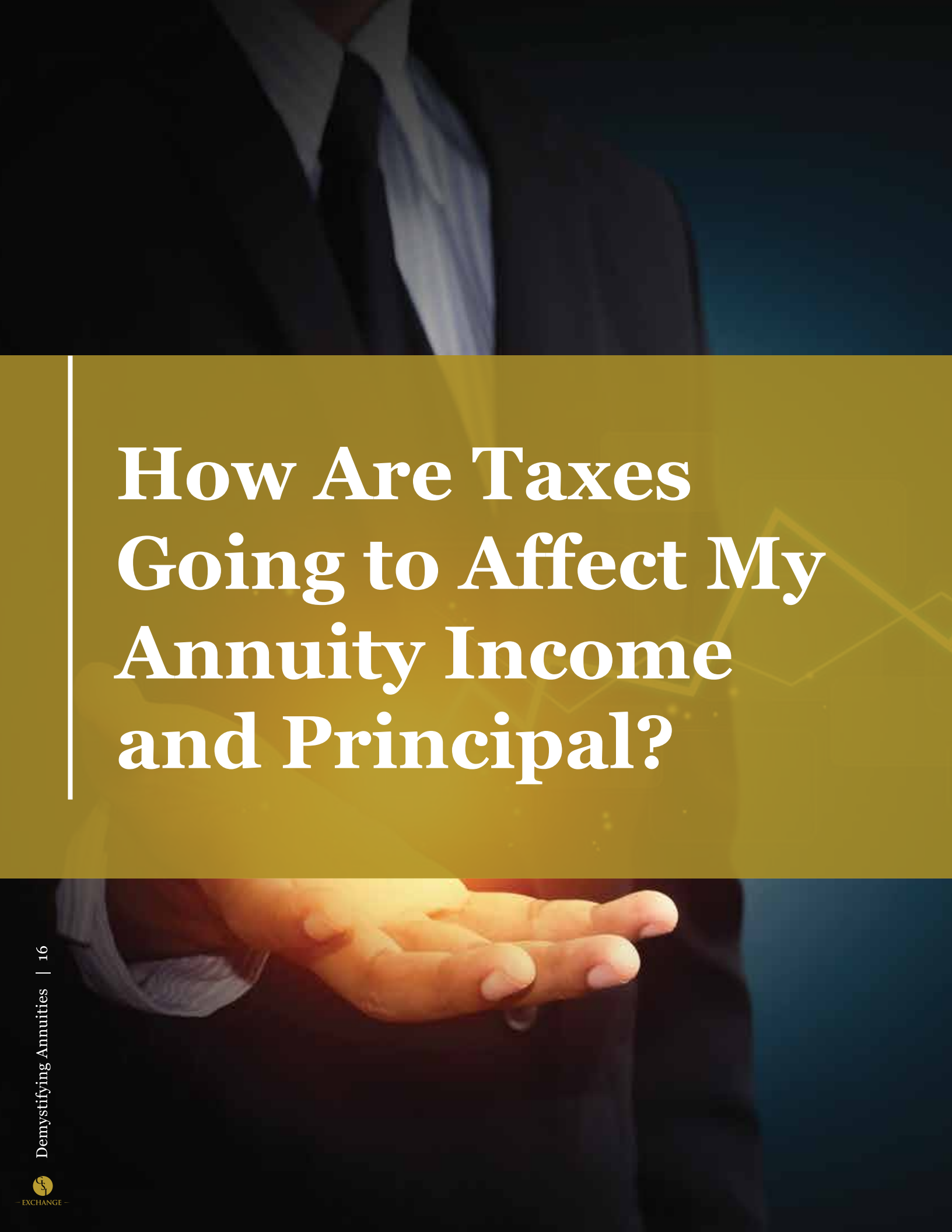
But here's another thing to consider: investors often purchase annuities out of fear of market volatility.

Here's what the same annuity might have returned during six of the worst declines in the S&P 500 (with an annuity floor of 1% and a cap of 5%).



Market Declines	Hypothetical Index Annuity	S & P 500	Gold
Sep 1976 - Mar 1978	2%	-19.4%	53.8%
Aug 1987 - Dec 1987	1%	-33.5%	6.2%
Jul 1990 - Oct 1990	1%	-19.9%	6.8%
Mar 2000 - Oct 2002	2%	-49.0%	12.4%
Oct 2007 - Mar 2009	2%	-56.8%	25.5%
May 2011 - Oct 2011	1%	-19%	9.4%

The point we're trying to get across here is that while lower risk via performance floors may provide relief to some investors, the effect of the performance caps and total fees over time may make it difficult for you to achieve your long-term investment goals. In fact, there are plenty of more efficient ways to achieve growth and capital preservation, such as adding gold to your retirement portfolio (as illustrated above).

A person in a dark suit and white shirt is shown from the chest down, holding a glowing, golden orb in their open palm. The background is a dark blue gradient with faint geometric patterns. A large yellow banner with white text is overlaid on the middle of the image.

How Are Taxes Going to Affect My Annuity Income and Principal?

Annuities are complex insurance products. When it comes to their tax treatment, we recommend contacting a tax professional for detailed and accurate information regarding the tax treatment of annuities. Although GSI Exchange is not a tax advisor, we can provide a few tips to help you get started in thinking about the tax implications of annuity contracts.

Income vs Capital Gains Taxes

Annuities provide a tax-deferred status for funds that are in an otherwise “taxable” account. Although they are not subject to capital gains taxes, they are subject to *ordinary income tax* upon withdrawal. *If your income tax rate is higher than the long-term capital gains rate, annuities can prove disadvantageous when it comes to taxation.* For this one reason, **FINRA recommends** considering other available tax-advantaged accounts before considering annuities.

No Additional Tax Advantages

Holding a deferred annuity within a tax-advantaged account, such as a traditional IRA, provides no additional tax advantage, yet this is what many annuity holders are doing. It’s likely that these investors are paying additional fees to gain a tax-deferred status that they already have by virtue of the product they hold.

Tax Penalties for Early Withdrawals

If you hold an annuity in a taxable account, you are subject to tax penalties (in addition to other possible penalties imposed by your provider) if you take early withdrawals before you reach the age of 59 ½. For accurate information on this matter, be sure to discuss it with your tax advisor.

How Will Inflation Impact My Annuity Income?

If your retirement plan entails living off a fixed budget and receiving a fixed income, then any decrease in your purchasing power can be detrimental to your lifestyle. And inflation is the one factor that is certain to affect your wealth and purchasing power over time.

The more time you spend in retirement, the more inflation will erode your returns. And if your retirement income remains at a fixed rate, then the reduction to the real value of your fixed income can become significant.

Bear in mind that since 1925, inflation has risen roughly 3% annually. This seemingly small amount can result in large-scale negative consequences throughout one's retirement time horizon.

For example, \$1,000,000 stored in a vault *will only be worth \$400,000 in 30 years!*

But here's a more relevant example: if you have estimated that you need around \$50,000 each year to pay for your retirement, then in 30 years, you'll need to have \$120,000 *just to have the same level of purchasing power.*

To offset this erosion to your income value, many annuities offer “inflation riders.” Unfortunately, the cost of this additional benefit can offset its protective advantages—instead of your money being eaten away by inflation, a good portion of it is being eaten up by fees. This makes annuities a poor performer when it comes to acquiring a safe haven asset.

The only asset that can provide a legitimate safe haven from inflation is gold.

From 1972 to 2018:

- The US Dollar’s purchasing power declined by 84%, while...
- Gold’s purchasing power *increased* by 394%!

Remember, money is about purchasing power. Without it, money is useless. And while the dollar and all dollar-based assets continue to lose purchasing power to inflation, gold continues to retain its purchasing power value.

Annuities can only provide a regular stream of income whose value will be reduced over time, if not by inflation itself, then, ironically, by the high cost of inflation protection.

If this doesn’t make sense to you, as an investor, it certainly makes sense to the provider, as such fees are designed to generate high profits at your expense.



The background of the page features several rolled-up US dollar bills. In the foreground, a \$100 bill is unrolled, showing the Federal Reserve seal and the text 'FEDERAL RESERVE SYSTEM' and 'LEGAL TENDER IN FULL'. Other bills, including a \$20 and a \$10, are visible in the background, some still rolled up and some partially unrolled. The bills are set against a light, neutral background.

How Might Annuities Impact My Beneficiaries When I Pass Away?

Although most annuities offer a Guaranteed Minimum Death Benefit, there is no “step-up cost basis” for those inheriting your benefits after your passing.

For most investments, a step-up cost basis means that surviving beneficiaries are subject to paying capital gains taxes only for the investment gains that have accumulated after inheritance.

This is not the case for annuities. Gains that are passed to beneficiaries are taxed at regular income rates. And if the beneficiary has a high income tax rate, then an annuity may serve more as a burden than a benefit.




Summary

What matters in the end is that you reach your investment goals. Maximizing growth while minimizing risk is certainly something you should strive for, but it has to be reasonable. If something sounds too good to be true, such as the case for annuities, then it probably is.

Annuities may seem like the perfect combination of growth, income, and safety. But they also have drawbacks that can significantly impact your retirement lifestyle. Often you won't find out about their drawbacks until it is too late.

Before you commit to an annuity, be sure to understand the details.



In the end, a combination of more traditional and sound investments—stocks, bonds, and precious metals—may serve you much better, providing growth, income, safety, and most importantly, *ownership and control over your own hard-earned money.*



— EXCHANGE —

AN EXCLUSIVE REPORT BY GSI EXCHANGE
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