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Dismantling the Myths of Annuities

Annuities have a bad reputation among some people — but not necessarily a well-deserved one. An annuity with broad investment choice, valuable product features and low fees can help you achieve your retirement income goals.

In April 2008, Edna Parker of Shelbyville, Ind., the world’s oldest known person, celebrated her 115th birthday. Scientists who study longevity are analyzing the genes of Ms. Parker and other supercentenarians (people who live to age 110 or older) to find out if longevity-enabling genes exist and whether they or other genetic factors hold clues to why some people live beyond age 110.

While Ms. Parker’s 115th birthday is certainly a cause for celebration, at present very few of us can expect to live to such a ripe old age: The Gerontology Research Group of Inglewood, Calif. reports that only 75 people throughout the world are known to be supercentenarians. However, while reaching age 110 or older is likely unattainable for virtually all of us, life expectancy is increasing for most Americans — and in some cases in dramatic ways. For example, according to the Centers for Disease Control and Prevention, a child born in the United States in 2005 can expect to live to nearly 78 years, a new high in U.S. life expectancy rates. Additionally, another study shows that 77 out of every 100 people who reach age 65 will live to age 80 or older, and almost a quarter will surpass age 95.

When it comes to retirement planning, these statistics demonstrate the importance of developing a strategy for making your retirement savings last a long time. In fact, when planning your financial future, one of your biggest concerns is “longevity risk,” or the risk of being unable to fund your retirement if you live much longer than expected.

Therefore, when planning your retirement, look into a product that offers one of the best ways to finance a long life expectancy — the life annuity. While annuities are often criticized for having high fees, being difficult to understand and not offering sufficient flexibility for receiving income in retirement, life annuities offer one advantage that other investment options do not — a guaranteed stream of income that will last as long as you live. (Note that these guarantees are based upon the issuing company’s claims-paying ability.) An annuity that provides a range of investment options among various asset classes, has relatively low costs and includes product features that are well-suited to your needs can play an important role in helping you fund your retirement.

What Are Annuities, and How Do They Work?

To appreciate the advantages that annuities can offer, it’s important to understand how annuities work. Annuities are contracts sold by insurance companies that are designed to provide regular payments to the contract holder (also known as the *annuitant*) and his or her annuity partner (if there is one). The basic principle behind life annuities is simple: A number of different annuity

purchasers provide funds, either in a lump sum or through regular premium payments, to the insurance company that issues the annuity. This creates a pool of assets that the insurance company manages. From this pool, at least some portion of the assets of those whose lives are shorter than expected are used to support income payments for those whose lives become longer than expected. With any annuity, all payments are based upon the claims-paying ability of the insurance company.

The two primary types of annuities are “fixed” (or guaranteed) and “variable.” In *fixed* or *guaranteed annuities*, the funds are invested in the insurance company’s general account, which typically contains fixed-income securities like bonds. The issuer, not the contract owner, assumes all investment risk. Fixed annuities offer a guaranteed payment, with the payout amount based on the assumed future returns of the investments and the annuitant’s life expectancy. The payment can be fixed for life, or can allow for future increases. *Variable annuities* provide the contract owner with the ability to invest in both fixed-income and stock-based accounts whose values change depending on the performance of these underlying investments. While variable annuities offer the potential for higher long-term returns than fixed annuities, generally their payouts will fluctuate (sometimes dramatically) from year to year. Unlike with a fixed annuity, the contract owner of a variable annuity assumes all investment risk.

Unless you choose a “period certain” annuity option, where payments stop after a specified time period, you will receive regular income payments from an annuity for as long as you live. For many people, this guarantee of lifetime income is the annuity’s major advantage when compared with other retirement income options.

Although annuities in the payout stage can be an effective vehicle for receiving income in retirement, many people have a negative impression of them, often based on misconceptions about what annuities are and the role they can play in retirement planning. Below, we list some of the most common myths about payout annuities, and then counter the myths with the facts.

Myth: “I don’t need an annuity — I can figure out how to take withdrawals from my retirement accounts to meet my income needs.”

Reality: When you retire, you can try to develop a strategy for taking withdrawals from your various retirement accounts and assets, which might include defined contribution plans like 401(k)s or 403(b)s, IRAs, individual investments like stocks and bonds, and personal savings. However, crafting an income strategy from investment and savings vehicles such as these by living off your interest and earnings, or by drawing down principal gradually, can be tricky; while you may be successful in meeting your income needs, there’s always a danger that you’ll either live longer than your income lasts or that your investments won’t achieve the earnings you thought they would. If this happens, you’d either have to cut back on spending or, in a worse-case scenario, run out of money altogether.

Through an annuity, you can help avoid the danger of exhausting your retirement assets since the annuity provides you with regular payments for as long as you live. For example, “Annuities: Now, Later, Never?”, a research paper published by the TIAA-CREF Institute (October 2006), demonstrates that a life annuity can provide the highest level of income available to a retired individual.

There are different ways you can choose to receive income from an annuity for yourself and, if applicable, your annuity partner. For example, if you only need income for yourself, you can

select what's known as a "single life annuity." If you also want to provide benefits to your annuity partner, the "full benefit to survivor option" provides full payments to both you and your partner until both of you die. Another alternative is the "two-thirds benefit to survivor" option through which, at either the death of you or your annuity partner, the annuity income drops to two-thirds of the amount it otherwise would be.

Myth: "If I own an annuity and I die, the insurance company will keep all my money."

Reality: This is a common misconception about annuities — and one that scares away many investors who might actually benefit from owning an annuity. Certainly, it's true that annuities are contractual arrangements that provide annuitants with payments until death, and if an annuitant dies soon after the payments begin, all payments from the annuity cease.

However, virtually all annuities offer an option called a *guaranteed period* that reduces the annuitant's risk of receiving too few payments. With a guaranteed period, if both you and your annuity partner die within the guaranteed period, payments continue to your beneficiary(ies) until the end of the period. If you die after the guaranteed period ends, no further payments are made to the beneficiary(ies). Insurance companies offer guaranteed periods that cover varying lengths of time, such as 10, 15 and 20 years.

Selecting a guaranteed period is an effective way to remove the risk of losing all your money to the insurance company due to an early death. Note that while selecting a guaranteed period will reduce the amount of your payments, the overall cost may not necessarily reduce your payments by a large margin. Talk to your financial advisor and consult the annuity's prospectus for further information.

Myth: "Annuities don't give me the flexibility I need to create a retirement income strategy."

Reality: Actually, as we've discussed, annuities can provide a wide range of flexible arrangements such as fixed and variable account options, a variety of ways to receive annuity income and guaranteed periods. Also, when funding your retirement, note that annuities don't necessarily have to be an "all or nothing" choice. In other words, depending on your financial goals, you can combine an annuity with lump-sum or systematic withdrawals, or other ways to receive your money, to create an income strategy that's tailored to your needs. In fact, some studies show that combining an annuity with other income options can provide a better way to fund your retirement than selecting either an annuity or some other income option individually.

For example, some people in the early years of retirement may initially need less income (especially if they are working part-time or phasing into retirement), and more income later on as they get older. If you are in this situation, one strategy could be to use some of your retirement savings to purchase an annuity to meet basic monthly expenses while keeping the rest of your money in savings or investments from which you can take withdrawals to meet any additional financial needs.

For retirees who have specialized income needs, another option is a *fixed period annuity*. In contrast to a life annuity, a fixed period annuity makes regular payments over a specific number of years. When the fixed annuity period ends, the annuitant will have received all of his or her principal and earnings, and the annuity payments will stop. A fixed period annuity may be a good option in cases where you have other sources of lifetime income and want to supplement your income for a specific period of time; you'd like regular income for a specific period of time

until you begin receiving lifetime income from another source; or you or your annuity partner is in poor health and you want a regular income for a limited time period.

Myth: “I heard that once I begin receiving income from an annuity, I can’t transfer money among the different investment accounts.”

Reality: It’s true that once you annuitize, the decision to receive payments through an annuity is irrevocable — you cannot, for example, transfer the money out of the annuity and put it into another investment vehicle such as an IRA. However, provided your annuity offers a sufficiently broad range of investment options, you can modify your investment strategy in response to market conditions or changes in your personal financial situation by reallocating your assets among the different investment accounts.

For example, as you grow older, you might decide you’d like a steadier income stream. You can take some of the annuity income you are receiving from more volatile investments such as stock (equity) accounts and transfer it to more conservative investment choices such as fixed-income accounts. Conversely, if you’d like to increase your exposure to equities, you may want to transfer money from more conservative asset classes like fixed-income and money market to stock accounts. No matter what your retirement investment goals are, note that an income stream that’s well diversified among different asset classes such as stocks, bonds, real estate and guaranteed accounts may provide a more stable income (in inflation-adjusted dollars) than if you have most or all of your investments in a single asset class. (Of course, diversification cannot eliminate the risk of fluctuating prices and uncertain returns.)

Myth: “Annuities are a bad deal for investors because they have high fees and hidden expenses.”

Reality: While it’s true that some annuities may charge high fees and other expenses, there are a number of lower-cost annuities available in the market. Therefore, if you’re interested in purchasing an annuity, shop carefully and look closely at the sales loads, mortality fees, surrender charges and other fees that a given annuity charges. Also, take the time to understand the different features available through any annuities you investigate and the prices for these features. Also, learn about the annuities’ fees, surrender charges, investment options, and performance track record (although an account’s past performance is no guarantee of future results). You can learn a great deal about an annuity and its features by reading the annuity’s prospectus or by visiting the website of the financial company that’s offering it.

Next Steps

Hopefully, dispelling these myths has helped you understand the potential advantages annuities can offer to your retirement planning. If you’d like to learn more about annuities and other retirement planning topics, go to **www.tiaa-cref.org** .

Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk, including possible loss of principal. Withdrawals prior to age 59½ may be subject to a 10% federal tax penalty on earnings, and surrender charges may apply in the early years of some contracts.

You should consider the investment objectives, risks, charges and expenses carefully before investing. Please call 877-518-9161, or go to www.tiaa-cref.org for a current prospectus that contains this and other information. Please read the prospectus carefully before investing.

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