Investment Basics and Vehicles

Whether you are planning for retirement, your child's education, or you'd like to make some investments in the market, there are some investment basics you should understand before making any decisions. This guide provides an overview of investment strategies and discusses the various types of investment vehicles available, including stocks, bonds and mutual funds. *Note*—This guide contains general information only and is not intended to provide investment advice. Always consult a professional with any questions about investments.

Investment Basics

Before you invest any money, consider these key investment issues:

- **Investment time horizon**—Your investment horizon refers to the amount of time you have to save until you need to access your money. Determine how many years you have until you need your money (retirement, college financing, etc.), and how much money you will need to meet your goals and/or dreams. Then determine what investment vehicles are best for you. If, for example, you only have a few years left to save before your child goes to college, you might choose investments that mature quickly.
- **Risk tolerance**—Each investment carries with it its own level of risk, or level of volatility and fluctuation. In general, the longer you have to reach your goals, the more risk you can take since the ups and downs of investment performance tend to smooth out over time. Depending on your time horizon and your own comfort level, determine your investment approach (low risk, moderate risk, high risk—or a combination thereof).
- **Tax consequences**—Remember that you will have to pay income taxes on distributions you receive from your investments. Determine how your investment income will be taxed when you use it and make sure you will have enough net income to achieve your goals.
- **Investment objective**—Define what you want your money to do for you (i.e., growth of capital, preservation of principal and income generation, balancing income and growth, etc.). Your planning curve for retirement savings, for example, might concentrate in high growth opportunities (if you plan early) then, as you approach retirement, you might shift investments to less risky, more liquid vehicles. Diversifying your funds across several investments with different risk levels is often a good way to reduce overall risk and attain long-term growth.

Creating a Balanced Portfolio: Asset Allocation and Diversification

Asset allocation is an investment management strategy that divides your investments among the major asset classes of equities (e.g., stocks or stock mutual funds), fixed income securities (e.g., bonds, bond mutual funds, CDs or annuities), and money market instruments (e.g., cash or money market funds). Since these investment categories have unique characteristics, they rarely rise and fall at the same time. Therefore, a combination of these asset classes can help reduce risk and improve overall portfolio return.

On the other hand, diversification is a strategy that divides your investments among different securities or instruments within each asset allocation category. By diversifying your investments (among, for example, five different mutual funds), you can further reduce risk.

Your overall investment objectives, time horizon and tolerance for risk will, in part, determine how you should allocate your assets and how your investments should be diversified.

Here are several sample allocations:

- **Aggressive** (longer time horizon): 80 percent equities (for instance, a well-diversified selection of mutual funds); 15 percent fixed-income securities (for instance, several bonds and CDs); and five percent cash.
- **Balanced** (mid-range time horizon): 60 percent equities; 30 percent fixed-income securities; and 10 percent cash.
- **Conservative** (short-time horizon): 20 percent equities; 70 percent fixed-income securities; and 10 percent cash.

When creating an investment portfolio, consider the investment vehicles described in the pages that follow.

Equity Securities/Stocks

Equity securities or stocks represent shares of ownership in a company. The two main types of equity securities are common stocks and preferred stocks.

Common Stocks

Common stocks are issued by corporations in order to raise capital. Common stocks of public companies are often traded on stock exchanges such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) and the National Association of Securities Dealers Automated Quotations (NASDAQ).

> Many people under age 40 have a growth objective; in other words, they invest in vehicles whose focus is on long-term gain and appreciation. When you invest for growth, you try to increase your money, or build on your investment, as much as possible. On the other hand, many retirees (and those close to retirement) invest primarily for income—that is, to generate interest income to help them live more comfortably now and for the rest of their lives. They might, for example, choose to invest in vehicles that pay regular dividends rather than those that reinvest their earnings.

You can invest in common stocks of public companies in two ways: You can buy stock individually (direct); or you can buy shares in a mutual fund that invests in common stocks (indirect). Direct ownership of stock means you've bought shares directly for your own account and you (or your broker or other custodian) hold the common stock certificate(s). As a direct owner of common stocks, you are also extended the privilege of voting on such matters as company board membership and important financial decisions. Indirect ownership of stocks is made possible by investing in equity or balanced mutual funds. As an investor, you own shares of an equity mutual fund and the fund, in turn, owns shares of stock in many corporations. (For more information, see the section "Mutual Funds.")

By investing in common stocks, you can benefit in two ways. First, you may receive income in the form of a dividend, usually declared and paid on a quarterly basis. Dividends represent distributions of a corporation's earnings to its shareholders proportionate to the number of shares each holds. However, not all common stocks pay dividends. Historically, income stocks have paid out a relatively high percentage of their earnings in the form of dividends to shareholders. Growth companies, however, have tended to pay little or no dividends, instead reinvesting earnings in the company to support continued growth. You might also benefit from stock ownership through capital appreciation—an increase in the share price of the company's stock. When a company does well, the price of its stock will generally rise. Conversely, if a company is experiencing difficulties, their stock prices may fall.

Types of Common Stocks

Not all stocks are the same; just as some pay dividends and others don't, some stocks experience greater swings in price than others. There are several types of common stocks:

- **Income stocks**—Income stocks are usually purchased for their stable and regular dividend income. Companies whose stocks fall into this category are typically in relatively stable industries, have a strong history of financial performance and pay out a substantial portion of their earnings in regular

dividends. As a result, income stocks tend to offer a higher than average dividend yield.

- **Growth stocks**—Investors typically buy growth stocks for capital appreciation. Since most growth companies use their current earnings to finance future growth and ongoing research, most—if not all—of their earnings are reinvested back into the company. While growth stocks are usually bought for their price appreciation potential, they may pay out a small portion of earnings in the form of shareholder dividends.
- **Blue-chip stocks**—Blue-chip stocks refer to the most secure and most highly rated common stocks available. They are typically issued by larger, well-established companies that have the proven ability to pay steady dividends in both good and bad years.

Tips to Follow Before You Invest In Stocks

Whether you should invest in one or many stocks depends on your risk tolerance, your investment time frame and your investment objectives. Keep in mind that there are drawbacks to investing in individual securities, including high transaction costs and a lower likelihood of diversification. Invest only after carefully researching your options and/or seeking the advice of a financial planner or investment professional. Some basic guidelines to follow when investing in stocks include:

- Allow time for research and study
- Diversify your portfolio
- Be patient; don't panic if stock fluctuates
- Contribute regularly
- Reinvest your dividends
- Stay abreast of market trends

Consult a financial professional for more information on specific investment strategies.

These companies are usually leaders in industries that tend to be less vulnerable to cyclical market swings.

- **Cyclical stocks**—Companies whose earnings tend to fluctuate sharply with their business cycles are issuers of cyclical stocks. When business conditions are good, a cyclical company's profitability tends to be high and the price of its common stock tends to rise. When conditions deteriorate, the company's sales and profits often fall sharply and/or rapidly. The timing of an investment in cyclical stocks is therefore very important.
- **Speculative stocks**—Speculative stocks carry greater risks—but offer the potential for higher returns. These stocks typically trade at a high price relative to the company's earnings (they have a high price/earnings, or P/E ratio) and are characterized by greater price swings than other, less volatile stocks.

Preferred Stocks

As with common stock, preferred stock also represents ownership in a corporation, and is subject to changes in market value. In contrast to common stock dividends, which change as corporate earnings fluctuate, preferred stock typically pays a predetermined, fixed dividend on a quarterly basis. Both common and preferred shareholders receive a dividend only after it has been earned and declared by the company. However, preferred shareholders receive priority and are paid dividends before common shareholders. If a company is liquidated, preferred shareholders receive priority over common shareholders in the distribution of assets. However, unlike common stock, most preferred stocks don't carry voting privileges.

Employee Stock Plans

Many companies allow eligible employees to invest in company stock through their employer by means of employee stock bonus plans, employee stock ownership plans, employee stock option plans and/or employee stock purchase plans. Employees who choose to participate in these plans can essentially become part-owners and may benefit from the company's long-term growth and profitability.

Types of Employee Stock Plans

- **An employee stock bonus plan** is maintained by an employer to provide benefits similar to those of a profit sharing plan, except that the benefits are distributed as stock in the employer company. Employer contributions to a stock bonus plan may be made in cash or stock.
- **An employee stock ownership plan (ESOP)** is either a qualified stock bonus plan, or combination stock bonus and money purchase plan (both of which are qualified) designed to invest primarily in qualifying employer securities.
- **Employee stock option plans** give employees the right to purchase stock at a predetermined price some time in the future. Although stock option plans provide no current tax benefits, employees may be able to purchase company stock at a discount, and under some types of plans, defer tax on any gain.
- **An employee stock purchase plan** gives employees the right to purchase shares of company stock through payroll deduction. Although the employee receives no current tax benefits, employees typically avoid paying any brokerage fees on such purchases and the company stock dividends often purchase additional shares commission-free.

Bonds

Often referred to as "fixed income investments" or "debt securities," a bond is essentially an IOU—when you buy one, you are lending your money to the bond issuer, typically a corporation, municipality or government agency. (This is different from a stock investment, which represents ownership in an individual company.) When a bond is issued, it usually carries a fixed maturity date for the repayment of the principal, a fixed rate of interest, and fixed times for the payment of interest—usually semi-annually (for example, June 1st and December 1st of each year). Some bonds are issued with a variable rate of interest; this means the interest payment amount fluctuates according to a formula established at issuance.

Advantages of Employee Stock Plans

- Employees are often given the opportunity to purchase company shares at a discount from the public offering price or the prevailing market price.
- If the stock price goes up after shares are acquired by an employee, the after-tax appreciation of the stock belongs to the employee.
- Some employee stock purchase plans allow employee contributions. If your company has this kind of plan, you may be able to designate a percentage of your income to buy shares. Your employer may even match your contribution. You typically avoid paying any brokerage fees and your dividends typically purchase additional shares commission-free.

Disadvantages of Employee Stock Plans

- Deciding when to exercise your stock options may be difficult.
- Like buying and selling stock through a stockbroker, exercising stock options can be risky; there is no way to know whether your investment will yield a profit within the option exercise period.
- Income tax rates may rise in future years, leaving you with less after-tax appreciation on your company stock.
- If your family's income and other benefits are tied to the success of your company, it can be risky to put your investment dollars in the same place—especially if there is a significant chance that your company may falter, or even fail. For example, if your company's stock price declines when you near retirement, your retirement security may be jeopardized.

Some notes and bonds are "callable," meaning that the issuer can decide to pay investors back earlier than the stated maturity date. This usually occurs when interest rates fall and an issuer wants to issue new securities with a lower interest rate to replace the higher-rated bonds outstanding. An issuer will typically offer a small premium (increase in price) over what the bond is really worth to compensate bondholders for early repayment.

Possible Bond Issuers

- **The federal government**—United States Treasury securities are IOUs from the federal government. U.S. Treasuries are debt instruments that pay interest income that is typically subject to federal taxes but exempt from state taxes. In addition, some government agencies (Fannie Mae, Ginnie Mae, Sallie Mae, Freddie Mac, etc.) issue bonds. Depending on the issuing agency, some of these securities are backed by the full faith and credit of the U.S. government; others stand on their own credit, which is usually considered very secure.
- **State and local governments**—Municipal bonds are debt securities issued by state and local governments and municipal agents (e.g., sewer and water authorities; highway, bridge and tunnel authorities; and schools). They represent debt obligations that are usually, but not always, free from federal and state and local taxes (as long as the investor is a resident of the issuing state). Municipal bonds typically offer a lower rate of interest than fully taxable corporate bonds; however, since the interest earned on most municipals is tax-free, they offer a competitive after-tax rate of return. Municipal bonds are an attractive investment vehicle for many investors in higher tax brackets.
- **Corporations**—Corporate bonds are debt securities issued by private corporations. They pay interest that is fully taxable.
- **Mortgage holders**—Mortgage-backed securities such as Ginnie Maes, Fannie Maes, Freddie Macs and Federal Home Loan Mortgage Corporation Securities are issued by both government and private agencies. These bonds are backed by mortgages that have been pooled together by the issuer. They offer either a fixed or variable rate of interest. As an investor in a mortgage-backed security, you, in effect, purchase some portion of the cash stream from payments on a pool of mortgages. A potential investor in mortgage-backed securities should be wary of potential fluctuations in interest rates. If interest rates rise, the value of the security will generally decline. If interest rates decline, mortgage holders tend to refinance their mortgages, which also reduces the value of mortgage-backed securities.

Depending on market factors and bond quality, taxable bonds often offer a better return, even to high-bracket taxpayers, than tax-exempt bonds.

Types of Bonds Available

- **U.S. savings bonds**—A savings bond is a U.S. government bond that is not traded in any market but can be bought only from the government at a reduced sum and must be held until redemption or maturity before the bond can be redeemed at face value. Series EE bonds are U.S. savings bonds issued by the federal government in face values of $50 to $10,000 with a maturation period of up to 30 years. For the first few years of the bond's duration, only small amounts of interest accrue. Higher amounts of interest are earned as the bond ages, giving the bondholder an incentive to hold the bond to maturity. Typically, an interest penalty is assessed on such bonds held less than five years.
- **Zero-coupon bonds**—This type of bond pays the bondholder no interest at all. Instead, zero-coupon bonds are sold at deep discounts off their face or redemption values—for example, $100 for a $1,000 bond—with the promise to redeem at full face value when they mature. No payment of any kind is made until the bond matures. Although a capital gain is realized at maturity, the holder of a zero-coupon

bond is not allowed the special tax treatment normally afforded such gains. Instead, regular income tax must be paid each year as if interest on the bond were actually being paid. For this reason, zero-coupon bonds are often bought only for nontaxable accounts, like pension funds and IRAs.

- **Municipal bonds**—Municipal bonds are bonds issued by a state, state agency or political subdivision such as a county or city. In many cases, interest on municipal bonds is exempt from state and local taxation if the bond is issued by a municipality within the state and sold to a resident of the state. The interest paid by municipal bonds is usually exempt from federal income tax.

Note—Interest paid by a specific category of bonds, known as "AMT" bonds, is subject to taxation under the alternative minimum tax imposed by the U.S. government.

Bond Investment Basics

You can create your own bond portfolio by buying bonds individually—or you can invest in a pre-selected portfolio of bonds by investing in a bond mutual fund. Bond mutual funds, because they offer investment in a diversified portfolio of bonds, are a popular investment vehicle providing relatively inexpensive professional money management and risk management.

All bonds are subject to general market or interest rate risk. For instance, the price of a bond will generally fall as interest rates rise. When interest rates rise, bondholders can expect to continue receiving interest payments; however, they may lose some of their initial investment if they sell the bond prior to maturity at a time when interest rates are higher than when the bond was purchased. Conversely, as interest rates fall, bond prices will generally rise. In this case, a bondholder who chooses to sell may receive sales proceeds in an amount greater than the initial purchase price of the bond. All bonds are subject to default risk—that is, the risk that the bond issuer may not be able to meet the interest payment schedule on the bond or repay the principal portion at maturity.

How do you know if the bond you're considering is safe? There are various services, including Standard & Poor's (S&P), Moody's, and Duff and Phelps, that rate the safety of bonds (i.e., a bond's probability of default). Although the major bond rating companies do not always agree on the safety of a particular security, each company's rating system and accompanying rates are widely understood and accepted. For example, Moody's rates bonds on a scale from AAA to C (AAA being highest rating). Bonds that are considered investment grade have a rating from AAA to BBB. The interest paid on investment-grade bonds is generally lower than that paid on non-investment grade (those rated BB or lower), higher-risk investments. High-yield bonds, formerly referred to as "junk" bonds, are bonds with a rating lower than BBB. High-yield bonds include bonds that were investment grade when originally issued but which have since been downgraded, and those bonds originally issued as low-grade bonds. While these more speculative bonds are subject to greater risk, they pay a higher rate of interest than investment-grade bonds.

Mutual Funds

Mutual funds are one of the most popular investment vehicles today. A mutual fund is an investment that pools an investor's money with the money of other investors (often thousands) and invests in stocks, bonds and other securities.

Mutual funds are assembled with an "investment objective" in mind. The investment objective determines the type of securities that are included in the fund portfolio. For example, if capital appreciation is the goal, the fund will invest primarily in common stocks. If income is the primary objective, then the fund might invest in a portfolio of bonds, preferred stocks and/or money market securities.

> Typically, a growth fund is considered a long-term investment, subject to greater fluctuations in price, whereas an income fund is considered more suitable for a short- or intermediate-term investment horizon.

Advantages of Mutual Fund Investing

- **Liquidity**—An investor can redeem all or a portion of his or her holdings, usually within days of selling.
- **Low cost**—The transaction costs to purchase or redeem mutual fund shares are much lower than the fees and commissions charged for buying and selling individual stocks and bonds. Also, a large number of mutual funds (so-called "no-load" funds) do not charge a sales commission for purchasing shares.
- **Low initial investment amounts**—An investor can start investing in a fund with as little as $500 to $1,000. Many funds now offer investors an automatic withdrawal feature that allows money to be withdrawn directly from a bank account by the mutual fund on a regular basis (weekly, monthly, etc.). The initial investment amount for this feature can be as low as $25 per period.
- **Easy reinvestment of capital gains and dividends**—Investors can choose to have their dividends or capital gains automatically reinvested back in the fund with very little bookkeeping or accounting involved. *Note*—The ease of reinvestment depends on the reporting capability of the fund and can become more complicated if partial liquidation is desired.
- **Professional portfolio management**—Investment decisions are typically made by full-time investment advisors, a luxury only the more affluent can afford when they invest on their own.
- **Diversification**—A mutual fund portfolio typically consists of large numbers of different securities representing a variety of issuers and industries to provide diversification and reduced investment risk.

Disadvantages of Mutual Fund Investing

- **Administrative fees**—Not all of an investor's money may be invested when he or she chooses a mutual fund. There may be various costs associated with mutual funds that reduce the amount of money actually invested.
- **Commissions**—If you buy a mutual fund from a commissioned financial professional, his or her commission is paid from the money you're investing.
- **Manager salary**—Mutual fund managers (including those of no-load funds) earn a salary that is paid out of investors' dollars.
- **Sales loads**—An investor incurs costs or sales loads to invest in certain funds. There are two basic types of sales loads: front-end loads and back-end loads. Some funds require the investor to pay a sales charge "up front" (a front-end load) when initially investing in the fund; other funds deduct the sales charge from the "back end" (a back-end load) when money is withdrawn or the account is closed. Sales loads vary depending upon the particular fund and according to the amount that is invested.
- **Advertising fees**—Many mutual funds, even no-load mutual funds, charge a fee for promotional costs (more commonly known as a 12(b)1 fee).
- **Risk**—There is a degree of risk inherent in any investment program, and mutual funds are no different. Mutual fund shares are not Federal Deposit Insurance Corporation (FDIC) insured, even when purchased through a bank. The degree of risk associated with a particular fund depends on its portfolio mix. Generally, an equity (common and/or preferred stock) fund is subject to greater risk than a bond or money market fund by the very nature of the underlying securities in the fund portfolio. Return on investment (ROI) analysis is a very important component of the investment process and is best discussed with a financial professional.

In other words, mutual funds offer an investor professional money management and "instant" portfolio diversification, which allows the investment risk to be spread across a range of investments. When you invest in a mutual fund, many millions of dollars are often invested along with your money. A mutual fund investor owns an undivided interest in a fund's portfolio; he or she is a mutual participant in the fund. Mutual funds typically issue common shares. Each investor shares mutually with the others in gains and/or distributions from the fund. An investor's share in the mutual fund's performance will be in direct proportion to the number of shares he or she owns.

Most mutual funds are open-ended—that is, money is accepted at any time to purchase new shares, and money is paid out when shares are redeemed. The value of the portfolio of securities fluctuates as the value of the underlying securities themselves rise or fall. Each investor's account value fluctuates in proportion to the value of the entire mutual fund.

Mutual funds provide a low-cost avenue through which to invest in a portfolio of securities. Many mutual funds are offered on a no-load basis—meaning you can invest in the fund without paying sales commissions. With no-load mutual funds, every dollar you invest will go to work for you.

Some mutual funds are sold with a sales load—or commission—that typically ranges from four percent to as high as 8.5 percent of what you invest.

Mutual Fund Ratings

A variety of companies are in the business of rating the performance of mutual funds. Morningstar, one of the largest mutual fund rating companies, uses a scale of one to five stars to rate mutual funds. This rating system should be viewed as a valuable tool to be used in conjunction with a full review of the fund's prospectus, financial statements and other relevant information. Analysts also often compare mutual funds by analyzing their relative "expense ratios"—the percentage of the net asset value that is used to pay the fund's expenses. Some of these expenses include administrative fees, trading costs, commissions and 12(b)1 fees (money withheld for sales and other promotional activities).

Certificates of Deposit (CDs)

Certificates of deposit (CDs) are interest-bearing bank investments with a fixed maturity date. The rate of return is directly related to maturity. Generally, the longer it takes for the CD to mature, the higher the yield (for example, CDs maturing in two years may offer a five percent yield, while a CD maturing in six months may offer a three percent yield). Interest earned on CDs is fully taxable.

Most CDs are purchased at commercial banks. The Federal Deposit Insurance Corporation (FDIC) insures all commercial bank deposits, which include CDs, for up to $100,000. However, CDs can also be purchased through a brokerage house that offers the following benefits:

- **A wider selection of banks**—Brokerage firms buy CDs from banks across the country.
- **A wider selection of interest rates**—Because brokerage firms buy CDs in bulk and from many different banks, they typically offer a wider selection of interest rates and dates of maturity to choose from.
- **A secondary market where investors can buy and sell CDs**—Brokerage houses offer an alternative to buying and selling CDs through a single bank. The brokerage market also allows investors to sell CDs to one another.
- **Easier evaluation/decision making**—Brokerage houses typically quote interest rates after commissions, so prospective investors can compare the effective annual yield of numerous CDs, including those offered within the brokerage firm and by a local commercial bank.
- **FDIC insurance**—Many CDs offered through brokerage houses are FDIC insured.

CDs are considered a relatively safe investment, but they tend to offer lower yields than most other investment vehicles. For this reason, CDs may not provide the desired level of return when investing to meet long-term goals, such as saving for retirement. However, they may increase in appeal as retirement draws near.

In addition to the investment vehicles described here, others are available. Ask a professional about whether these investment vehicles may be right for you:

- Savings accounts
- Money market accounts
- Life insurance with cash value
- International securities
- Real estate
- Precious metals
- Limited partnerships

Annuities

An annuity is a contract between you and an insurance company, under which you make a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date. Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a guaranteed minimum amount, such as your total purchase payments.

There are generally two types of annuities-fixed and variable. In a fixed annuity, the insurance company guarantees that you will earn a minimum rate of interest during the time that your account is growing. The insurance company also guarantees that the periodic payments will be a guaranteed amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

In a variable annuity, by contrast, you can choose to invest your purchase payments from among a range of different investment options, typically mutual funds. The rate of return on your purchase payments, and the amount of the periodic payments you will eventually receive, will vary depending on the performance of the investment options you have selected.

Variable annuities have become a part of the retirement and investment plans of many Americans. A variable annuity offers a range of investment options. The value of your investment as a variable annuity owner will vary depending on the performance of the investment options you choose. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

- Periodic Payments. Variable annuities let you receive periodic payments for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.
- Death Benefit. If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount-typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.
- Tax-Deferred. You pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals.

How Variable Annuities Work

A variable annuity has two phases: an accumulation phase and a payout phase.

During the accumulation phase, you make purchase payments, which you can allocate to a number of investment options. For example, you could designate 40 percent of your purchase payments to a bond fund, 40 percent to a U.S. stock fund, and 20 percent to an international stock fund. The money you have allocated to

each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, variable annuities often allow you to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (e.g., three percent per year).

During the accumulation phase, you can typically transfer your money from one investment option to another without paying tax on your investment income and gains, although you may be charged by the insurance company for transfers. However, if you withdraw money from your account during the early years of the accumulation phase, you may have to pay "surrender charges," which are discussed below. In addition, you may have to pay a 10 percent federal tax penalty if you withdraw money before the age of 59½.

At the beginning of the payout phase, you may receive your purchase payments plus investment income and gains (if any) as a lump-sum payment, or you may choose to receive them as a stream of payments at regular intervals (generally monthly).

If you choose to receive a stream of payments, you may have a number of choices of how long the payments will last. Under most annuity contracts, you can choose to have your annuity payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of you and your spouse or other beneficiary). During the payout phase, your annuity contract may permit you to choose between receiving payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that you select for receiving payments. Be aware that some annuities do not allow you to withdraw money from your account once you have started receiving regular annuity payments.

In addition, some annuity contracts are structured as immediate annuities, which means that there is no accumulation phase and you will start receiving annuity payments right after you purchase the annuity.

Features of Variable Annuities

The Death Benefit

A common feature of variable annuities is the death benefit. If you die, a person you select as a beneficiary (such as your spouse or child) will receive the greater of:

- All the money in your account

OR

- Some guaranteed minimum (such as all purchase payments minus prior withdrawals)

Some variable annuities allow you to choose a "stepped-up" death benefit. Under this feature, your guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be your account value as of a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to "lock in" your investment performance and prevent a later decline in the value of your account from eroding the amount that you expect to leave to your heirs. This feature carries a charge, however, which will reduce your account value.

Other Features

Variable annuities sometimes offer other optional features, which also have extra charges. One common feature, the guaranteed minimum income benefit, guarantees a particular minimum level of annuity payments, even if you do not have enough money in your account (perhaps because of investment losses) to support that level of payments. Other features may include long-term care insurance, which pays for home health care or nursing home care if you become seriously ill. You will pay for each benefit provided by your variable annuity, so it is important to be sure you understand the charges and carefully consider whether you need the benefit. If you do need the benefit, consider whether you can buy the benefit more cheaply as part of the variable annuity or separately (e.g., through a long-term care insurance policy).

You may want to consider the financial strength of the insurance company that sponsors any variable annuity you are considering buying. This can

affect the company's ability to pay any benefits that are greater than the value of your account in mutual fund investment options, such as a death benefit, guaranteed minimum income benefit, long-term care benefit, or amounts you have allocated to a fixed account investment option.

Variable Annuity Charges

You will pay several charges when you invest in a variable annuity. Be sure you understand all the charges before you invest. These charges will reduce the value of your account and the return on your investment. Often, they will include the following:

- Surrender charges—If you withdraw money from a variable annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a "surrender" charge, which is a type of sales charge. This charge is used to pay your financial professional a commission for selling the variable annuity to you. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the "surrender period." For example, a seven percent charge might apply in the first year after a purchase payment, six percent in the second year, five percent in the third year, and so on until the eighth year, when the surrender charge no longer applies. Often, contracts will allow you to withdraw part of your account value each year-10 percent or 15 percent of your account value, for example - without paying a surrender charge.
- Mortality and expense risk charge—This charge is equal to a certain percentage of your account value, typically in the range of 1.25 percent per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to your financial professional for selling the variable annuity to you.
- Administrative fees—The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of your account value (typically in the range of 0.15 percent per year).
- Underlying Fund Expenses—You will also indirectly pay the fees and expenses imposed by the mutual funds that are the underlying investment options for your variable annuity.
- Fees and Charges for Other Features—Special features offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges.

Other charges, such as initial sales loads, or fees for transferring part of your account from one investment option to another, may also apply. You should ask your financial professional to explain to you all charges that may apply. You can also find a description of the charges in the prospectus for any variable annuity that you are considering.

Ask Questions Before You Invest

Financial professionals who sell variable annuities have a duty to advise you as to whether the product they are trying to sell is suitable to your particular investment needs. Don't be afraid to ask them questions. And write down their answers, so there won't be any confusion later as to what was said.

Variable annuity contracts typically have a "free look" period of ten or more days, during which you can terminate the contract without paying any surrender charges and get back your purchase payments (which may be adjusted to reflect charges and the performance of your investment). You can continue to ask questions in this period to make sure you understand your variable annuity before the "free look" period ends.

Before you decide to buy a variable annuity, consider the following questions:

- Will you use the variable annuity primarily to save for retirement or a similar long-term goal?
- Are you investing in the variable annuity through a retirement plan or IRA (which would mean that you are not receiving any additional tax-deferral benefit from the variable annuity)?
- Are you willing to take the risk that your account value may decrease if the underlying mutual fund investment options perform badly?
- Do you understand the features ofthe variable annuity?
- Do you understand all of the fees and expenses that the variable annuity charges?
- Do you intend to remain in the variable annuity long enough to avoid paying any surrender charges if you have to withdraw money?
- If a variable annuity offers a bonus credit, will the bonus outweigh any higher fees and charges that the product may charge?
- Are there features of the variable annuity, such as long-term care insurance, that you could purchase more cheaply separately?
- Have you consulted with a tax adviser and considered all the tax consequences of purchasing an annuity,including the effect of annuity payments on your tax status in retirement?
- If you are exchanging one annuity for another one, do the benefits of the exchange outweigh the costs,such as any surrender charges you will have to pay if you withdraw your money before the end of the surrender charge period for the new annuity?

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