

INVESTING WITH DISCIPLINE

NEWSLETTER

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UNDERSTANDING ANNUITIES: PROS & CONS

By Brian Lawrence, CFA

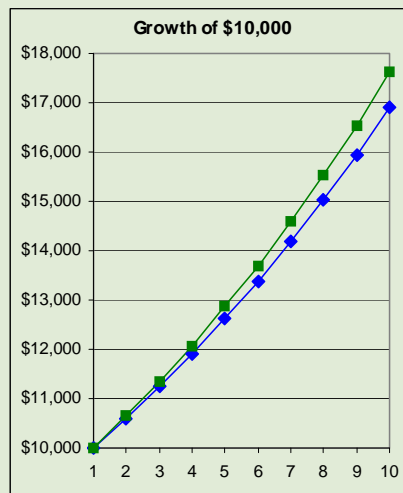
Whenever stock markets go through a slump, investors naturally cast about for options that may help protect their hard earned money. Buzz often picks up regarding annuities and the guarantees they offer. The thought of safety and earning higher returns than a bank account are enough to tempt even savvy investors. However, there is an old saying about offers that sound too good to be true. Let's examine annuities more closely to understand the pros & cons of these relatively complex investment products.

First of all, an annuity is an insurance contract wherein you pay the insurance company a chunk of money and they agree to provide you with income, either now or at a certain point in the future. There are two types of annuities – 'fixed' and 'variable.'

Fixed annuities promise to pay you a set rate of interest, typically reset annually. The value of your investment does not fluctuate. Variable annuities allow for the investment in mutual funds (or subaccounts) whose values will vary based on their performance. The variable annuity contract has an insurance wrapper that is normally designed to protect against a loss of capital, assuming you hold the investments for a certain time period.

INVESTMENT COMPARISON

The chart shown below illustrates the potential outcome of buying a variable annuity vs. low cost mutual funds. Even with tax-deferred earnings growth, there are scenarios where mutual funds are a better choice primarily because high annual fees for the annuity eat away at the earnings. Annuities may be appropriate in some situations. See page 2 for model assumptions.



Years	Variable Annuity	Tax-Efficient Mutual Funds
1	\$10,000	\$10,000
2	\$10,600	\$10,649
3	\$11,236	\$11,340
4	\$11,910	\$12,076
5	\$12,625	\$12,860
6	\$13,382	\$13,694
7	\$14,185	\$14,583
8	\$15,036	\$15,530
9	\$15,938	\$16,538
10	\$16,895	\$17,611
FINAL VALUES	\$11,151	\$14,969

after-tax and upon lump sum withdrawal

INDEX SCORE-CARD

QUARTERLY RETURNS

	2 ND	3 RD
US Large Cap:	15.9%	15.6%
US Small Cap:	20.7%	19.3%
International Stocks:	25.4%	19.5%
Emerging Markets:	33.6%	20.1%
US Bonds:	1.8%	3.7%
Foreign Bonds:	5.4%	6.8%
REITs:	27.3%	33.3%
Commodities:	11.7%	4.2%
TIPS:	0.7%	3.1%
Treasury Bills:	0.05%	0.04%

2ND Quarter for the period ending
6/30/09

3RD Quarter for the period ending
9/30/09

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UNDERSTANDING ANNUITIES: PROS & CONS (CONTINUED)

The unique structure of annuities affords them advantages, including:

- tax-deferred growth
- potential for guaranteed lifetime income
- no limit to how much you can contribute
- no income restrictions
- no forced withdrawals at age 70 ½

These are significant advantages, especially if you have contributed the maximum to your 401k or IRAs. However, annuity contracts also have significant disadvantages. First and foremost, they carry so many fees and expenses that these additional costs can easily overwhelm the tax deferral advantage. What are some of these costs?

Front-end Loads: the up front commission paid when buying an annuity, sometimes exceeding 5%.

Surrender Charges: a penalty for early withdrawal, typically a percent charged on the total value of the contract.

Mortality & Expense (M&E) charges: covers the insurance guarantee and administrative expense of a variable annuity, as well as possibly incorporating commissions on the sale of the annuity.

Mutual Fund Expenses: the amount charged by the managers of the variable annuity mutual funds.

Death Benefit: An optional feature to guarantee an annuity will maintain a certain value should you die before the annuity payments begin.

Inflation Adjustment: An optional feature to protect the value of the contract from inflation.

In addition to the onerous and often opaque costs, annuities have several other big problems. Income from these accounts is treated as ordinary income, and once money is committed, it cannot be accessed before age 59 ½ without incurring a 10% penalty. Also, investments within an inherited variable annuity do not receive a step up in basis. Let's say you buy a

mutual fund within an annuity for \$100 and by the time it is passed on to your kids it's worth \$1,000. Your children inherit the entire \$900 tax liability. And that liability is taxed as ordinary income, not at the lower capital gains rate.

The combination of fees, taxation, and how they are passed on to the next generation make annuities toxic for most investors. Investors are likely better off buying low cost and tax efficient mutual funds, which have distinct advantages. Fees are transparent and controllable. Many gains are taxed at capital gain tax rates. Inherited investments receive a full step up in basis so your heirs will avoid a big tax hit when they sell.

Annuities may be appropriate for someone who is in a low income tax bracket, is not concerned with passing on the investments to their heirs, and needs lifetime income. Not all contracts are bad. However, they should be approached with great care and scrutiny. They must be dissected to understand the fees and should not be viewed in isolation but in the broader context of all your investments, other assets, and estate plan. Most investors would do well to resist the sales pitch and avoid the cost and confusion that follows.

CLUTTERED MAILBOX?

There are 2 simple ways to reduce the amount of mail you receive.

*1) Elect **E-Delivery** notification of statements and trade confirms.*

*2) **Consolidate** multiple accounts into **ONE** Statement, **ONE** envelope for your household.*

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Investment Comparison: Model Assumptions

Beginning Value: \$10,000.00

Rate of Return: 8%

Tax Rates:

25% Federal Tax Rate on Ordinary Income

9% State Tax Rate on Ordinary Income

15% Capital Gains Tax Rate

Fees:

2.00% Total Fees on Variable Annuity

0.24% Weighted Mutual Fund Expense Ratio

0.52% Weighted Average Mutual Funds Tax Cost

0.75% Management Fee on Mutual Fund Investments

Index List

US Large Cap: S&P 500.

US Small Cap: Russell 2000.

International Stock: MSCI EAFE.

Emerging Markets: MSCI Emerging Markets Index.

US Bonds: Barclays Capital Aggregate Bond Index.

Foreign Bonds: Barclays Capital Global Aggregate Bond Index.

REITs: FTSE NAREIT Composite Index.

Commodities: Dow Jones UBS Commodity Index.

TIPS: Barclays Capital US Treasury Inflation Protected Securities Index.

Treasury Bills: Short-term government issued securities with maturities less than 90 days.

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