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Lily L. Ku, CFP®
Financial Planner

Hongmin Lu, CFA
Compliance Officer &
Quantitative Analyst

Michael C. Yu
Operations Manager

Devon M. Chan
Operations Analyst

Offices:

Southern California:
2540 Huntington Dr.
Suite 105
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
333 Gellert Blvd.
Suite 121
Daly City, CA 94015
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

~ Are Annuities a Good Investment for You ~

By Lily L. Ku, CFP®

With some annuities "guaranteeing" returns, investors are pondering this question in the current market. Pushed by the insurance industry's aggressive marketing and the fear of the volatile equity market, fixed annuity sales climbed tremendously at the end of 2008 and beginning of 2009. There was a similar disconcerting trend back in 2000 to 2003, when sales of the variable annuity sped-up due to the market downturn, misleading information and lack of understanding by general investors.

The Wall Street Journal recently published a special report titled: **Brokers Fear Many Insurers Are Ignorant of Annuity Risks.** In this article, the author cited Merrill Lynch's latest annual survey conducted in February 2009 that indicated: **More than 70% of financial advisers said they were concerned about the risks insurers have taken on with guaranteed-minimum variable annuities -- and nearly a third said they doubted the insurers themselves understood those risks.**

With some of the biggest names in the U.S. life-insurance industry suffering negative outlooks, rating downgrades and possible bankruptcies, the concern about insurers' default risk become very real to the general investor. Thus it is important for us to evaluate the annuity, its related products and its suitability for you and your family.

Insurance agents tout annuities as great investments that are safe, secure, and tax-advantaged. And in the right situation annuities do have their place in a well devised financial plan. Unfortunately, commission driven agents have at times prescribed annuities for unsuitable investors and the results have been disastrous. It is important to remember that annuities are NOT right for everyone and to ***always evaluate the suitability of all financial instruments according to your financial goals and cash flow needs***.

Regulators have been cracking down on the sale of variable annuities in recent years, charging some insurers and brokerages with questionable sales practices. The National Association of Securities Dealers (NASD) accused several companies of frightening elderly customers into buying high-cost, high-risk annuities to protect their assets and downplaying or even concealing the disadvantages or restrictions that make annuities inappropriate investments for those clients, according to the reports.

Annuities are unique because of their combination of tax deferral and the opportunity for a stream of income payments. In many ways, annuities are similar to nondeductible IRAs but with features such as no contribution limit and no Required Minimum Distribution (RMD) for people age 70-and-a-half. If you have maxed out your 401(k), Roth IRA or traditional IRA, then an annuity might be an appealing way to continue your tax-deferred savings **IF** you fully understand these products.

Types of Annuities

Before we explore further, let us try to understand how it works: You give the company from which you're purchasing the annuity a chunk of money, a.k.a. your premium, either in a lump sum or over a period of years. During this accumulation phase, the earnings are not taxed but accumulated to the cash value of the annuity contract. The accumulation phase continues until the annuity contract is terminated or the distribution payment begins. The annuitization phase starts when the annuity payout is distributed. This phase continues until the last payment is made according to the annuity payout option chosen by the agreement.

Additionally, because most annuities are offered by an insurance company, they are often packaged as a combination of an insurance contract (death benefits) and an investment in which your gains can grow tax-deferred. The insurance part guarantees that, if you die, your beneficiaries will receive the benefits as stated on the contract. As an insurance product the annuity is also protected from lawsuits and creditors.

Most annuities have the above properties, but individual annuities differ from each other in several distinctive categories: **Fixed** and **Variable Annuities** (payment streams are at a fixed rate or payments vary based on the performance of the underlying investment); **Deferred** and **Immediate Annuities** (primary purpose being accumulation or payout, respectively)

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Important considerations for Annuities:

Overall annuities sound great with death benefits, an income stream, deferred taxes, and asset protection. But unfortunately, there are also **many drawbacks** to be considered.

Tax deferral has a downside. In an annuity your gains are not taxed until you withdraw the money but are treated as ordinary income at the time of withdrawal. If you held comparable investments in a diversified portfolio, you can harvest losses to offset gains or you can pay long term capital gains tax rates of 15% for holding any stock over 1 year. This may turn out to be the better option if you have other taxable investment holdings or your future income tax bracket is high.

Multiple fees. The death benefits and insurance portion of the annuity are not the only costs built into an annuity. Based on the industry survey, there are many other fees that investor needs to be aware of:

Mortality and Expense Charges

The first fee typically imposed by an annuity will be what's known in the industry as a "Mortality and Expense" (M&E) charge. This fee pays for the insurance guarantee, commissions, and selling, and administrative expenses of the contract. In general, these fees in a variable annuity will be charged as a percentage of the average value of the investment and will probably be quoted in terms of "basis points." According to the National Association of Variable Annuities (NAVA), the industry average M&E in 2008 was 1.35%. In a fixed annuity, these charges are usually incorporated in the insurance company's determination of the periodic interest rate or the annuity payment amount during the distribution phase.

Surrender Charges

The terms of surrender charges is something to be treated with caution. Many annuities will impose a surrender charge if the annuity is cashed in before a specific period of time. That period may run anywhere from 1 to 12 years. A typical surrender charge is one that starts at 7% in the first year of the contract, and declines by 1% per year thereafter until it reaches zero.

Management Fees

Management fees on sub accounts are another layer of fees assessed by variable annuities to the investor. On average, it could add another 0.8% to 2% to the fees.

10% IRS penalty. Cashing out of an annuity early not only invokes surrender charges, those who cash out before age 59½ (except an immediate annuity contract) also face a 10% additional penalty tax imposed by the IRS.

An inherited annuity is considered Income in Respect of a Decedent (IRD). The decedent's cost basis carries over to the beneficiary. On the other hand, for an inherited investment portfolio, the cost basis will be stepped-up to fair market value at the date of the death.

The quality and security of an Annuity are based on the financial strength of the underlying insurance company. While annuities espouse safety and guarantees, their benefits are tied to the financial strength of an insurer. In the current market downturn, as reported by the Wall Street Journal, many annuity companies are having a difficult time meeting the investment guarantees frequently built into their products. An investor should not overlook the increasing **default risk** within the insurance industry nor the additional complications and risk of insufficient payments caused by insolvency. According to the National Organization of Life and Health Insurance Guaranty Associations, if an insurer fails, the safety net is a state-mandated guaranty association. The coverage limits vary from state to state, but most set basic limits at only $100,000 per person for the guaranteed portion of annuities.

It indeed can be very distressing when investors lock in an annuity before realizing the restraints of high surrender charges and other unsuitable characteristics. The best way to avoid this is to ***ask questions, talk to your financial planner or advisor, study all the fine print on the contract and make sure it is indeed suitable to your financial situation***.

Tips for reviewing Annuities:

- **Don't buy an annuity that will be held in a retirement plan** – the main benefit for an annuity is tax deferral. Just as unnecessary as a poncho under an umbrella; you should not buy an annuity in a tax deferred IRA or 401(k)/403(b). If the death benefit is the appealing reason for you to buy an annuity, buying a low cost term life insurance policy would be a cheaper solution to provide for your loved one's future. If a fixed income stream is what you are looking for, a customized, well diversified portfolio of stocks and bonds would be a better investment choice to help you not only achieve the income stream that you need, but also to outpace inflation through your retirement years.
- **Don't buy an annuity until you've exhausted other retirement savings vehicles.** You should not consider an annuity product until you have contributed the maximum to your 401(k)/403(b) and have fully funded your traditional or Roth IRA for the year.
- **Make sure this isn't money that will be inherited.** Annuities, unlike most other investments, do not get a special tax treatment known as a "step-up in basis" when you die. The original cost basis will be carried over to your heirs who inherit an annuity.
- **If you're worried about asset protection, consider alternatives.** There are other ways to protect your assets, such as buying an umbrella liability insurance policy. This liability insurance is not only cheaper but also covers one's non-business activities anywhere in the world.
- **Shop around and shop smart** – there are many good quality companies that offer lower cost annuities without surrender charges or expensive terms. Always ask questions such as: Who is the underlying insurance company? What is their credit rating? How do they guarantee the return? Can that be possible? And lastly, what is the exit plan?