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# Understanding Variable Annuities

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## What is a Variable Annuity?

A variable annuity is a contract between you and an insurance company. With a variable annuity, the insurance company agrees to make periodic payments to you in the future. You can purchase a variable annuity contract by making either a single purchase payment or a series of purchase payments. Please note that certain benefit options (e.g., death benefit or living benefit protection options) may limit additional purchase payments.

Variable annuities offer features not generally found in other types of investment products, including:

- Tax-deferred earnings,
- Tax-free transfers among a variety of investment options (or “subaccounts”),
- Access to the research and due diligence of the annuity’s professionally managed, unique investment options and investment allocation strategies,
- Death benefit protection options,
- Living benefit protection options, and
- Lifetime income options.

An annuity has two phases — the savings (or “accumulation”) phase and the payout (or “annuitization” or “income”) phase. During the savings phase, you make purchase payments into the contract and the earnings accumulate on a tax-deferred basis. The payout phase starts when you begin receiving regular payments from the insurance company by electing an annuity income option. Many contracts include an annuity commencement date, generally between ages 85 and 95, where annuity owners are required to select a payout option (also known as “forced annuitization”). Annuitization of annuity contracts generally requires control of the investment to be given to the insurance company and will generally terminate any living or death benefits provided in the contract.

## Why Consider a Variable Annuity?

A variable annuity is a long-term investment primarily designed for retirement or another long-range goal. As noted above, a variable annuity lets you accumulate assets on a ►



This reference document is provided by Morgan Stanley<sup>1</sup> solely to provide a general overview of variable annuities. It is designed to provide you with a better understanding of variable annuities and the benefits they can provide in helping you plan for a secure retirement. It is not meant to describe a single product or pertain to a particular insurance company. The views expressed in this document are those of Morgan Stanley, are subject to change, and do not necessarily reflect the views of any other company. Please contact your Morgan Stanley Financial Advisor or your local branch if you have any questions regarding this document.

- tax-deferred basis. If you are looking to supplement other sources of retirement income—such as Social Security and pension plans—you may want to consider a variable annuity.

When considering the purchase of a variable annuity, numerous factors should be taken into account including, but not limited to, your:

- Age,
- Annual income,
- Financial situation and needs,
- Investment experience and investment objectives,
- Intended use for the variable annuity (e.g., to leave assets to beneficiaries, to receive income for life, etc.),
- Investment time horizon,
- Existing assets including investment and life insurance holdings,
- Liquidity needs (see the section titled “Share Class, Surrender Periods and Tax Deferral” for more information),
- Liquid net worth,
- Tolerance for risk and
- Tax status.

Please note that variable annuities involve investment risk and a variable annuity may lose value. Therefore, you should consider your ability to sustain investment losses during periods of market downturns. Before buying any variable annuity, you should request a prospectus from your Financial Advisor and read it carefully. The prospectus contains important information about the annuity contract including fees and charges, investment options and objectives, risks, death benefits, living benefits and annuity income options. All of these should be considered carefully.

You should compare the benefits and costs of the variable annuity you are considering to other variable annuities and to other types of investments before investing.

### “Free Look” Period

Variable annuities typically have a trial period of 10 or more days from your receipt of the contract. This is known as the “free look” period. During this time, you can terminate the contract and get back your purchase payments without paying any surrender charges. The purchase payments may be adjusted to reflect charges and the performance of the subaccounts you selected. You are encouraged to ask questions before the “free look” period ends to make sure you understand your variable annuity and confirm that it is right for you.

### Variable Annuity Fees and Charges

There are fees and charges that are unique to variable annuity products. These fees and charges cover the cost of contract administration, portfolio (or investment) management and the insurance benefits (e.g., death and living benefit protection options, lifetime income options).

familiar with both types of fees and charges and the methodology for their calculation within the particular variable annuity you are purchasing. The most common fees and charges are:

#### ● MORTALITY AND EXPENSE RISK CHARGE (M&E):

The M&E charge compensates the insurance company for insurance risks and other costs it assumes under the annuity contract. M&E charges are deducted from the value of the subaccounts (i.e., the investment options you select). The fees for any optional death and/or living benefit you may select are described below and are not included in the M&E charge. M&E charges are assessed daily and typically range from 1.15% to 1.85% annually.

#### ● ADMINISTRATIVE AND DISTRIBUTION FEES:

These fees cover the costs associated with servicing and distributing the annuity. These fees include the costs of transferring funds between subaccounts, tracking purchase payments, issuing confirmations and statements as well as ongoing customer service. Administrative and distribution fees are deducted from the value of the subaccounts. These fees are assessed daily and typically range from 0% to 0.35% annually.

#### ● CONTRACT MAINTENANCE FEE (OR “ANNUAL FEE”):

The contract maintenance fee is an annual flat fee charged for record keeping and administrative purposes. The fee typically ranges from \$30 to \$50 and is deducted on the contract anniversary. This fee is typically waived for contract values over \$50,000.

#### ● UNDERLYING SUBACCOUNT FEES AND EXPENSES:

Fees and expenses are also charged on the subaccounts. These include management fees that are paid to the investment adviser responsible for making investment decisions affecting your subaccounts. This is similar to the investment manager’s fee in a mutual fund. Expenses include the costs of buying and selling securities as well as administering trades. These asset-based expenses will vary by subaccount and typically range from 0.70% to 2.50% annually.

- **CONTINGENT DEFERRED SALES CHARGE (“CDSC” OR “SURRENDER CHARGE”):** Most variable annuities do not have an initial sales charge. This means that 100% of your funds are available for immediate investment in the available subaccounts. However, insurance companies usually assess surrender charges to an annuity owner who liquidates their contract (or makes a partial withdrawal in excess of a specified amount) during the surrender period (see the section

titled “Share Class, Surrender Periods and Tax Deferral” for additional information). The surrender charge is generally a percentage of the amount withdrawn and declines gradually during the surrender period. A typical surrender schedule has an initial surrender charge ranging from 7% to 9% and decreases each year that the contract is in force until the surrender charge reaches zero. Generally, the longer the surrender schedule, the lower the contract fees. Most

contracts will begin a new surrender period for each subsequent purchase payment, specific to that subsequent purchase payment.

### Share Class, Surrender Periods and Tax Deferral

Variable annuities are traditionally offered with varying fee and surrender periods. These are otherwise known as “share class options.” As noted in the table below, “B Share” and “Bonus Share” or “X Share” annuities ►

TYPE OF ANNUITY	SURRENDER PERIOD	SURRENDER CHARGES	TYPICAL CONTRACT FEES	TYPICALLY SUITABLE FOR THESE TYPES OF INVESTORS
“B Share” Annuities	6-8 years on each contribution	CDSC starts at approximately 8% and subsequently declines each year to zero over the Surrender Period	Asset-based contract charges generally in the 1.15% to 1.55% range; contract fees generally range from \$0 to \$50; and underlying fund expenses that generally range from 0.70% to 2.50%	<ul style="list-style-type: none"> <li>• Those who have a long-term time horizon (e.g., 10 years)</li> <li>• Those who do not intend to access their investment until the end of the surrender period</li> <li>• Those who want the lowest cost annuity available</li> </ul>
“Bonus Share” or “X Share” Annuities (may also be called “Premium Enhanced Annuities”)	8-9 years on each contribution	CDSC starts at approximately 9% and subsequently declines each year to zero over the Surrender Period	Asset-based contract charges generally in the 1.40% to 1.85% range; contract fees generally range from \$0 to \$50; and underlying fund expenses that generally range from 0.70% to 2.50%	<ul style="list-style-type: none"> <li>• Those who have a long-term time horizon (e.g., 10 years)</li> <li>• Those who anticipate the investment credit to outweigh the additional cost of the annuity</li> </ul>
“L Share” Annuities	3-4 years on each contribution	CDSC starts at approximately 8% and subsequently declines each year to zero over the Surrender Period	Asset-based contract charges in the 1.60% to 1.75% range; contract fees generally range from \$0 to \$50 and underlying fund expenses that generally range from 0.70% to 2.50%	<ul style="list-style-type: none"> <li>• Those who value easier access to their money within a three- to four-year time horizon</li> <li>• Those who are willing to pay higher fees in exchange for the flexibility to reposition investments if needs or goals change</li> </ul>
“C Share” Annuities	Fully liquid	Offers full liquidity to owner at any time after purchase	Asset-based contract charges in the range of 1.65% to 1.80%; contract fees generally range from \$0 to \$50 and underlying fund expenses that generally range from 0.70% to 2.50%	<ul style="list-style-type: none"> <li>• Those who value easier access to their money immediately after investing</li> <li>• Those who are willing to pay higher fees in exchange for the flexibility to reposition investments if needs or goals change</li> </ul>

- are generally lower-cost alternatives with the longest surrender periods while “L Share” and “C Share” annuities are higher-cost alternatives with the shortest surrender periods. ***Since the share class selected will determine the fees and surrender charge associated with your selected variable annuity contract, you should familiarize yourself with all share class options available before you decide to invest.***

Specific points to consider include:

- Tax deferral and the selection of optional living benefit protection options generally require an investment time horizon of at least 10 years to realize the full benefits.
- Contract fees and/or surrender charges may significantly impact the annuity contract's investment performance.
- Unexpected life events and individual preference may lead an investor to prioritize greater access to their investment and therefore choose a more expensive share class option.

- Investors who do not anticipate needing access to the dollars they invested in a variable annuity should consider purchasing B Share or Bonus/X Share annuities because these will be the lowest-cost options over long-term time horizons. This will enhance the potential for increased returns versus the purchase of the more expensive L Share or C Share annuities.

Determination of the appropriate balance between a) access to your investment, b) contract fees and charges and c) the duration required to take full advantage of any optional benefit you may select are important factors to review with your Financial Advisor. Before you invest, you should carefully read and compare the description of costs, including the applicable surrender schedule, included in the variable annuity prospectus. You should understand the features, benefits and costs of the variable annuity you are considering. This information is also included in the variable annuity prospectus. Because Bonus/X Share annui-

ties contain an investment credit (i.e., a credit of generally 2% to 6% of your premium is added to your contract by the insurance company to increase your potential to realize tax-deferred growth), it may have higher fees and expenses as well as a longer surrender schedule than other similar annuities without an investment credit.

Please note that certain annuity products may limit their offerings to a single share class that may have a surrender period ranging from 5 to 7 years. These offerings may include a “liquidity rider,” available at an additional cost, that gives you access to your investment prior to the end of the surrender period. ■

# Benefits and Features of a Variable Annuity

## Investment Options ("Subaccounts")

During the savings phase, a variable annuity offers a wide range of fixed and variable subaccounts with different objectives and investment strategies. The value of your variable annuity will vary depending upon the performance of the investment options you choose. The variable subaccounts include actively managed portfolios, exchange-traded funds, indexed or indexed-linked portfolios, alternative investments and other quantitative-driven strategies. The variable subaccounts typically invest in various asset classes that may include stocks, bonds, private placements, derivatives, commodities, money market instruments or other investments. Although the subaccounts within variable annuities are similar in many respects to mutual funds, fees and expenses may differ. Like mutual funds, you bear all the investment risk for amounts allocated to the variable subaccounts.

The fixed subaccounts offer a fixed rate of return that is guaranteed by the insurance company for a period of one or more years (i.e., the "guarantee period"). If you withdraw or transfer from a fixed subaccount during the guarantee period, a market value adjustment (or "MVA") may apply. MVAs will result in an amount added to or subtracted from the contract value based on the changes in inter-

est rates since the beginning of the guarantee period. In general, if interest rates have decreased, the investment value will increase. And, if interest rates have increased, the investment value will decrease.

Please note that in a low interest rate environment, the performance of interest rate sensitive investments (e.g., money market funds) may not be sufficient to override contract fees and/or subaccount expenses which could lead to negative returns for your variable annuity.

Alternative Investment strategies are available as a variable subaccount or a model asset allocation investment in certain variable annuities. Alternative Investment strategies are speculative, involve a high degree of risk to loss in principal, typically have higher fees than other investments, and may engage in the use of leverage, short sales and derivatives. These may increase the risk of investment loss. Alternative Investment strategies include derivative exposure that may not perform as intended, can

*During the savings phase, a variable annuity offers a wide range of fixed and variable subaccounts with different objectives and investment strategies.*

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significantly increase each portfolio's exposure to the existing risks of the underlying investments and may be illiquid and difficult to value. As a result, the portfolio may not realize the anticipated benefits from the derivative it holds or it may realize losses. Alternative Investment strategies may create investment leverage, which may increase volatility and may require liquidation of securities when it may not be advantageous to do so. These investments are designed for investors who understand and are willing to accept these risks.

Liquid Alternative Investment strategies seek alternative-like exposure and may be available as a variable subaccount or model allocation within many variable annuities. These investments include alternative-like exposure and seek investment returns that have lower correlation to traditional markets in an attempt to increase diversification in an overall portfolio.

Unlike traditional hedge funds, subaccounts that seek alternative-like exposure a) do not require the same investor prequalifications, b) enable efficient tax reporting, c) are subject to lower investment minimums and lower fees, d) provide portfolio transparency, e) offer daily liquidity and f) are required to provide daily Net Asset Value (or "NAV") pricing.

Because of 1940 Act limitations, subaccounts that seek alternative-like exposure generally must utilize a more limited investment universe and, therefore, will have relatively higher correlation with traditional market returns. Registered variable investment funds are ►

- statutorily limited in their use of leverage, short sales and the use of derivative instruments. Therefore, they may not provide the same market exposures and opportunities as traditional alternative investment strategies.

Hedge funds typically charge an asset-based fee and a performance fee. Potential benefits to hedge funds include a) greater flexibility in terms of seeking enhanced returns through the use of leverage, b) exposure to less liquid investments, and c) the more flexible use of complex instruments such as derivatives.

As a result of these differences, performance for a variable subaccount that seeks alternative-like exposure and its portfolio characteristics may vary from a traditional hedge fund that is seeking a similar investment objective.

**ASSET ALLOCATION/BALANCED PORTFOLIOS:** While investment in certain asset allocation or balanced portfolios could mitigate losses during declining market conditions, they may also hamper potential gains during rising market conditions. Asset allocation investments may be required to gain access to a certain living or death benefit guarantee and may provide very different potential risk/reward characteristics. These investments may manage volatility to mitigate the insurer's guarantee obligations by potentially reducing investment returns that an investor might have received during favorable market conditions.

It is important to note that diversification and asset allocation do not assure a profit or protect against a loss in a declining market.

**MARKET-LINKED SEGMENT BUFFERS:** Certain registered annuities provide other, more limited, forms of downside protection called "Segment Buffers." These limited guarantees typically track investment returns associated with the change in the level of one or more published equity or commodity-based indexes, such as the Standard

& Poor's 500 Composite Stock Price Index™ (S&P 500), which tracks the performance of the 500 large-cap publicly-traded securities.

Some of the features unique to Market-Linked Segment Buffers include:

- **SEGMENT CREDITING:** This is the method (e.g., point-to-point) used to measure the change in the underlying index over an investment term (or time period) that may reset regularly such as every 3 or every 5 years. For example, on a 1-year term segment, if the underlying index equals 1000 on the date of purchase and equals 1100 on the first anniversary date of purchase, then the change in the index ( $1100 - 1000 = 100$ ) divided by the index value at purchase (1000) equals 10%.

● **PERFORMANCE CAP:** With this method, the maximum index-based performance is credited to the contract upon the investment's segment termination. For example, on a 1-year term segment, if there is a 6% cap and the underlying index increased by 10% in a year, the credit to the contract would only be 6%, thereby foregoing 40% on the upside.

- **BUFFER:** With this method, there is a maximum indexed-based percentage performance loss — typically 10%, 20% or 30% — that will be credited to the contract owner upon the investment's segment termination. For example, on a 1-year term segment, if the product includes a 10% Buffer and the underlying index equals 1000 on the date of purchase and equals 800 in a year, then the change in the index equals 20% ( $800 - 1000 = -200/1000$ ). The loss of 20% is then subtracted from the 10% Buffer to equal a net loss of 10% to the contract, thus only realizing half of the loss.

● **PERFORMANCE CAP THRESHOLD:** With this method, a minimum rate is specified by the contract owner for a new segment to be equaled or exceeded in order for amounts to be transferred into a new segment. For example, on a 1-year term segment, if the product includes a 6% Performance Cap Thresh-

old (set by the contract owner) and a Cap of 5%, the investment will be held in a holding account until the Cap rate reaches 6% or the threshold is reduced by the contract owner to 5%.

- **PARTICIPATION RATE:** With this method, the percentage of the calculated index gain that will be credited to the contract as interest may be reset annually. For example, if the Participation Rate is 90%, then a 10% change in an index would result in a 9% credit ( $90\% \times 10\% = 9\%$ )

Please note that Performance Cap Thresholds can be an important tool to investment in Market-Linked Segment Buffers. Not specifying a threshold would risk the possibility that the Performance Cap established will have a lower cap on returns than you would otherwise find acceptable. You may wish to discuss the appropriate Performance Cap Threshold with your Financial Advisor. When specifying a Performance Cap Threshold, please review the effective date and date of expiration.

Market-Linked Segment Buffers include a risk of a substantial loss of principal because you agree to absorb all losses from the portion of any negative index performance rate that exceeds the Segment Buffer at maturity. Also, the Performance Cap limits the maximum amount you may receive from indexed gains. You should consider your ability to sustain investment losses during periods of market downturns. An annuity with a Market-Linked Segment Buffer is generally not suitable for individuals seeking principal preservation or who have a short time horizon. Before buying an annuity with Market-Linked Segment Buffers, request a prospectus from your Financial Advisor and read it carefully. The prospectus contains important information about the risks associated with this type of annuity contract. You should compare the benefits and limitations of the annuity to other annuities

and to other types of market-linked or structured investment vehicles.

**CHARGES ASSOCIATED WITH MARKET-LINKED SEGMENT BUFFERS:** Typically, Market-Linked Segment Buffers do not have upfront sales loads. The insurance company's costs and profits are built into the Caps, Participation Rate, Segment Buffer and/or other features of the contract. Your contract may be subject to surrender charges in the first 5 to 10 years of the contract. You may also be subject to a fair value (or "Interim Value Formula") calculation if an early withdrawal, reallocation or termination is requested while invested in a market-linked segment.

### Tax-Free Transfers

You may transfer your money from one subaccount to another — or to a fixed account — within a variable annuity without paying current taxes on any earnings. If market conditions change, you may reallocate money among the investment options without worrying about current taxes. Transfers are subject to any limitations (e.g., only a specific number of transfers may be made within a one-year period) imposed by the insurance company and are detailed in the prospectus.

### Tax-Deferred Earnings

Earnings from an annuity grow on a tax-deferred basis. This means that income taxes that would have been paid on interest, dividends or capital appreciation are deferred until you make a withdrawal from the annuity contract. Therefore, investments may grow faster in an annuity than in a taxable investment vehicle with a similar rate of return because money

that would have been used to pay taxes on earnings remains invested and continues to grow and compound. It is important to note, however, that when you withdraw your money from a variable annuity, you will be taxed on the earnings at ordinary income tax rates rather than the lower tax rates applicable to capital gains. And, if you take the withdrawal before you attain age 59 1/2, you may be subject to an additional 10% federal tax penalty. The benefits of tax deferral may outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement or other long-range goals.

### Death Benefit

Variable annuity contracts allow for the payment of the current contract value to your named beneficiary (or multiple named beneficiaries) upon your death.

Typically, contracts may also include, as a standard death benefit, the greater of a return of premium less any withdrawals or the current contract value.

Some contracts also offer "enhanced" death benefits for an additional charge. For example, one enhanced death benefit includes the

allowance to periodically "lock in" your investment performance. Another enhanced death benefit may guarantee a minimum rate of return on the value of your account.

The earnings-enhanced death benefit is another optional death benefit that may be available. This feature entitles the named beneficiary to a death benefit that is increased by an amount — typically 25% to 40% of the earnings in the contract — that can be used to help offset taxes that may be due when the death benefit is paid.

Generally, when the owner (or annuitant, as specified in the prospectus or contract) of the annuity dies, the beneficiary is taxed on all appreciation when the death benefit is received. This is different than investments held in a taxable account that may receive a stepped-up cost basis (i.e., the value of the account at the owner's death including all appreciation).

The cost for these optional death benefits typically ranges from 0.20% to 1.50% annually.

There are some additional considerations you should be aware of regarding variable annuity death benefits:

- The death benefits described above may terminate once you elect an income option and enter the payout phase of the contract.
- Depending on the contract, death benefits may be payable upon the death of the owner, the annuitant or both.
- Withdrawals during the savings phase will reduce the death benefit.
- Contracts that include a return of account value death benefits as the sole death benefit option should only be purchased for their additional features such as optional living benefit, access to a certain unique investment strategy or the benefits of tax deferral on nonqualified contracts and should not be purchased solely for death benefit protection.
- Most optional death benefits must be elected when the contract is issued and cannot be canceled.
- Earnings distributed as death benefits are taxed as ordinary income when received by the named beneficiary.

### Living Benefit Options

Annuities are characterized by their ability to provide retirement income that cannot be outlived during the payout phase. Many annuity products offer, on an optional basis, "living benefits" that provide principal and/or income guarantees to help protect your retirement income from ►

- declining markets during the savings phase (i.e., insurance for your purchase payments).

There are three basic types of living benefits, each with a distinct objective, that are summarized in the chart below. The actual guarantees and corresponding fees will vary by contract. **These living benefits are available for an additional cost. Minimum holding periods and investment restrictions may apply. Deviations from these limitations may result in material reduction or termination of the benefit.** As with any optional benefit, it is important to weigh the costs against the benefit when adding

such riders to your contract. Read the prospectus carefully before selecting a living benefit.

The cost for optional living benefits typically ranges from 0.30% to 2% annually. The costs (or fees) may be identified as static or dynamic. Dynamic fees may go up or down, with the range bound by contractual limitations, and in certain instances are tied to a specific benchmark (e.g., VIXX or US 10-Year Treasury). Please review the prospectus to ensure all fees, ranges, caps and frequency of fee alterations are completely understood prior to investing.

### **Lifetime Income (Annuitization)**

Variable annuities offer several income options for receiving payments, including the option to receive payments for the rest of your life (or your life and the life of your spouse or any other person you designate). This feature, known as annuitization, offers protection against the possibility that you will outlive your assets. Generally, you cannot change the income option once annuity payments begin. Once a contract has been annuitized — whether the decision has been made to annuitize or it has been done through forced annuitization — the contract owner surrenders control of the contract to the insurance company. ■

LIVING BENEFITS OPTIONS	BENEFIT DESCRIPTION	ADDITIONAL CONSIDERATIONS
<b>Guaranteed Minimum Accumulation Benefit (GMAB)</b>	Generally, this benefit guarantees the return of your purchase payments or a higher stepped-up value at the end of a waiting period, typically ten years from issue or last step-up, regardless of your investment performance. If your contract value is below the guaranteed amount at the end of the waiting period, the insurance company will increase your contract value to equal the guaranteed amount (adjusted by any withdrawals).	At the end of the waiting period, the benefit may be renewed for another waiting period, depending on the terms of the contract. If the benefit is not renewed, your purchase payments will become subject to market risk and may lose value. Additionally, some contracts require that all of your assets be allocated in specified investment options during the waiting period, and deviation from these investment options may result in material reduction or termination of this benefit.
<b>Guaranteed Minimum Income Benefit (GMIB)</b>	Generally, this benefit guarantees a lifetime income stream when you annuitize the GMIB amount (after a seven-to-ten-year waiting period), regardless of your investment performance. The GMIB amount is generally based on the greater of your current contract value, your purchase payments (adjusted pro rata or dollar-for-dollar by any withdrawals) compounded annually at a rate of 4% to 8% (often referred to as the roll-up value), or it may equal the greater of the contract's highest anniversary value or the roll-up value (roll-up/anniversary value may be adjusted pro rata or dollar-for-dollar by withdrawals). The GMIB amount must be annuitized. It is not available as a lump-sum payment.	The income stream is often limited to payments for life with a minimum number of payments guaranteed. The GMIB income stream is determined by applying the GMIB payout rates to the GMIB amount, although you may receive a higher income stream by annuitizing under the regular provisions of your contract. In this case, the GMIB provides no additional benefit. Additionally, some contracts require that all of your assets be allocated in specified investment options during the waiting period and deviation from these investment options may result in material reduction or termination of this benefit.
<b>Guaranteed Minimum Withdrawal Benefit (GMWB)/Guaranteed Lifetime Withdrawal Benefit (GLWB)</b>	Generally, these benefits guarantee a return of your purchase payments over a specified number of years or over the lifetime of an individual or an individual and spouse through a series of annual withdrawals. Certain benefits may provide for a higher stepped-up benefit base via a 3% to 8% annual roll-up of your benefit base and/or an annual reset based on positive market performance.	During the withdrawal period, withdrawals in excess of the benefit withdrawal limit (3% to 7%) may negatively affect the guarantee. Additionally, some contracts require that all of your assets be allocated in specified investment options, and deviation from these investment options may result in material reduction or termination of this benefit. Generally, there is no waiting period to begin withdrawals, but liquidity limitations based on current age or before age 59 ½ may apply. Withdrawals not taken generally do not accumulate or carry over to the next year.

# Other Features, Benefits and Considerations

## Withdrawals

Annuity contracts generally offer the right to withdraw up to 10% of the contract value annually without incurring a surrender charge. However, withdrawals of earnings are subject to applicable income tax and, if they are taken before you attain age 59 1/2, a 10% IRS penalty tax may also apply.

As noted earlier, withdrawals will reduce your contract value, death benefit and living benefit guarantees. Depending on the annuity contract, a withdrawal will generally reduce the death and living benefit's base on a dollar-for-dollar or pro rata basis (or the greater of the two). A pro rata reduction means that the withdrawal will reduce the benefit base by the proportion that the withdrawal reduces the contract value. If at the time of withdrawal, the contract value is less than the benefit amount, a pro rata reduction will reduce the benefit base by an amount greater than the withdrawal. For example, if the contract value is \$200,000 and the death benefit is \$300,000, a withdrawal of 50% of the contract value (or \$100,000) will reduce the death benefit by 50% (or \$150,000), not merely by the amount of the withdrawal.

When calculating a withdrawal, you should take note of the minimum contract value required to maintain a contract as active. This calculation should include an analysis of the impact of fees and negative fund performance to a contract's value as these factors may cause the insur-

ance company to liquidate the contract and terminate existing benefits ("forced liquidation"). Please read the prospectus carefully for more information pertaining to contract withdrawals.

## Probate

By simply naming a beneficiary, the assets of your annuity are transferred directly to your beneficiaries, bypassing probate.

## Automatic Rebalancing

Due to changing market conditions over time, the investment allocation within your variable annuity may change. Most variable annuities offer — and some require — programs that automatically rebalance your portfolio back to your original desired allocation. You can select the frequency for rebalancing your portfolio when you set up the program (e.g., quarterly, annually, etc.).

Please note that dollar-cost averaging and automatic rebalancing do not assure a profit or protect against a loss. Before beginning a dollar-cost averaging program, you should consider your ability to continue purchases through periods of fluctuating price levels.

## Tax Considerations

The tax rules that apply to variable annuities can be complicated. Before investing, you should consult a tax advisor about the tax consequences of investing in a variable annuity.

## Annuities in Tax-Advantaged Retirement Accounts

As noted, tax-deferred growth is a key advantage of investing in a variable annuity. It is important to remember that if you are investing in a variable annuity through a tax-advantaged retirement plan (e.g., IRA, SEP, Keogh, etc.) you will get no additional tax advantage from the variable annuity because the retirement account already provides tax-deferred growth. You should only consider buying a variable annuity in a retirement plan if it makes sense because of the annuity's other unique features, such as guaranteed lifetime income payments, access to a unique investment option or guaranteed living and/or death benefit protection.

If you are concerned about market risk, the risk of outliving your income or the impact on your named beneficiaries if you die during a down market, then you might consider buying a variable annuity in a retirement plan. Variable annuities may provide financial guarantees during your retirement plan accu- ►



## DOLLAR-COST AVERAGING

Dollar-cost averaging allows you to systematically invest equal amounts into the same subaccounts at regular intervals over a set period of time. Many variable annuities offer you the option of automatic dollar-cost averaging by using a money market or fixed account option to hold money and then invest it into the available subaccounts of your choice. For dollar-cost averaging programs that require an initial investment in the fixed account, the annual effective yield on the fixed account is paid on a declining base (i.e., as money is moved from the fixed account to the variable subaccounts there is less money in the fixed account earning the fixed interest rate).

► mulation or distribution phases. Variable annuities can also be converted into a guaranteed lifetime income stream. And, at death, the value of your investment can be protected with a death benefit guarantee. The terms of variable annuities differ and not all variable annuities offer all of the benefits described here. Similar to all types of investments within a retirement plan, annuities in a retirement plan require that distributions begin upon attainment of age 70 1/2. Please read the prospectus carefully for more information before you invest.

### **IRS Contribution Limits**

An annuity purchased outside of a tax-advantaged retirement plan with after-tax dollars (a “nonqualified annuity”) offers distinct advantages over tax-advantaged retirement plans (e.g., 401(k), 403(b), IRA, SEP, Keogh, etc.) because there is no IRS-imposed limit on the amount that can be contributed to the annuity (although insurance companies may suspend or impose contribution limitations). While it is advisable to make the maximum allowable contributions to your tax-advantaged retirement plan(s) first, it may be appropriate to invest any additional assets earmarked for retirement into a nonqualified annuity.

### **1035 Exchanges**

Section 1035 of the Internal Revenue Code (IRC) allows for the direct exchange of an annuity for another annuity without tax consequences. A 1035 exchange may be appropriate if your contract is older and does not provide features offered in newer products such as more flexible or enhanced death benefits, living benefits or a wider choice of investment options.

Please note that while a 1035 exchange is a tax-free event, other charges—such as surrender chargers—may be incurred or a new surrender charge period may be imposed. If you are considering a 1035 exchange, you should discuss it

with your Financial Advisor. You should also consult with your tax advisor to make sure the exchange is tax-free, to understand the charges that might be incurred and to determine whether the benefits of the new annuity outweigh the costs of surrendering the old one.

The IRS has issued Revenue Procedure 2011-38 (or “Rev. Proc. 2011-38”) which provides modified guidance with respect to the federal tax treatment of partial 1035 exchanges of annuity contracts. Under Rev. Proc. 2011-38, if any surrender—in whole or in part—of either contract occurred within 180 days of the partial 1035 exchange, the partial 1035 exchange would be treated as a taxable event. The limitation on amounts withdrawn from or received under an annuity does not apply to amounts received as an annuity payout for a period of 10 years or more, or during one or more lives. Rev. Proc. 2011-38 amended Rev. Proc. 2008-24 and it became effective for partial 1035 exchanges that are completed on or after October 24, 2011.

### **Spousal Continuance**

Some variable annuities offer your spouse the opportunity to continue the contract in the event of your death. The spousal continuation feature may allow your spouse to continue the contract

at the greater of the contract value or the death benefit amount. This has the advantage of locking in the higher death benefit and, at the same time, delaying a taxable event for the new beneficiary.

### **How Morgan Stanley and Your Financial Advisor Are Compensated When You Buy a Variable Annuity**

Morgan Stanley offers a wide selection of variable annuities from approved insurance companies (or providers) for you to choose from. We review and evaluate each insurance company, whose products we offer, based upon various factors including, but not limited to:

- Quality and competitiveness of the products offered,
- Financial strength of the insurance company,
- Systems’ compatibility and ability to provide technological support for the sale and servicing of annuity contract,
- Ability and commitment to support our Financial Advisors through training, education and sales literature, and
- Level of interest and demand among clients and Financial Advisors.

Evaluating insurance companies in this manner allows us to focus our marketing and sales support resources on the

### **Tax Reporting**

Here are some things you should be aware of when it comes to annuities and tax reporting:

- There are no required annual IRS forms that need to be filed for nonqualified annuities owned by an individual.
- Once you begin to take withdrawals from the annuity, they will be reported on IRS Form 1099-R.
- IRAs that hold annuities as investments need to report the December 31<sup>st</sup> value to the IRS annually in order to satisfy Fair Market Value reporting requirements and to calculate the Required Minimum Distribution once you attain age 70 1/2.
- Non-natural ownership of a nonqualified annuity—such as by a trust—may result in annual IRS reporting unless proper ownership documentation is provided to the issuing insurance company.

companies of greatest interest to—and that offer the most competitive and suitable products for—our clients and their Financial Advisors. Morgan Stanley Financial Advisors are not permitted to recommend variable annuity products from insurance companies that have not been reviewed, evaluated and approved.

### Revenue Sharing

For the variable annuity products that are offered, Morgan Stanley seeks to collect a revenue sharing payment from insurance companies. In 2013, insurance companies paid fees on assets of up to 0.25% per year (\$25 per \$10,000), calculated quarterly, based upon the aggregate value of variable annuity assets—including assets invested in fixed rate subaccounts within variable annuities—invested in contracts for which Morgan Stanley is designated as the broker-dealer or agent of record. This rate may be subject to volume discounting (i.e., as the amount of assets increases, the percentage payment for those assets decreases). Revenue sharing payments are paid out of the insurance company's revenues or profits and not from a client's contract value or the assets invested in the subaccounts. It is important to note that our Financial Advisors receive no additional compensation as a result of these revenue sharing payments.

### Commissions and Service Fees

Each time a variable annuity is purchased through a Morgan Stanley Financial Advisor, the insurance company pays Morgan Stanley compensation—based upon a standard schedule for all insurance companies—in the form of a commission (or “upfront commission”). The commission is based on the product and share class selected and the amount invested in the variable annuity. The commissions payable to Morgan Stanley are consistent for all insurance companies regardless of the

volume of business Morgan Stanley submits to the insurance company or the profitability of the variable annuity to the insurance company. However, Morgan Stanley may receive differing levels of compensation depending upon the client age and the share class selected. Please note that no insurance company—or the parent or affiliated company of the insurance company—has any material interest in Morgan Stanley Smith Barney LLC or its licensed insurance agency subsidiaries, Morgan Stanley Insurance Services, Inc., SBHU Life Agency, Inc., and Morgan Stanley Smith Barney Insurance Services LLC.

A portion of the commission paid to Morgan Stanley is, in turn, paid to the Financial Advisor. Financial Advisor commissions generally range from 0% to 5% of monies invested in a variable annuity contract. Insurance companies also pay Morgan Stanley the following:

- Trails (or “annuity contract servicing payments”) ranging from 0.25% to 1.40% of the variable annuity assets. Morgan Stanley passes all or a portion of these trails to the Financial Advisor.
- Additional percentage of the amount invested in a variable annuity generally not exceeding 1.80%.

Upfront and trail commission payments are paid out of the insurance company's assets and are derived from the product fees and expenses described in the prospectus.

### Expense Prepayment or Reimbursement

Morgan Stanley may seek prepayment or reimbursement by approved insurance companies, their parent or affiliated companies, or other service providers for the expenses incurred for various sales meetings, seminars and conferences held in the normal course of business. Morgan Stanley may also seek prepayment or reimbursement for expenses related to administrative and compliance services.

### MORGAN STANLEY'S RELATIONSHIP WITH THE FUNDS (OR SUB-ACCOUNTS) OFFERED IN VARIABLE ANNUITIES

The variable annuities offered through Morgan Stanley may include subaccounts managed by Morgan Stanley & Co. LLC and its affiliates as well as subaccounts managed by independent money managers. Morgan Stanley & Co. LLC, as a firm, earns management fees if you choose to invest in the Morgan Stanley & Co. LLC subaccounts available within a variable annuity. However, our Financial Advisors receive the same commissions and trails regardless of the subaccounts you pick.

### Compensation From Insurance Companies

Morgan Stanley—and its parent or affiliates—receive from certain approved insurance companies—or their parent or affiliated companies—the following:

- Compensation in the form of commissions and other fees for providing traditional brokerage services including related research and advisory support, and for purchases and sales of securities for their own portfolios or the portfolios of subaccount investment companies.
- Compensation for financial services performed for the benefit of these companies.

Morgan Stanley prohibits linking the determination of the amount of brokerage commissions and service fees charged to these companies to the aggregate values of our overall variable annuity product sales or client holdings of these products, or to offset the revenue sharing or expense reimbursements described above.

For additional information on a particular insurance company's payment and compensation practices, please refer to the insurance company's product prospectus and Statement of Additional Information. ■

# Before You Decide to Buy a Variable Annuity

You should consider the following before you decide to buy a variable annuity:

## Investment Goals

- Will you use the variable annuity to save for retirement or a similar long-term goal?
- Are you purchasing the variable annuity in a retirement plan or IRA? If so, remember that you will not receive any additional tax-deferral benefit from the variable annuity.
- Do you intend to remain invested in the variable annuity long enough to avoid paying any surrender charges?
- Do you intend to remain invested in the variable annuity long enough to benefit from any optional living benefit riders if you have to withdraw money?
- Are you willing to take the risk that your account value may decrease if the underlying subaccounts perform poorly?
- Have you consulted with a tax advisor and considered all of the tax consequences associated with purchasing an annuity, including the effect of annuity payouts on your tax status in retirement?

## Costs and Benefits

- Do you understand the features of the variable annuity?
- Do you understand all of the fees and expenses that the insurance company charges for the variable annuity?
- Do you understand the various ways in which Morgan Stanley and your Financial Advisor are compensated when you purchase a variable annuity?
- If a variable annuity offers an investment credit, will the credit outweigh the variable annuity's higher fees and charges?
- Are there features of the variable annuity that you could purchase separately and for a lower cost?
- If you are exchanging one annuity for another, do the benefits of the exchange provide a substantial financial benefit that outweighs the costs? Be sure to consider any surrender charges that need to be paid on the old annuity and the impact on your liquidity resulting from the surrender charge schedule on the new annuity.
- Is your investment time horizon and pref-

erence for access to your money consistent with the share class that you selected?

## Senior Suitability

In recent years, regulators have expressed concern about annuity sales to the elderly. There are a number of key points of interest you should consider in advance of investing. These include:

- Your investment risk tolerance,
- Your liquidity and potential long-term care needs,
- Your life expectancy in contrast with the annuity's holding period,
- The variable annuity's fees and charges,
- Tax consequences, and
- Your ability to understand all of the features, benefits and costs associated with the variable annuity. ■

## For More Information

Before purchasing a variable annuity, you owe it to yourself to learn as much as possible about how a variable annuity works, the benefits it can provide and the fees and charges you will pay. For more information, contact your Financial Advisor or visit the following websites:

- American Council of Life Insurers at [www.acli.com](http://www.acli.com)
- Securities and Exchange Commission at [www.sec.gov](http://www.sec.gov)
- Financial Industry Regulatory Authority at [www.finra.org](http://www.finra.org)—see these FINRA Investor Alerts for additional information: "Variable Annuities: Beyond the Hard Sell" and "Should You Exchange Your Variable Annuity?"
- Insured Retirement Institute at [www.irionline.org](http://www.irionline.org)

<sup>1</sup> Morgan Stanley is intended to mean Morgan Stanley Smith Barney LLC, the broker-dealer, when used in this document.

**Variable annuities are sold by prospectus only. The prospectus contains the investment objectives, risks, fees, charges and expenses, and other information regarding the variable annuity contract and the underlying investments, which should be considered carefully before investing. Prospectuses for both the variable annuity contract and the underlying investments are available from your Financial Advisor. Please read the prospectus carefully before you invest.**

Payment obligations of the issuing insurance company are backed by the financial strength and claims-paying ability of the issuing insurance company.

Morgan Stanley Smith Barney LLC offers insurance products in conjunction with its licensed insurance agency affiliates.

An annuity is not a deposit of, or other obligation of, or guaranteed by, the Depository Institution, or an affiliate of the Depository Institution, and involves investment risk, including the possible loss of value.

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Portions of this brochure have been excerpted or paraphrased from the online publication, "Variable Annuities: What You Should Know," which can be found at the US Securities and Exchange Commission website, <http://www.sec.gov/investor/pubs/varannyt.htm>. We encourage you to read this publication.