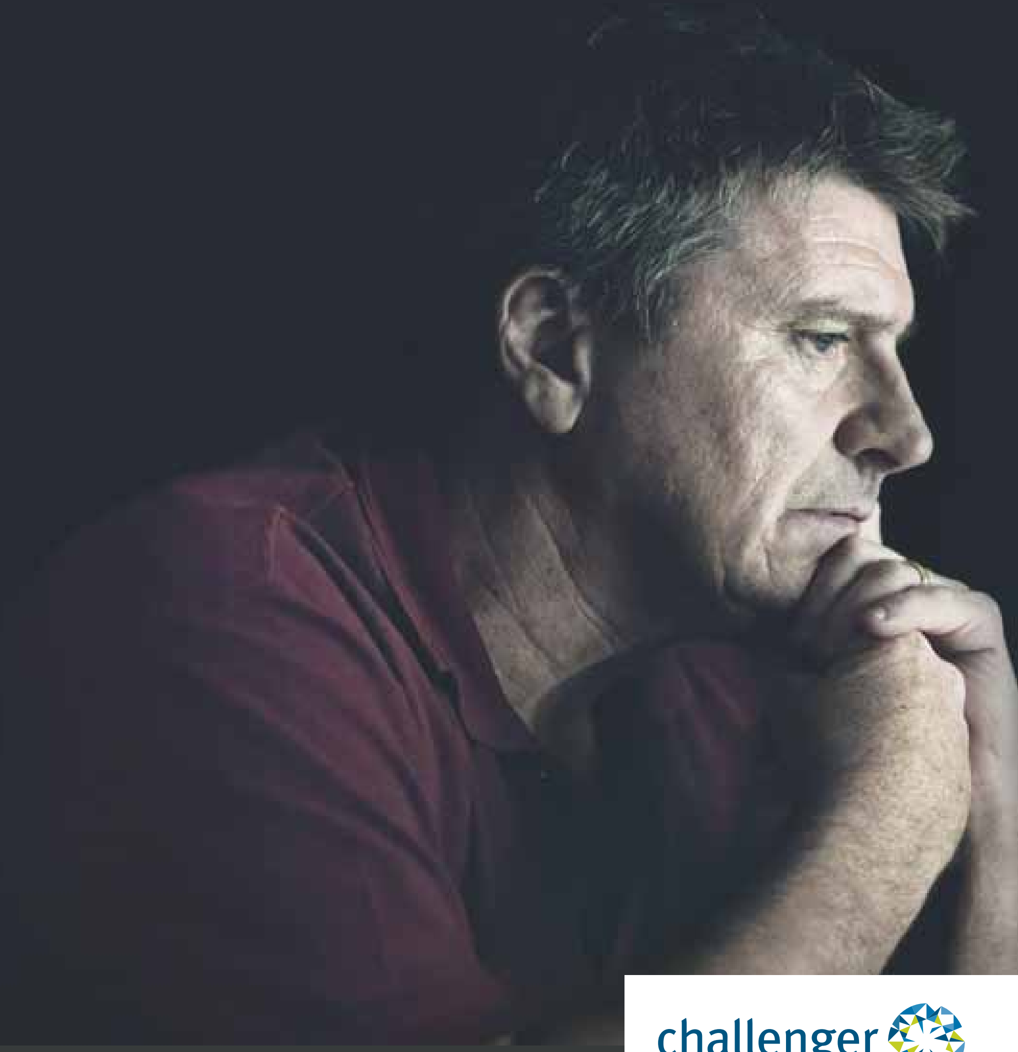
Understanding annuities

Secure your future with a safe, reliable income stream



challenger

Future-proof your retirement

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Retirement today

Previous generations saw retirement as being a few easy years of comfort after a life of hard work.

In the 21st century, things are so different that we really need a new term for the period of life after full-time work. Now we're not just living longer, but thanks to amazing medical and social advances, living better.

Many people don't see retirement as an end, but a beginning – an opportunity to learn new things, visit new places, take up new activities and enjoy life to the full. It's an exciting time.

However with this new opportunity comes an age-old challenge. How are we going to pay for it?

The introduction of compulsory superannuation in 1992 has helped Australians save for their retirement but building up funds for retirement is only half the battle. Making those funds last throughout retirement is just as important.

Average life expectancy is increasing every year. Australian Bureau of Statistics* figures show that over the past 20 years, the number of people aged 100 years or over increased by 185% (compared to a total population growth of 30.9%). On this basis, if you're 65 today, there's a good chance you'll live well into your 90s, so the decisions you make about investing your retirement funds are critical for ensuring your money lives as long as you do.

*Australian Bureau of Statistics, Population by Age and Sex, Australian States and Territories, June 2010.

Share market risk

Over the long term shares have delivered considerable growth. The Australian share market experienced a bull market through most of the past two decades, with particularly strong performance between 2003 and 2007.

Buoyed by these strong growth prospects, Australians have increasingly invested in shares, particularly as part of superannuation. In 2009, our super funds still had the highest exposure to shares amongst all OECD countries.*

Many Australian investors had become so accustomed to shares going up they lost sight of the risks involved.

However, when the global financial crisis (GFC) hit in 2008, and our share market plunged, 26.7% was wiped off the total value of Australian superannuation funds, wreaking havoc for many retirees.

Investing in shares is not for the faint hearted. As demonstrated by the GFC, shares can be extremely volatile over short periods and take a long time to recover.

*Source: OECD Pension Markets in Focus – October 2009.

Growing assets versus protecting assets

During our working lives, when we're building up our superannuation, most people can afford to take some risks in order to maximise gains over the long term. For example, if you want to retire in 20 years or more and you do not need access to your super, you can probably weather a market correction.

However, for retirees who require a regular income from their superannuation funds, exposure to market corrections can have a very adverse impact. During 2008 and 2009, as a result of the GFC, retirees who were heavily invested in shares were forced to sell down their holdings to fund their basic income requirements.

Then, by eating into their capital, these investors had a smaller base from which to generate growth when the market recovered.

This is the key difference between investing during your working life and investing during retirement; once you start depleting your capital to fund your living expenses, your ability to recover losses is severely diminished.

As people reach retirement, protecting their assets and preserving their savings become much more important.

What is an annuity?

An annuity is a simple, secure financial product that guarantees a series of payments, for a fixed term or for life, in return for an upfront investment. The capital can be returned at the end of the agreed term or gradually during the term of the annuity in the form of income payments.

The rate of return is fixed at the outset, and this applies for the length of the annuity, regardless of share market movements or interest rate fluctuations. Annuities provide the comfort of a pre-agreed, guaranteed income stream for a specific period of time or for life.

Annuities can only be issued by life insurance companies. In Australia they are strictly regulated by the Australian Prudential Regulation Authority (APRA), which also oversees our banks and superannuation funds.

Annuities are extremely popular, with $9.5 billion invested in Australian annuities as at 30 September 2010 according to Plan for Life Actuaries and Researchers.

Features of an annuity

Annuities have a number of features that can be tailored to suit different needs. The main features are as follows:

Term

'Term' refers to the length of an annuity policy. Fixed term annuities are generally available for fixed terms of between one and 50 years. The investor selects the term most appropriate to them. The term of a lifetime annuity is the rest of the investor's life – income payments continue until they die.

Earnings rates

The earnings rate (or rate) refers to the interest paid by a fixed term annuity. For example, an investor taking out a $100,000 three year annuity, offering a rate of 6.46% p.a. and annual income payments, would receive interest of $6,460 each year*. The earnings rate provided at the

*Based on the rate of a RCV100 Challenger Guaranteed Annuity as at 28 February 2011.

For information about how an annuity is guaranteed, see page 13: 'About the guarantee'.

time of the investment applies for the term of the annuity.

Payments

Payments can generally be made monthly, quarterly, half-yearly or annually. The amount of income paid can be fixed at the outset, indexed by a set percentage or indexed to inflation. For a lifetime annuity payments must be indexed to inflation. Indexing against the impact of inflation may be particularly relevant for long-term annuities as it provides protection against increases to the cost of living.

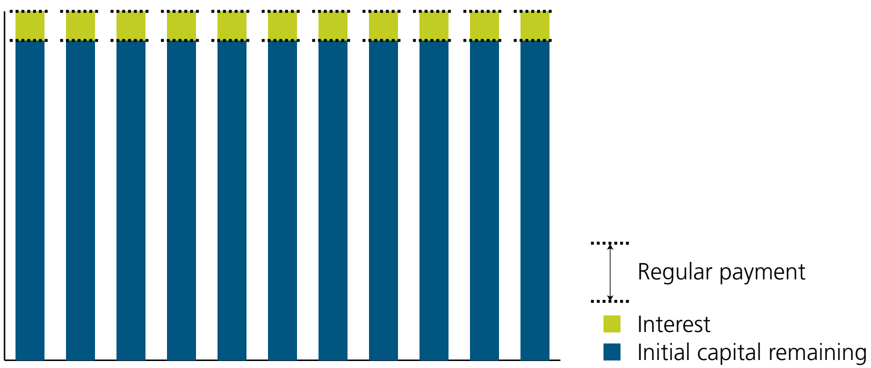
Residual capital value (RCV)

Any capital left at the end of an annuity term is known as 'residual capital value'. The residual capital value, or RCV, is usually set by the investor at the start of the annuity. It can be 100% of the capital invested, 0% of the capital, or generally somewhere in between.

If an RCV of 50 is set, then 50% of the initial capital is paid out through income payments and 50% is repaid to the investor at the end of the term.

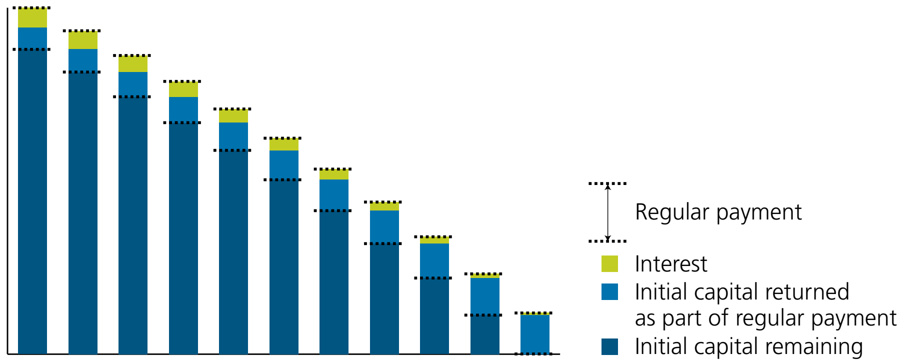
In the case of a 100% RCV annuity (also known as RCV100), income payments are made up entirely of interest earned on the investment. The initial investment amount is preserved and paid back to the investor when the term of the annuity ends. This outcome is shown in the following graph.

RCV100



At the other end of the spectrum, income payments for a 0% RCV annuity (also known as RCV0) include interest earned on the investment and a portion of the original capital invested. There is no capital left at the end of the investment. This outcome is shown in the following graph.

RCV0



Types of annuities

Fixed term annuities

Fixed term annuities have a fixed start date and end date as chosen by the investor. The term can be as short as one year or as long as 50 years. Income payments are made for the duration of the term.

Lifetime annuities

Lifetime annuities are designed to pay an income for the rest of an investor's life. Income payments start when the investment begins and end when the investor dies.

With each generation generally living longer than the last, there's the chance you will outlive your savings. Our research shows that for a 65 year old couple there is a 50% chance that at least one partner will live to 98 years of age*.

Lifetime annuities can help alleviate the worry that you will outlive your retirement savings by paying you an income until your death.

*Source: Challenger, as at 6 January 2011.

Benefits and risks

Benefits

Guaranteed income and capital

In contrast to shares, annuities provide a guaranteed income regardless of market movements. Capital payments are also guaranteed, whether you choose to preserve your capital until the end of the agreed term or have it returned as part of the regular payments. See page 13 for more information about the guarantee.

No management fees

Unlike most retirement income products, annuities have no management fees. Broadly speaking, the life insurance company that offers the annuity derives income from the return on its investment portfolio minus the earnings rate paid to the investor. The ability to derive this return is taken into account when setting the applicable earnings rate. This means the return that is offered is what you get.

Regular, dependable income

When you buy your annuity you know exactly what income you'll receive for the duration of the term. Your income will typically depend on:

- the amount you invest;
- the term of the annuity;
- the rate being offered by the life insurance company:
- the frequency of payments;
- your chosen RCV level; and
- whether your payments are fixed or indexed.

This makes planning your finances much easier as you don't have to worry about market volatility affecting the income you receive from an annuity.

Attractive returns

Annuities have historically offered highly competitive earning rates when compared to many other fixed income investments. In fact, annuities have often outperformed the average 'balanced' managed fund. When fees for managed funds are taken into account, annuity rates become even more attractive as they do not have

any product fees. Challenger has generally led the industry in offering competitive earnings rates on its annuity products.

Flexible terms and payments

With annuities you can choose your investment term. It can be as short as one year, as long as 50 years or even for your lifetime. You can also select how often you get paid – monthly, quarterly, half-yearly or annually.

Inflation protection

With some annuities, you can elect to index your payments so they move in line with inflation (CPI) or at a fixed indexation rate. This way you won't need to worry about the impact of inflation on your future payments.

Tax effectiveness

If you are over 60 and invest in an annuity using superannuation monies, payments from the annuity are tax free.

Lifetime income

In the case of a lifetime annuity you can enjoy a guaranteed, regular income for the rest of your life. For more information about how income payments are guaranteed, see page 13.

Risks

As with all investments annuities carry some risks. These risks include the risk of locking up your money for an extended period of time, potentially receiving less back than the amount originally invested if you terminate the annuity early, possibly affecting your social security benefits, inflation risk and the risk that the provider is not able to meet the payments under the annuity when they are due. Some additional information about risks is included in our Frequently asked questions on page 16.

The significant risks and how they are managed are described in the product disclosure statement (PDS) for the relevant annuity. Therefore, before deciding to invest in an annuity you should read the PDS (including the information about significant risks) and consider the suitability of the annuity to your circumstances.

How you can use annuities

Annuities can be suitable for many different investors with a range of investment objectives. Here are a few examples of how investors are using annuities to achieve their short and long-term goals.

These examples are for illustrative purposes only and do not take into account any person's particular objectives, financial situation or needs. They are also not forecasts or predictions of future outcomes.

Investing for the long term

Rob and Anne are 64 and 65 and retiring soon. They each have $150,000 to invest which they want to last 25 years. They decide to keep it within their superannuation to minimise tax and are deciding between an allocated pension and an annuity.

Scenario 1

An allocated pension invested in 50% growth assets and 50% defensive assets, assuming a consistent return of 7% on their investment (after fees) per year and no market corrections.

In this scenario, Rob and Anne are able to draw a combined income of $25,743 each year for the 25 year period, totalling $643,586.

Scenario 2

The same allocated pension assuming GFC market conditions in the first three years similar to the period between 2007 and 2010 and a subsequent recovery to 7% per year. According to Challenger research, a balanced allocated pension fund with 50% invested in growth assets and 50% invested in defensive assets had a positive return of 9.72% in 2009-10, a negative return of 6.99% in 2008-09 and a negative return of 7.50% in 2007-08*.

In this scenario, if Rob and Anne draw the same amount of $25,743 each year, they will use up their retirement savings in the 15th year, even if the market recovers sufficiently to achieve a return on their investment of 7% p.a. (after fees) for the last 22 years. Their drawings will total $382,695. This is because Rob and Anne would have needed to sell assets to meet their living expenses even though these assets had been impacted by

the negative returns in 2007-08 and 2008-09. As a result they had less capital invested when future periods delivered positive returns.

Scenario 3

The whole amount invested in a simple 25 year, RCV0 annuity offering an earnings rate of 6.83%^.

In Scenario 3, Rob and Anne receive a guaranteed $25,353 each year for the 25 years; a cumulative total of $633,649.

	Scenario 1: Allocated pension: no market correction	**Scenario 2: Allocated pension: market correction in first three years**	**Scenario 3: Annuity: outcome regardless of market movements**
Annual payment	$25,743	$25,743	$25,353
Years of payment	25	15	25
Total payment	$643,586	$382,695	$633,649

^Challenger Guaranteed Annuity rate as at 28 February 2011.

While Rob and Anne receive $390 less per year in Scenario 3 than in Scenario 1, they can rely on a guaranteed amount of income payments and don't have to worry about share market fluctuations.

*Source: Challenger using Bloomberg and Iress. Balanced allocated pension returns calculated using the following market indices: Australian shares (30%) – S&P/ASX 200 Accumulation Index, International shares (15%) – MSCI World Accumulation Index with Gross Dividend $A, Australian listed property (5%) – S&P/ASX 200 A-REIT Accumulation Index, Australian fixed interest (30%) – UBS Composite Bond Index, International fixed interest (20%) – Barclays Capital Global Aggregate Index Hedged $A. Scenario 2 assumes average franking of 70% on shares and a company tax rate of 30%. All returns are less fees of 1.47% p.a. (average fee for a Personal Super Fund – Rice Warner Super Fees Report 2008).

Investing for the short term

David is 63 and is retiring with $150,000 of superannuation money to invest. He is considering withdrawing the money as a lump sum and investing in a term deposit (outside superannuation) or rolling the money to a superannuation annuity. He is looking at a two year timeframe and his marginal tax rate is 31.5% which will apply to the earnings of the term deposit.

The table below compares David's pre and post-tax income for the two options.

	Two year 100% RCV annuity*	Two year term deposit
Investment amount	$150,000	$150,000
Interest rate	6.19% p.a.	6.20% p.a.
Interest paid before tax	$9,285 p.a.	$9,300 p.a.
Tax	$0	$2,929.50 p.a.
Interest paid after tax	$9,285 p.a.	$6,370.50 p.a.
After tax interest rate	6.19% p.a.	4.25% p.a.

*Challenger Guaranteed Annuity rate as at 28 February 2011 for a 2 year, RCV100 annuity with annual interest. Example $150,000 two year (major) bank term deposit rate, with interest paid annually as at 4 March 2011.

David can boost his after tax income by over $2,900, or 1.94%, by keeping it in the superannuation environment.

This is based on the current tax treatment of superannuation and non-superannuation monies continuing over the 2 year period.

Short-term annuities can also be suitable for investors with non-super money, for example those under 60, who are looking for a secure, short-term investment and want the certainty of an agreed payment level for a set period of time.

About Challenger

Challenger is Australia's largest provider of annuities. Around 60,000 investors have placed their trust in Challenger, for whom we invest over $7.6 billion*.

In 2011 Challenger was named winner of the AFA/Plan for Life 'Annuity Provider of the Year' for the third year in a row, by independent research house Plan for Life.

Challenger is a life insurance company registered under the Life Insurance Act 1995 and is regulated by the Australian Prudential Regulation Authority (APRA). Challenger must hold a minimum amount of capital, set by APRA, to ensure it can meet all investors' income payments into the future.

Challenger offers competitive earnings rates on its annuities which are backed by a diversified portfolio of high quality assets including fixed interest investments, property, infrastructure and cash. Challenger has generally led the industry in offering competitive earnings rates on its annuities.

Challenger's annuity investors have not been exposed to market volatility in the same way as investors in shares. Regardless of how share markets have performed, Challenger's annuities have reliably delivered on the capital and income promises made to investors.

About the guarantee

The references to guaranteed payments in this booklet are references to the contractual obligations of Challenger Life under the terms of the applicable annuity to make these payments. The payment obligations of Challenger Life are subject to the terms and conditions of the relevant annuity and the Life Insurance Act, including any changes to the relevant laws (for example, taxation laws) that apply to life insurance companies and annuities. Challenger Life's ability to meet these obligations is dependent on the assets it holds from time to time to support these obligations and on capital support held in accordance with APRA's capital adequacy standards.

*As at 31 December 2010.

Challenger's products

Fixed term annuities

Challenger's fixed term annuities provide a guaranteed, regular income for a selected term, in exchange for an initial lump sum investment amount.

Our fixed term annuities can be purchased by investors with either superannuation monies (if you are over 60) or with private monies. They are designed for retirees and investors who are seeking a regular income as part of their investment portfolio.

We offer two basic versions of our fixed term annuities. Challenger Guaranteed Annuity provides the flexibility for an investor, along with their adviser, to agree a level of explicit adviser remuneration. Challenger Guaranteed Income Plan has in-built adviser remuneration for the financial adviser providing advice on your annuity investment. The minimum investment amount for both products is $10,000.

In addition, we offer complying annuity versions of both of these products for eligible investors rolling over superannuation monies from a self-managed super fund paying an Assets test exempt (complying) income stream.

Lifetime annuities

Challenger's current lifetime annuities provide a guaranteed, regular income for an investor's lifetime and, if selected, the lifetime of a second person, in exchange for an initial lump sum investment amount.

They are designed to provide investors with:

- a regular income regardless of how long they live;
- income that is indexed in line with the costs of living (CPI); and
- a withdrawal value if an investor commutes (withdraws) their investment within the first 15 years.

Our lifetime annuities can be purchased by:

- investors aged 60 and over with superannuation monies;
- investors aged 18 and over with ordinary monies; or
- companies, trusts and superannuation funds.

The minimum investment amount is $10,000.

We offer two basic versions of our lifetime annuities. Challenger Guaranteed Annuity (Liquid Lifetime) provides the flexibility for an investor, along with their adviser, to agree a level of explicit adviser remuneration. Challenger Guaranteed Income Plan (Liquid Lifetime) has in-built adviser remuneration for the financial adviser providing advice on your annuity investment.

In order to invest in a Challenger annuity you must obtain a copy of the current PDS for the product and complete the attached application form. Before investing it is important that you read and understand the information in the PDS and consider the suitability of the relevant annuity to your objectives, financial situation and needs. Copies of the PDS can be obtained from your financial adviser, from Challenger's website: www.challenger.com.au or by calling Challenger's Investor Services team on 13 35 66.

For information about how an annuity is guaranteed, see page 13: 'About the guarantee'.

Frequently asked questions

How is the money I invest in an annuity used?

Challenger invests in a broad range of assets, including fixed interest, property, infrastructure and cash to generate the income paid out under the terms of its annuities. The Challenger investment team manages the investment portfolio with the objective of exceeding the returns promised to investors. Any return it achieves on top of the payments it is required to make under the terms of the applicable annuity is retained by the company as its profit. Any return it achieves less than this is absorbed by Challenger.

How safe an investment are annuities?

Annuities and the companies that offer them are tightly regulated. Annuities can only be issued by life insurance companies. The way in which life insurance companies are managed is regulated by the Life Insurance Act and overseen by the Australian Prudential Regulation Authority (APRA).

APRA specifies certain prudential standards, including capital adequacy standards that apply to life insurance companies. Broadly speaking, these capital adequacy requirements are designed to ensure the solvency and financial soundness of the life insurance company and to provide a high level of certainty that life insurance companies can meet their obligations to investors and creditors on an ongoing basis.

Are there any risks with annuities?

Some risks exist with annuities, which you should consider including:

- Fixed term annuities are locked in for a set period of time.
- If you withdraw before the end of the term, you may get back an amount less than the amount you invested, even after taking into account the payments that may have already been made to you.
- Investing in an annuity may affect your eligibility for a social security benefit issued by Centrelink or the Department of Veteran's Affairs.

- The real value of income payments may reduce over time as a result of inflation.
- There is a risk that the assets backing the underlying annuities are insufficient to meet investors' payments. Please note, however, that the way Challenger Life manages the investments underpinning annuities is governed by rules and regulations set by the Australian Prudential Regulation Authority (APRA).

The significant risks are described in more detail in the PDS for the relevant annuity. It is important that you consider this information before making any investment decision regarding an annuity.

How can I buy annuities?

We suggest you talk to your financial adviser about whether annuities could play a role in your investment or retirement portfolio. PDSs, including application forms, are also available from the Challenger website www.challenger.com.au or by calling 13 35 66.

What costs are involved?

Challenger's annuities carry no ongoing management fees. The earnings rate quoted prior to the start of your investment will be exactly what you get. You will receive the payments promised at the time of investment without any erosion due to fees and charges. For additional information, please also refer to the section headed 'No management fees' on page 8.

Can I take my money out of an annuity before the end of the term?

You can. It's known as 'commutation'. If you commute your annuity before the end of the term you may receive back significantly less than the amount you originally invested, even after taking into account any payments you've already received.

What happens to my annuity investment if I die before the term is up?

For a fixed term annuity, the investor's estate or beneficiaries have the option of either continuing to receive payments until the end of the term or commuting (terminating) the annuity and having it paid as a lump sum. The commutation value may be significantly less than the original amount invested, even after taking into account any payments already received.

With Challenger's lifetime annuity, a withdrawal or commutation value is only available for the first 15 years of the annuity term.

Where can I get more information?

You can access more information about the annuities issued by Challenger by reading the PDS for that annuity, available from your financial adviser, the Challenger website, www.challenger.com.au or Challenger's Investor Services team on 13 35 66. In addition, Fido, the Australian Securities and Investments Commission financial tips website, also has more information on its website www.fido.gov.au

How are annuities assessed for tax?

If you are over 60 and buy an annuity with superannuation money and your chosen income payments meet the Government's minimum payment standards, then all regular payments are tax free. Minimum payments standards are based on your age and a percentage of your account balance, as shown below.

Age	% of account balance
Under 65	4%
65 – 74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95+	14%

If the annuity is purchased outside superannuation (i.e. with private monies) then the income component of regular payments is considered to be assessable income and will be subject to tax.

Are annuities counted towards social security benefits?

Assets Test

The purchase price of an annuity is assessed under the Assets Test. If you choose to receive all of the capital at the end of the selected term (RCV100), the assessed asset value does not change.

If you choose to have some of the capital returned as part of the regular payments (such as an RCV0 policy), the asset value is recalculated every six or 12 months and reduced by the amount of capital returned up to that time.

Income Test

The amount of income assessed depends on factors including the term of the annuity, your life expectancy and the RCV.

A financial adviser can provide you with more detailed information on how your investment choices can affect your Centrelink entitlements.

Do I need a financial adviser to invest in an annuity?

We recommend you seek financial advice from a qualified financial adviser to determine whether an annuity is right for your circumstances. A financial adviser can help you understand how an annuity could fit within your investment portfolio and how to select the appropriate investment amount, term and RCV.

If you do not have a financial adviser, call Challenger on 13 35 66 to be referred to a financial adviser in your area or to obtain more information about the features of Challenger's annuities. While we are happy to refer you to a financial adviser, we provide no endorsement or recommendation of any financial adviser.

Glossary

Asset test exempt annuity (or a complying annuity)	An annuity, purchased prior to 20 September 2007, which is exempt from assessment against the Age Pension Assets Test.
Allocated pension (super)	An account used by retirees to provide a regular income stream. It can only be bought out of superannuation monies.
Defensive assets	Investments such as fixed interest and cash. Defensive assets are expected to deliver lower returns than growth assets, however with a more stable capital value.
Growth assets	Investments such as shares and property whose capital value is expected to grow over the long term to provide returns above inflation. Growth assets generally have higher expected returns and higher risk of a negative return.
Private monies	These are non-superannuation monies.
Superannuation annuity	An annuity purchased with superannuation monies.
Superannuation monies	A lump sum benefit from a superannuation or rollover fund (including lump sum proceeds from another superannuation annuity) or a Directed Termination Payment from an employer.

Annuities at a glance

- Fixed terms up to 50 years
- Lifetime policies available
- Regular income
- Income payments guaranteed regardless of share market movements
- Capital payments guaranteed
- Payments can be monthly, quarterly, half-yearly or annually
- Highly competitive earning rates
- No hidden costs or management fees
- Strictly regulated by APRA
- May be tax-free if purchased through superannuation