Beware the Equity Indexed Annuity

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A financial product that allows you to participate in the stock market's upside, promises you won't lose money, and gives you income for life—it sounds too good to be true. In most cases, it is. Meet the equity indexed annuity. Many investors who survived the crash of 2008 only to be met with wild stock market gyrations want calm and stability. The equity indexed annuity promises just that—along with returns based on the stock market. As a result, sales have soared. What's really going on in there?

An equity indexed annuity is an insurance product, not an investment. That matters, because it means equity indexed annuities aren't subject to the same level of reporting and disclosure as mutual funds. Instead, they are regulated by state Insurance commissioners. The result is a lack of transparency, along with no standardization between insurance products. That makes it very difficult to compare apples to apples. As an official with the Financial Industry Regulatory Authority (FINRA) put it, "With equity indexed annuities when you've seen one, you've seen one." There are many common features, but different annuities have different combinations of them:

Index Tracking. A person who buys an equity indexed annuity isn't actually investing in a stock market. Instead, the insurance company pays interest based on the performance of a stock market index. Most annuities are linked to the S&P 500, an index of the five hundred largest U.S. companies, as measured by their market capitalization. The S&P 500 is hardly the only index out there, and it excludes large chunks of the world's economy. Further, the majority of equity indexed annuities exclude dividends from their index calculations. Over the past 85 years, dividends have comprised up to 40 percent of the S&P 500's total return. So right off the bat, the annuity will provide less growth than the complete index.

Participation, Caps, and Spreads. These provisions seriously erode any return an annuity purchaser might receive. Again, an equity indexed annuity may have one, two, or all three of these features.

- *Participation* is the percentage of the index returned to the annuity holder—typically 80 percent. For instance, if the index returned 10 percent, the annuity holder would be limited to an eight
- A *cap* is the upper limit on a return over a certain time period. Both the upper limit and the time period matter—a shorter time period can seriously limit how much interest the annuity holder actually receives. For example, assume the overall cap on the index return is nine percent but is expressed as a monthly cap of 0.75 percent. If, as is not unusual, the stock market has a great year but the larger returns are clustered in three months, then the annuity holder may receive 2.25 percent (three months of 0.75 percent returns) in a year when the S&P 500 has double-digit returns.
- The *spread* is a percentage fee deducted from the index's return when calculating the gain the annuity returns. If the annuity company's spread is three percent, that comes off the top, often before calculating the participation and cap.

An equity indexed annuity may provide one potential upside—a first year bonus, based on premiums, added to the contract value. However that bonus, along with any earnings on it, is typically subject to a lengthy vesting schedule. An annuity holder who cashes out before a decade or more has passed may see none of it.

As if that isn't enough, many equity indexed annuity contracts give the insurance company the right to change any of these numbers, as frequently as annually. Once the annuity owner has purchased the contract, he has no negotiating power to prevent this.

<u>Downside protection—sort of</u>. Beyond the quasi-stock market participation, equity indexed annuities claim a guaranteed return and no loss of initial investment. Take a close look at that guaranteed return. Typically, the annuity promises to return 87.5 percent of the initial investment, plus interest ranging from one to three percent annually on that 87.5 percent. Thus, if you don't make much on the stock market participation, the interest guarantee won't necessarily make you whole.

Further, equity indexed annuities come with steep surrender charges. They can begin as high as eleven percent of initial investment, stepping down one or two percent each year before terminating. Cashing out of an annuity with that surrender charge in place can swamp any gains an investor may have managed to eke out. This makes equity indexed annuities very illiquid.

Some annuities offer a guaranteed lifetime withdrawal amount—at a cost. That benefit is usually limited and reduces the annuity's return by another percentage or so annually.

Finally, if there are any gains in an equity indexed annuity, they come out as ordinary income. Gains on sales of securities are typically capital, taxed at a lower rate.

Remember that any guarantee on an annuity is only as good as the insurance company issuing the product. There is no federal guarantee behind it, and insurance companies have been known to fail.

Given all of that, it should be no surprise that in 2012, FINRA issued an investor alert, warning to be wary of equity indexed annuities. Although FINRA issues many investor alerts, this is only the sixth one it has issued in the area of insurance and annuities since 2002. That shows how seriously it views this product's structure and consumers' ability to understand it.

What's a cautious, concerned investor to do? Fidelity ran an analysis, comparing a typical equity indexed annuity to an investment portfolio consisting 90 percent of zero-interest Treasury notes and 10 percent of the S&P 500 Index. The 90 percent Treasury note was to match the annuity's income guarantee, and the 10 percent S&P index was to match the index participation. Fidelity ran simulations over 53 different ten year periods and determined that on average, the Treasury note/S&P 500 Index basket had an annualized rate of return of 3.39 percent, while the equity indexed annuity returned only 2.65 percent annually. Think about that for a minute—a product that pitches stock market performance returns less than a portfolio made up 90 percent of Treasury notes. Moreover, those Treasury notes have less credit risk and more liquidity than the equity indexed annuity.

All this demonstrates the benefits of asset allocation in achieving a long-term, sustainable rate of return. You don't need fancy, expensive products to manage risk. Asset allocation, diversification, and disciplined rebalancing—with an eye to managing the tax consequences—will reach that result at far less cost.