

# Equity Indexed Annuities Investment Nirvana?

By Charles Coty

**E**quity Index Annuities are in vogue these days and are really being pushed especially by those that are not licensed to truly market equity-based investments. They are predominantly being pushed by insurance agents. Are they all they're cracked up to be? Are they really the panacea of wise investing?

By implication you are probably under the impression that I think these quasi securities are inherently a bad choice for any investment dollar but that's not the tenor of this article. Under the right circumstances and through a respected insurance carrier that doesn't lace the contract with all kinds of "smoke & mirrors" it might fit – however, there are usually better alternatives.

In the Tampa Bay area there's a heavily run radio spot that goes something like this: "Get double digit returns without risk of principal". By the tone and the content of the ad you'd think that you'll average double digit returns without the potential for loss! I'm always looking for something consumer-oriented so I called the number given and spoke with the guy behind the curtain to find out the secret to this "perfect investment nirvana". You already know what the pitch was...it was how equity indexed annuities will solve all your financial woes. If I hadn't already been well-acquainted with these products I'd have surely thought I'd hit the jackpot.

Are these Equity Indexed Annuities really that good? Let's proceed to help you unravel the potential pitfalls that you might encounter by adding these indexed annuities to your portfolio.

Millions of retirees (this is the target group since they are very fearful of losing principal) are being urged into buying the latest high-cost, high-commission products concocted by the insurance industry—Equity Indexed Annuities (EIAs). It seems like sales of EIAs are being sold by a mind-numbing number each year and the figures are growing exponentially.

It's those of modest means who seem most susceptible to the EIA sales pitch. According to Morningstar, the average EIA investor is in his or her late 50's to early 60's and invests approx \$40,000. Those who are traditional 'CD' savers who have been dissatisfied with the low rates are especially targeted.

I am not attempting to alarm you but unless you are a financial mechanic who can look under the hood to see how these EIAs operate, you may not realize the obvious disadvantages.

First, let me explain EIAs. They allow you to participate in the stock market 'good times' while being 'guaranteed' of earning a minimum amount of interest during the 'bad times'. Saying it another way, they are supposed to give you the peace of mind of a Certificate of Deposit (CD) but the growth of the stock market.

However that fairy tale story goes there is another side to be aware of:

1. They tie up your money for sometimes 7 to 10 years or more, limiting your flexibility. This certainly is not always the case – some come with shorter time periods.

2. If you need more than the annually allowed withdrawal amount before the term of the EIA, then you may have to pay surrender penalties that can be as high as 10% & sometimes more.
3. EIAs are not regulated by the SEC or the NASD and any 'guarantees' are only backed by the strength of the issuing insurance company. This certainly is something to consider but certainly equity-based products such as mutual funds and variable annuities don't offer guarantees.
4. Most EIAs will put a ceiling on how much you can earn, no matter how much the stock market goes up. But that doesn't mean you can earn the maximum amount because...
5. Many EIAs have an asset fee that is subtracted from the ceiling. A 2% asset fee is common. With a 10% ceiling and a 2% asset fee, you can never earn greater than 8% in any one year. Currently there are 36 interest crediting methods and the complexity is growing. Just take my word that they are not all straight forward. I had a client trade in their variable annuity for one of the worst EIAs on the market. The agent that performed this switcharoo promised them the moon while at the same time telling them of the incredible risks and exorbitant charges associated with variable annuities. On the surface it sounded great but it had so many gotchas that it was a nightmare.
6. Some contracts are sold with the pot of gold of 36% potential return for the year! The radio spot I referred to earlier was made with this product in mind. The contract states that every month the market goes up 3% or more you will get that interest put in a bucket. After 12 months of 3% you theoretically could be credited with 36% for the year. Wow! That means that the market would have to increase evenly at 3% or better each month for the entire year. Has this ever happened? Not even close! Let's look at an example:

Let's say that over a 12 month period the market (could be DOW or S&P 500 or some other indices') did the following: +2%, +1%, +7%, -3%, +8%, +6%, -4%, -2%, +1%, +5%, -6%, +8%. That's a hefty 23% total return for the year. What would you have been credited with the 3%/month strategy? Two big factors that you must consider:

1. The maximum you can be credited each month is 3% no matter how high the month's growth is.
2. All negative months count fully against the total.

On a month by month basis you'd have 2%+1%+3%-3%+3%+3%-4%-2%+1%+3%-6%+3% or a total of a whopping 4%! Yes, you see that correctly. These numbers are certainly hypothetical but they are also quite plausible. The market never goes up in straight lines whether you are measuring by the months or by the year.

7. You may not earn the 'guaranteed rate' on the full amount you invest. Some only pay the guaranteed rate on percentage of your original investment and then only if you stay in for the entire 7, 10, or 12 years. For example the EIA might state that it guarantees 3% of 87.5%. What in the world does that mean? That means that if you decide to liquidate the EIA at let's say the 7<sup>th</sup> year, you may have a worst case scenario of getting 3% added to 87.5% of your money. On a \$100,000 investment you'd walk away with 3% of \$87,500 (which is \$2,625) + \$87,500 or a total of \$90,125. At this point it must be clear that most contracts do have a guarantee that

the insured will receive no less than the amount invested or the contract value whichever is larger. Not the kind of bulletproof guarantee you thought you had!

8. Are EIAs truly free of any charges including fees and expenses? Well, the reality is that the expenses are built into the returns. So just because the fees are not obvious does not mean they don't exist. Consider the following:
  1. There are surrender charges in every contract I'm aware of
  2. By design the interest-crediting method will most always yield the insurance company the bulk of the interest
  3. There may be forced annuitization in order to get the promised interest return
  4. Access to funds may be severely limited etc.

The bottom line? If anyone thinks that an agent can be paid as much as a 10% commission or more in some cases; the investor can get double digit interest rates; and all without any risk...well, I don't have to finish the sentence.

History does not look very favorably upon EIAs. When you run the numbers, there are no ten-year time periods since 1975 where an EIA would have come close to performing as well as the S&P 500 index. Plus, you'd have access to your money in an index fund any time you wanted without the automatic surrender penalties imposed by EIAs.

The EIA is a win win scenario for the insurance company. How does the insurance company invest the consumer's funds? Are they really investing in the stock market? Will they lose if you win? Absolutely not. Without going into the nitty gritty details, what the insurance company is doing is buying stock options with the 3% or 4% interest they would have paid you had you purchased a fixed annuity. If the market goes up they cash in the options and lock in the gains. If the market goes down they just lose the premium they paid for the option and therefore you receive no interest.

Following is a statement written by a financial planner who has very little use for EIAs. *"So here's the bottom line, in my opinion. If you are looking for income, don't invest in an Equity Indexed Annuity. If you are investing for long-term growth, don't invest in an Equity Indexed Annuity. Quite frankly, I cannot think of anyone who would benefit from owning one."*

I think this is far too harsh. As told to me by an individual who has designed EIAs, they are designed to produce a return of approx. 5-7% interest per year. Is that potentially better than a fixed annuity where the interest rate is stated each year and dictated by the board of directors of the insurance company? Certainly it could be but is it better than a well-managed portfolio of mutual funds or variable annuities? That answer is dictated by the investor and their anticipated investment longevity.

To wrap up. EIAs can be a viable instrument for investing under the right circumstances and there are scenarios where they can make sense. However, more times than not, they may not be the best choice. They clearly are not all created equal and understanding them might even be difficult for rocket scientists!