Equity-Indexed Annuities: Toxic Investments

Introduction

Equity-indexed annuities ("EIAs") are contracts with insurance companies that pay investors part of the capital appreciation in a stock index and guarantee a minimum return if the contract is held to maturity.

The NASD has issued an Investor Alert and a Notice to Members on EIA sales practices.[1] Also, the SEC has warned investors of EIAs' complexity and hidden costs.[2] Despite the NASD and SEC's concerns, sales of these toxic products have reached over $20 billion per year.

Sales abuses are rampant because EIAs generate enormous commissions, and are inadequately regulated. For an example of misleading EIA descriptions, see the attached Legg Mason page printed off their website today.

EIA Structures

With at least 50 different variants in the marketplace, EIAs are purposefully complex making it impossible for investors to disentangle their true costs.[3]

EIAs have ***surrender charges*** as great as 20% which can last throughout the contract's life, making their cash surrender value less than the premiums paid for many years.

EIAs guarantee a ***minimum rate of return***, applied to the adjusted cash surrender value but often only if the annuity is held to term - typically six or seven years.

EIAs may credit the contract holder an ***additional return*** based on the change in the level of the S&P 500 (excluding dividends) or some other index.

There are 3 common ***indexing methods*** or formulas used to translate the change in the index level into a gross return on the contract.

- The most intuitive method, the ***point-to-point*** index return, is the percent increase in the index level from the beginning to the end of the contract term.
- In some contracts, a point-to-point return is calculated, and the indexed contract value is ***annually reset*** or ratcheted up to reflect the credited return.
- The increase in the index level from the start of a year to the average monthly level over some subsequent period is the ***monthly average*** return.

The ***participation rate*** is the fraction of the index change credited to the investor. Participation rates vary significantly and can be applied to different measures of index level changes.[4] The gross credit calculated by multiplying the index change by the participation rate is then sometimes further reduced by ***caps, fees or spreads***.

Conclusion

Ironically, both the SEC and the NASD caution investors to review and understand the impact on likely returns of the myriad EIA features. No registered rep, insurance broker, or retail investor, and precious few derivatives PhDs, could understand these products.

The net result of EIAs' complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors.

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[1] See *Equity-Indexed Annuities – A Complex Choice*, NASD Investor Alert, June 30, 2005 and *Equity-Indexed Annuities* NASD Notice to Members 05-50, August 2005.

[2] See www.sec.gov/investor/pubs/equityidxannuity.htm. The SEC asked for public comment on the regulation of EIAs in 1997. *www.sec.gov/rules/concept/337438.txt*.

[3] We just list the main features here. See our upcoming article on EIAs for a more complete treatment.

[4] 100% participation in the monthly average return is essentially 50% participation in the increase in the index. Investors are misled into believing that an EIA with 80% or 100% participation gives them 80% or 100% of the returns to the index.

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Revisiting Equity-Indexed Annuities

By the end of 2004, sales of equity-indexed annuities (EIAs) are expected to reach about $17 billion, up from $14 billion in 2003.[1]

Experts say the rise in EIA sales corresponds to the rise in the stock market. As stock prices improve, investors may want to participate in wealth-creation opportunities. EIAs may be just the type of risk-managed financial vehicle that many investors can use to round out their retirement plans.[2]

EIAs offer the potential for index-type returns but feature a minimum return rate guarantee like traditional fixed annuities.

Best of Both Worlds

EIAs are fixed annuity contracts that offer returns tied to a market index, such as the S&P 500. They offer the potential for index-type returns but feature a minimum return rate guarantee like traditional fixed annuities.[3]

Typically, EIAs include a no-loss provision, which means that once a premium payment has been made or interest has been credited to the account, the value of the account cannot decrease below that amount. In the event that the index to which the annuity is tied underperforms or experiences a loss, the worst it can do is earn the contract's minimum guaranteed rate of return. Finally, EIAs also offer the potential for tax-deferred accumulation.

Complicated Calculation

EIAs are not appropriate for every investor. Participation rates are set and limited by the insurance company. So an 80 percent participation rate limit means that only 80 percent of the gain experienced by the index for that year would be credited to the contract holder. Also, like most annuity contracts, EIAs have certain rules, restrictions, and expenses.

An EIA can be an important vehicle to consider for those who like the outlook for the financial markets, yet want to manage their risk. Please call if you would like to determine whether EIAs are appropriate for your current financial situation.

1) *The Wall Street Journal*, June 15, 2004
2) Most annuities have surrender charges that are assessed during the early years of the contract if the contract owner surrenders the annuity. In addition, if you surrender the contract before age 59½, you may be subject to a 10 percent federal income tax penalty.
3) The guarantees of fixed annuity contracts are contingent on the claims-paying ability of the issuing insurance company.