

THE TRUTH ABOUT INDEX ANNUITIES

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In recent years, Index Annuities have become one of the “hottest” products in the financial world. Their popularity has emerged since the dot-com crash of 2000, largely due to their promise to offer market-linked growth without risk of market loss. This protection has resulted in an estimated \$30 Billion annually being transferred out of traditional market investments into Index Annuities; a fact that has generated considerable alarm in the traditional investment industry. As a consequence, representatives of that industry have pushed back with various negative, disinformation campaigns. To be sure, not all Index Annuities are the same and any would-be detractor could easily select the least favorable elements of the worst products to hold up as an example of the entire industry. Doing so would be just as misrepresentative as a proponent taking the most attractive elements of the best products and holding those up as an example of the entire industry.

In order to understand and fairly evaluate an Index Annuity, it is important to first understand a few basics about annuities in general. In its most basic form, an annuity is an accumulated sum of money that is converted into a stream of income. As such, the two most common “annuities” are Social Security Income payments and Pensions. Commercially, annuities are offered by insurance companies, largely because calculating lifetime incomes involves the use of actuarial tables – the “domain” of the life insurance industry.

Annuities may be classified in several ways:

- **Fixed vs. Variable** - A Fixed Annuity offers guarantees for both Principal and Interest and does not subject the account to market risk. A Variable Annuity is a direct investment vehicle (often Mutual Funds) and offers no actual market guarantees although some have provisions that appear that way. These “guarantees” are more correctly an internal insurance product in which the issuing company assumes the risk (for a premium). Also, this “guarantee” is frequently offered as a death benefit only and does not apply to account values for the owner.
- **Single Premium vs. Flexible Premium** - A Single Premium Annuity is one that can be funded one time only. Additional contributions are not permitted (although there is no limit to how many annuities a person may own). A Flexible Premium Annuity is one that permits repeat deposits for a least a specified number of years. These annuities offer a depositor a place to make repeat or even scheduled deposits without having to open a new contract or repeat the minimum deferral period.
- **Deferred vs. Immediate** - A Deferred Annuity offers tax-deferred growth on a parcel of money, usually for a stated minimum time before income is generated. An Immediate Annuity has no deferral period. The income starts as soon as it is funded.
- **“Single Tier” vs. “Two Tier”**- All annuities offer a full array of income options (called “annuitization”) as well as annual free withdrawal privileges. Single Tier Annuities also offer the option to withdraw the deposit plus all net gains in lump sum; Two Tier annuities do not.

All Annuities share certain features that make them very attractive, particularly for Retirement Planning:

- Tax-deferred Growth
- Named Beneficiaries of equal or unequal benefit at the sole discretion of the owner
- Automatic Bypass of Probate
- The ability to generate income for a specified number of years, for life, or a combination of both
- The ability to generate income that is *not* 100% taxable

Index Annuities (IAs) are a special class of Fixed Annuity that offer growth indirectly based on market gains but not market losses. Sometimes called “Equity Indexed Annuities,” “Fixed Index Annuities” or “Interest Index Annuities,” they are *Insurance* products, NOT market investments. In other words, the insurance company agrees to pay a fixed rate of interest (e.g., annually) that is fully insured and guaranteed. However, rather than providing an internally derived fixed interest rate (e.g., as with CDs or money market accounts), the

interest is determined by indirectly measuring an external market index (e.g., S&P 500). Thus, while the credited growth is affected by performance of the index, because neither the company nor the depositor is actually “invested” in that market index, there is no risk of loss to either party. Rather, the annuity contract specifies a minimum annual interest (typically 0) below which the depositor can never fall. On the upside, a depositor has the ability to capture much if not all of the gains of the index in a good year. However, not all IAs are created equally. The following is a checklist of considerations:

- **Single Tier or Two Tier Annuity** - Two Tier products often offer more growth potential as compensation for their lower lump-sum liquidity. As a general recommendation, Single Tier products are more suitable when a sum of money is being grown for future use *other than* income generation. Conversely, Two Tier products are suitable when account liquidation is not anticipated (such as from IRAs when that action would trigger a large tax event) or where they are being used for inheritance planning.
- **Participation Rate** - Some IAs offer partial participation rate (e.g., 70%). This means that if for example the index rose 10%, the account would be credited 7%. Others offer 100% participation and occasionally one sees products that offer more than 100%.
- **Caps and Fees** - In exchange for the promise of market-linked gains without market risk, the issuing company generally limits the annual growth potential in some fashion. Growth caps specify a maximum amount of credited return that will be offered for a given period of time. For example, an annual cap of 10% means that if the market index returns more than 10% in a single year, the IA will only receive 10% interest for that year. Conversely, a monthly cap of 3% means that the monthly gain will be limited to 3% in a given month. Fees, on the other hand, reduce the credited return by the size of the fee. Technically, they’re not “fees” in the traditional sense because they cannot reduce the net gain below the guaranteed floor (e.g., 0). For example, a market return of 12% with a 4% fee will result in a net gain of 8%, but a market loss with a fee of 4% will result in a 0 gain (but also a 0 loss). In most cases, IAs with caps offer better long term gain than IAs with fees.
- **Indexing method**- There are several different indexing techniques:
 - *Monthly Average*: In this case, the raw scores of the market index, based on the market value at the close of the “monthiversary” date are averaged and compared with the index value on the previous year’s anniversary value. If the difference between those two values is a positive number, that amount is applied to the account, subject to participation rate, cap and fee limitations.
 - *Annual Point-to-Point*: In this case, the raw scores of the market index, based on the market value at the close of each policy anniversary date (i.e., once each year) are compared. If the difference between those two values is a positive number, that amount is applied to the account, subject to participation rate, cap and fee limitations.
 - *Monthly Point-to-Point*: Here a series of monthly scores (e.g., 12 over a one-year measuring period) are tallied. Both good and bad months are added. If at the year’s end, the result is positive, that becomes the applied interest. If not, then the number is discarded. Either way, the process is repeated for each measuring cycle. Most policies limit growth by virtue of a “monthly cap.” In any month where the index out-performs the cap that stated upper limit is substituted into the tabulation.
 - *Annual Reset*: With an annual reset feature, each year’s gains are captured and forever guaranteed going forward as the future minimum, regardless of what occurs in the index in the future. Some products reset every two (biannual) or every three (triannual) years. Products that do typically offer higher caps as an incentive but the longer one waits to reset, the greater the opportunity that one or two years of gains get wiped out by one bad year.
 - *High Water Mark*: With this feature, the year-by-year account values will actually fluctuate with the ups and downs of the index, but the account captures and guarantees the highest anniversary account value recorded. Thus, while the account may seem to fluctuate, any past return is captured and preserved going forward regardless of future index performance.

- **Deposit Bonuses** - Some IAs offer deposit bonuses. Essentially, this is matching money from the issuing company. Some products limit the bonus offer to the opening deposit only and some provide for bonuses on additional future deposits for one or more years. Making additional deposits does *not* require a depositor to start the initial waiting period over.
- **Required Minimum Deferral** - All IAs require some minimum holding period to be effective. Generally, this is 5 years. In most cases, the owner has the option to continue the growth without restriction for an unspecified time after achieving that deferral threshold.
- **IAs and the IRS** – For seniors with IRAs, it is important to know that IAs are compliant with IRS rules of minimum distribution. This means that an IA set up as an IRA will automatically provide the annual required minimum distributions starting at 70½. The issuing company will, subject to your direction, make the distribution, withhold and pay the taxes for you and send you a 1099. Moreover, in many cases, a depositor may chose to take those distributions on an annual or monthly basis. In addition, required minimum distributions are penalty-free regardless of when the annuity was opened or how large that mandatory distribution. Of even greater significance, is that IAs, particularly bonus annuities are the ideal method of handling multigenerational or “stretch” IRAs. The reason is that they uniquely offer all of the necessary criteria to ensure maximum transfer and minimal loss over two generations. These criteria are:
 - custodian that provide the proper forms for beneficiary designation to access the more favorable set of tax rules
 - custodian willing (and able) to handle two generations of distributions (e.g., for 85 years) without charging fees for the service
 - a guarantee against loss of account value to bad market returns or subtractions from fees.
 - the ability to outgrow the Required Minimum Distributions over two generations of owners.
 - a bonus which serves to “buy time” against minimum distributions. The effect of an opening deposit bonus is to provide a “prepayment” of the first 1-3 years of required minimum distributions *before* the principal deposit and its annual growth are tapped for mandatory distributions. For example, a 5% deposit bonus more than pays the first year distribution for anyone opening the account under the age of 79. A 10% deposit bonus effectively pays the first 2 ½ years of required distributions.

How good are Index Annuities?

In 2005, over \$30 Billion was transferred into IAs. The reason is obvious. According to one study (National Underwriter, December 8, 2003) the total average return of Index Annuities (from 9/30/98 to 9/30/03) was 30.4%. This five-year return was also reported to have beaten the five-year total average return of Index Funds (5.0%), Variable Annuity Equities (9.3%), Stock Finds (21.2%), CDs (23.0%), Variable Annuity Bonds (26.4%) and Bond Funds (27.6%). Based on the past 10 years, many IAs have reported average annual returns in the neighborhood of 8 to 9% per year. The obvious trade-off is time. IAs that offer the greatest potential growth also have longer time commitments than those with short-term minimum holding periods. For example, someone who purchases a two-tier, bonus IA can anticipate much more growth than one whose minimum deferral time resembles a CD. Obviously, past performance cannot promise the future and different products will be suitable for different people and different circumstances. However, for someone who wants safety and guarantees without sacrificing growth potential, an Index Annuity may offer the “best of both worlds.”