Equity-Indexed Annuities Appeal to the Squeamish

By Kathy M. Kristof | *Los Angeles Times Staff Writer*

A little-known investment product offers a guarantee: You can't lose principal. But yields are lower.

At first glance, it seems like a case of extremely bad timing.

Tom Gochenour invested the bulk of his inheritance in the stock market Sept. 1, then stock prices plunged after the Sept. 11 terrorist attacks. But the value of Gochenour's inheritance didn't fall at all. The key: a little-known investment product called an equity-indexed annuity.

"An equity-indexed annuity provides a means to participate in the market with no downside risk," said Tom McNeily, owner of McNeily & Associates, an insurance brokerage in Hinsdale, Ill. "I've become really sold on them in the last few years."

Equity-indexed annuities are a complicated hybrid product and aren't for everyone, McNeily said. People who can handle market volatility are likely to earn more in the long run by investing directly in the market - through stock mutual funds for instance.

But indexed annuities provide an option - albeit a lower yielding one - for those who can't stomach a loss in their savings.

"I am 52 years old and this is my retirement money," said Gochenour, a pharmacist who lived in Chicago. "I sleep a lot easier knowing that the principal is protected.

Like all annuities, equity-indexed annuities combine insurance with an investment component. In this case, the insurance element provides a simple guarantee: You can't lose principal, and in some cases, you can't lose past years' investment returns, either.

The returns on these annuities are loosely tied to a stock market index--most commonly the Standard & Poor's 500.

However, the investor does not get the full return of the index.

Depending on the annuity selected, the investor will get either a portion of what the index gained--40% to 90% of the rise of the index--or they might get a return that's based on the percentage gain in the index, minus a margin. (In other words, if the index rose 12%, investors might earn 9%, or the index minus a three-percent-point margin.

In return for giving up some of the investment potential of the index itself, the investor gets a guarantee that the worst his investments can do over a specified period is earn zero return.

The viability of these products lies in the details, said Jack Marrion, founder of the Advantage Group, a St. Louis insurance research and consulting firm. Some index annuities are a great deal for the investors; others provide substandard returns.

The average annual return of these investments has been about 8.7% over the last five years, Marrion said. The S&P 500, the most commonly used stock market index returned almost 11% a year over the same period.

But the gulf between annuities with the best returns versus the worst returns is wide. In 1997, when the S&P 500 rose 31%, the best-returning annuity paid 38%, he said, and the worst paid merely 6%.

(It's worth noting that not all annuities are tied to the S&P. Many allow investors to put some money into several indexes at once--for instance a small cap index, the S&P and a fixed income fund. Marrion's figures represent the best and worse various options could do.)

When the market soured in 2000, and the S&P 500 fell 9%, a handful of annuities paid as much as 12%, while many paid nothing.

To tell good index annuities from bad, experts suggest that investors look for a few key elements:

The Guarantee

The insurance component of equity-indexed annuities guarantees that the investor won't lose principal. But does it also insure against losing investment returns accumulated over the years?

The answer depends on the annuity, Marrion said. Some annuities reset the principal value each year. Consequently, the amount of principal that's protected rises every year that the investment produces a gain.

However, another type of equity-indexed annuity uses a "point-to-point" formula, which resets the principal value every few years. The exact number of years can vary. There can be a three-year, five-year or even 10-year gap between reset points.

Because the insurance company is taking somewhat less risk by making fewer guarantees with "point-to-point" annuities, they sometimes are more generous when formulating an investor's return.

However, it also means that several years' worth of investment returns could be wiped out in a bad year.

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