Indexed Annuities: Keep Up With the Market Without Risking Principal

Indexed annuities are a very hot investment option these days because they provide benefits unmatched by other investment options, such as fixed annuities, variable annuities, and certificates of deposit. This type of investment utilizes the stock market, which can provide very high returns.

You are also guaranteed a rate of return from the insurance company. This factor makes the indexed annuity similar to the fixed annuity, but the added bonus of stock market capabilities makes this tool much more attractive. Essentially, you will make money when the stock market rises, but not lose money when it falls. So, this type of annuity is very safe.

Since this type of annuity is tied to the stock market (typically the Standard and Poor's 500), it is somewhat similar to a mutual fund. Most managers will invest very conservatively especially if the economy is down, like today's market.

The one thing to keep in mind when discussing the stock market's role in this investment is that you are not investing in individual shares of stocks per se, you own an insurance contract.

There are some complicated parts of the contract that the policyholder needs to understand. First, the insurance company will establish a participation rate (usually a percentage between 60 and 110), which will ultimately determine the interest rate of return. The participation rate may change at the end of the policy term, yearly, or even daily, depending on the contract.

There are many different methods that insurance companies use to calculate the rate of return. As mentioned before, the policyholder is not directly investing in individual shares of stocks, but an overall index, such as the S&P 500. The growth or fall of the entire index will determine the earning potential.

The first type, the Annual Reset method, recalculates the interest rate every year during the contract term.

Essentially, the starting point is reset every year, which will allow you to recuperate earnings if the market turns sour. Thus, this method should perform well in a good economy as well as in a bad economy.

The second method is the High Water Mark method and is calculated by looking at the index at various points during the term. Taking the difference between the starting point and the current rate will net the interest. If the current rate is lower than the starting point, it means the index (or market) has gone down. The insurance company will "look back" over the contract to determine if any interest should be granted to the investor (based on market conditions). If the index has decreased, the investor does not lose money.

The third formula of calculating the rate of return is the daily average method, which as the name suggests, is an average of every single day during the contract year.

Other methods are often used, such as the Point-to-Point method, which calculates the difference in the index from the starting point to the maturity date of the contract. The insurance company will credit insurance accordingly. Another type will measure the growth form the first day of the contract to an

average of the final three to six months.

Therefore, there are many types of calculating the rate of return from the index. Become familiar with these by discussing them with a specialist before signing the contract.

Sounds like a simple investment right? Well, there are some disadvantages to the indexed annuity. The first disadvantage is that the indexed annuity is complex, based on the number of factors that are involved, the methods of interest calculation, and the unpredictable stock market.

Second, you may incur surrender charges if you withdraw the earnings before the policy term is complete. This charge is typically a percentage and may be imposed yearly across the length of the term of the policy. This charge is to cover the insurance company in case the market takes a turn for the worse and the policy loses money. However, some contracts will allow you to take out part of your money once or twice during the year.

Third, the contract usually has a vesting schedule, which is the amount of earnings the policyholder receives in case of early withdrawal. The percentage generally rises as the term approaches the end and is always at 100 percent at the end.

Finally, one small factor is the "cap rate", which is a ceiling, or limit, the amount of growth can be. This is the maximum rate of interest an annuity will earn.

This type of investment is advantageous for someone who is young and willing to allow the earnings to mount for retirement. If you don’t need the money and are not dependent on it, this is your best bet. Depending on your situation, all of your earning potential may be ahead of you, so leaving it alone is the way to go.