Equity Indexed Annuities

Equity-indexed annuities are one of the hottest insurance products going these days. Equity indexed annuities offer you a guaranteed minimum return in the stock market in exchange for a limit in maximum return. In short: You get less upside but much less downside.

Annuities have long been seen as a prudent way to earn a comfortable return on your money while deferring the taxes on your gains. Fixed annuities offer a specified and company-guaranteed return, but you pay for that guarantee in the form of modest returns (because fixed annuities invest your premiums in interest-bearing obligations, whose interest rates have historically trailed stock-market returns). Variable annuities let you place your funds in any number of investment-grade securities and, therefore, offer better returns, but also higher risk.

During the previous bull market security-based annuities became so popular that insurance product developers were drawn to the concept of combining the security of a guaranteed return with the allure of participating in the booming stock market. Voila: Equity-indexed annuities!

Equity-indexed annuities, or EIAs for short, offer consumers what could be described as the best of both worlds: a market-driven investment with potentially attractive returns, plus a guaranteed minimum return.

Brokers and agents like EIAs for another quite practical reason: EIA returns are tied to indexes of market activity and not to the performance of individual stocks or funds, they have not been considered an investment product subject to U.S. Securities and Exchange Commission oversight. Therefore, while variable annuity products must be registered with the SEC, must issue prospectuses and can only be sold by professionals with securities licenses, Equity Indexed Annuities are not federally regulated and brokers don't need a securities license to sell them.

But just what are equity-indexed annuities? Why do some financial experts call them the worst of both worlds?

"They're all different"

Just understanding the equity-indexed annuities market is a daunting task. "If you've seen one equity-indexed annuity, you've seen one," an actuary said recently. "They're all different."

Equity-indexed annuities guarantee customers a minimum interest rate (often about 3 percent) while offering the potential of higher rates by tying your return to an index like the Standard and Poor's 500.

While it's a lot like investing directly in the stock market, you don't get the full boost of a rising market. With equity-indexed annuities, the money put down by you, as a purchaser, isn't invested directly in the stock market. Instead, you are offered a percentage of how much the index gains over a period of time (not including dividends, which accounted for about 30 percent of the total return of the S&P 500 for the last 20 years), and a guaranteed minimum return if the stock market declines.

At predetermined times during the annuity's life, you are credited with a percentage of the gain of the index. The schedule varies with each annuity. Some offer annual "indexing," while others use various averages taken over the life of the annuity.

Indexing methods

There are five main indexing methods, each with its own variations and benefits:

1. The European, or point-to-point, method divides the index on the maturity date by the index on the issue date and subtracts 1 from the result. (Other indexing methods use this same formula, with different data points.) This ignores all the fluctuations between start and finish, and makes this method the simplest both to understand and to calculate. One drawback is that market fluctuations can produce very different results for customers who bought the policy just a few days apart. The method's name comes from European stock markets, where options can only be exercised on their expiration date.
2. The Asian method involves averaging several points of the index to establish the beginning and/or ending index. This method can help shield you from the risk of a market decline on the maturity date. Some companies take an average of the 12 monthly indices to establish the policy's maturity index level. This method takes its name from the Asian stock markets.
3. The look-back or high-water-mark method is another popular approach. On each policy anniversary, the company notes the index level. The highest of these is then taken and figured as the index level on the maturity date.
4. The low-water-mark method uses the lowest of the indices on each of the policy anniversaries before maturity as the level of the index at issue. This method tends to lessen the risk of market decline.
5. The annual reset, or cliquet or ratchet, method is among the most complicated. The increase in the index is calculated each policy year by comparing the indices on the beginning and ending anniversaries. Any resulting decreases are ignored. Appreciation is figured by adding or compounding the increases for each policy year.

Determining which method will perform best depends on a number of factors.

The percentage of the index's gain that you receive is called the "participation rate." These rates vary all over the board, with some companies offering 50 percent and others offering 100 percent or more — but you have to read the fine print.

For example, a product offered by Physicians Life has a 100 percent participation rate, but it's not based directly on the S&P 500. Instead, you receive 100 percent of the average of the daily closing prices during the course of a year.

At the end of 1994, the S&P 500 was at 459. When 1995 came to a close, it had risen to 616 — a pretty hefty 34 percent gain. The average of the daily closing prices during 1995 was 542, a gain of just 18 percent. Therefore, you'd get 18 percent. That's not bad, but if you'd invested in the market yourself, you could have had that 34 percent gain. (It should be noted that mutual funds also have administrative costs, so your actual return would be less than 34 percent.)

Most equity-indexed annuities offer participation rates between 70 and 90 percent, and some place a cap on how much you can gain. If the product has a 14 percent cap, and the market gains 34 percent, you're stuck with 14 percent.

Say you plunk down $5,000 (a typical sum) for an equity-indexed annuity with an 80 percent participation rate and a 14 percent cap. If the S&P 500 goes up 15 percent, you'll gain $600. If you'd invested your $5,000 directly in the stock market, you'd have gained $750.

Many happy returns?

While it would seem investing in the stock market might be a better option, it's also riskier. Equity-indexed annuities are designed to offer a safety net — that guaranteed minimum return.

Most companies offer a guaranteed minimum return of at least 3 percent, but sometimes that's not on the entire sum you put down. More often, the company guarantees you'll get at least 3 percent of 90 percent of your deposit. If the stock market takes a dive, you could still lose money.

Even if the guaranteed return is based on your entire deposit, you might just wind up breaking even. Over the last few years, inflation has averaged about 3 percent. If you earned 3 percent each year on a deposit of $5,000, you'll have $6,149.37 after seven years (a typical term for an annuity). But if inflation keeps steady at 3 percent in those same seven years, your $6,149.37 will be worth the same as the $5,000 you put down in the first place.

The federal Securities and Exchange Commission does not currently regulate equity-indexed annuities. But that could change. The SEC is seeking comment on whether the products should be categorized as insurance, a security or both.

Insurance companies cover their costs for equity-indexed annuities by investing the premiums they collect. Companies typically buy coupon bonds to cover the guaranteed minimum return, and call options to cover market appreciation. It's a delicate balance — one that does not offer the company any guarantee it will make any money. Companies often use interest-rate caps to cover their bases.

How good an investment are equity-indexed annuities?

If you had bought one just before the collapse of the stock market instead of investing in the stock market itself, you would be very happy right now!

Before you invest in an Equity Indexed Annuity you will want to read the fine print. There are surrender charges for early withdrawal, although most companies now allow yearly withdrawals at set amounts. Notably, the surrender charges often decrease the longer you let the company keep your money.