Index Annuities: Separating Facts from “Sizzle”

Introduction:

Index Annuities have become very popular in the United States with risk adverse investors. Like most popular investments, there are strengths and weaknesses. In the case of Index Annuities, the marketing of the products has truly been remarkable with product innovation being very high and creative. Having been in the deferred annuity market for many years, we were cautious purveyors of Index Annuities choosing to stick with our philosophy of matching products with goals and objectives.

We see the Index Annuity as a solution to some of the major concerns some retirement investor’s face in their efforts to match risk toleration with return. Like any other product, marketing can drive the process with investors buying the “**sizzle**” and not looking at suitability or inherent risks. In this paper we will attempt to dissect the Index Annuity from the point of view of an educated annuity specialist, responsible for placing billions of retirement dollars in various retirement vehicles over 40 years. It is our intention to demonstrate the strengths and weaknesses of the Index Annuity along with some serious considerations for determining policy terms and suitability. Index Annuities are fixed annuities that enjoy all of the tax benefits and rules of deferred annuities. This paper will focus on the unique aspects of the Index Annuities.

In general, an Index Annuity is a fixed deferred annuity where the annual interest credited is tied to some formula that is based on the positive performance only of some external popular stock market index.

Capital Account:

Annuity companies use many terms to express the account that contains the money you invest such as account value, gross cash value etc. We like to refer to it as the **capital account**. The capital account is where your money is invested. In most Indexed Annuities, there is no charge for expenses levied against the capital account. The Indexed Annuity is a spread product meaning that the insurance company makes its money from the difference it pays you and what it earns on the money they invest on your behalf. They do assess penalties for withdrawal of more than the penalty free withdrawal allowance before the end of the term you select (5,6,7,8, &10 yrs.). Most companies allow a penalty free withdrawal of the capital 0f 10% per year.

In general, the Index Annuity credits interest annually to the capital account based on a formula which is based on the positive growth, if any, of some stock market index. Negative performance is not credited. The most commonly used index is the **S&P 500 index** without dividends, although other indexes are available. The exclusion of dividends in the measurement is important to consider as dividends have accounted for between 2 and 4% of the reported growth of the S&P 500 index, depending on the year. Most of the media reporting of the S&P 500 index is based on the performance with dividends.

Surrender Value:

With an **Index Annuity** you select a policy term, usually 5-10 years. Benefits are usually greater for longer terms. During the term, withdrawals can be made usually up to 10% per year without penalty. Should you surrender the policy before the end of the term, there is usually a penalty assessed against the capital account called a **surrender charge** applied to the amount in excess of the 10%. The surrender charge is stated in advance in a table that usually declines each year until the end of the term where it is zero. There may be a **Market Value Adjustment** called an a MVA assessed against the capital account as well if interest rates have increased since the policy was issued. The MVA may also add to the capital value if interest rates have gone down during the period. The surrender value then is the Capital account less the surrender charge and Market Value Adjustments, if any. Surrender charges and MVA are usually waived on death and other events like nursing home admission. Longer term annuities usually provide higher cap interest crediting rates and other benefits like bonuses. The larger surrender charges in the longer term annuities come from the application of the higher benefits and commissions the agent receives on a longer term annuity. A balancing of the extra benefits of longer terms vs. the longer commitment needs to be made in selecting a policy term.

Actual Point to Point Interest Rate Crediting:

While there are many formulas used to credit interest for an Index Annuity, the most popular are the point to point **cap rate formulas.** An annual point to point cap rate is the maximum interest rate that is credited to the capital account for the upcoming year only. An annual cap rate of 6% for example, means that the maximum interest that will be credited for the year is 6%. To determine that interest, usually the S&P index without dividends at the beginning of the policy year (point 1) is compared to the S&P 500 index without dividends at the end of the policy year (point 2) and the % change is calculated. If the return is positive, then that calculated percentage rate capped at 6% in our example will be the interest credited that year to the prior year's capital balance. For example, if the point to point calculation is 10%,7%,6%,5%, and -10%, the interest credited with a 6% cap is 6%,6%,6%,5% and,0% respectively. It is important to remember that the cap rate is generally only guaranteed for 1 year and can change each year. This crediting method is simple to understand and has gained the most popularity.

Annual Caps today range from 5.5% to 8%. Once the interest is credited to the capital account, the capital account value is locked in and will not go down unless there are withdrawals made by the owner.

Monthly Point to Point Interest Rate Crediting:

The monthly point to point cap works in a similar fashion to the Annual Point to Point Cap Except that the points are monthly. With the monthly cap each of the 12 months during the policy year is added and if the total is positive, that is the rate of interest that is added to the prior year's capital balance.

If the total is negative, the interest credited for the year is zero. With the monthly cap, negative months are included in the total while positive months are limited to the cap. For example, with a 2% monthly cap, a monthly return of 5% is capped at 2% whereas a loss of -5% is added to the total. Should the totaling of the twelve months' result in a negative number, then the interest credited is zero. Monthly point to point caps vary between 1.75% and 2.5% per month.

Which is better: Monthly or Annual?

Monthly caps theoretically have more potential. With a 2% monthly cap for example, gives a potential interest credit of 24%. To do that each month during the year would have to earn at least 2%. The monthly cap formula also adds the full value of negative monthly performance to the total. While the addition of negative performance to the calculation will not result in a loss, it does detract from the performance in positive months which are capped.

The monthly caps do better when there are few negative months and or when the negative months are rather small. The **Annual cap** tends to favor more volatile monthly returns that end up in a positive number. Our observation is that over a decade, the two types of caps generate similar results.

What determines the size of the cap?

Caps of course vary from company to company based on competitive company factors and the financial quality of the issuing company. They tend to be larger for larger initial investments (75,000-100,000). They also tend to be larger for longer term plans. Generally, a 5 yr. plan has a lower cap rate than a 7 or 10 yr. plan. Caps also tend to be lower for plans that provide an initial bonus than for similar plans that have no bonus.

Insurance companies invest Index Annuity premiums in their general account. They use the interest they earn on the general account on your premium to both pay you interest and hedge their responsibility to you by buying Stock Index Options and other derivative instruments.

When interest rates are low on the insurance company's general account, caps rates tend to be lower. Also, the cost of hedging such as buying Stock Index Options varies over time and its cost structure enters into the cap rate the insurance company provides. Monthly caps are less expensive to hedge than annual caps as the cost of buying short term options is less than buying annual options. As a result of this cost advantage, monthly caps have been more stable at renewal and are less affected by interest rates and hedging costs.

Other Index Crediting Formulas:

There has been no lack of imagination in the index crediting options. The problem has been that many of the options have caused losses for the insurance companies as the designs were ill conceived. A less popular formula is the **Participation Index**. The participation formula takes the entire return for the policy year and applies the participation index to it. A participation index of 40% means you get 40% of the performance of the index. As an example, if the index does 10% you get 4% interest credited. If it does 40% you get 16%. This type of index crediting requires big returns to amount to anything. There is less certainty of return with this type of crediting methods and the insurance companies found significant lapses of policies from disappointed investors. Some of these Participation Indexes come with caps. For example, 100% participation with a cap of 8% would be equivalent to an 8% point to point cap. The participation index crediting method favors large market returns and it somewhat inconsistent with the generally conservative investor attracted to the index annuity. The method implies that the investor is willing to gamble that the market will earn outsized returns **Trigger cap** rates are a rather new offering by a few companies.

Trigger Annuities typically pay a fixed interest rate if the index does not loose during the year. Any positive or flat performance results in the crediting of the entire interest rate. A trigger rate of 5.5% pays 5.5% if the index less dividends does not decline during the year. Since over 70% of the time the index is positive or flat (zero return) this type of crediting has some appeal. The main virtue of this type of annuity is that it is simple to understand, favors positive results in 7 out of 10 years and most companies guarantee the cap for the term of the policy. The problem with this is that if you only get 5.5% as an example credited 70% of the time, the return is 3.85%. Fixed annuities, depending on the market environment, may guarantee more than that.

Guaranteed Interest Option:

Most Index Annuities have a guaranteed interest option. This option usually guarantees the interest rate one year at a time. Most Index Annuities allow the investor to allocate the investment of the capital account to the monthly cap, annual cap and fixed interest option.

They usually allow an allocation to be changed on each policy anniversary. The fixed interest rates can be valuable when rates rise when the investor perceives that market opportunities do not offer the same opportunity of a relatively large guaranteed interest rate. Fixed interest rates offered on Index Annuities tend to follow the shorter maturity annuity rates.

Return Reality:

Marrion, VanderPal and Babbel of the University of Pennsylvania Wharton School of Business did a study of actual returns received by investors over the period 1997-2008 in a paper dated October 5,2005. Their paper can be obtained at the following link: http://fic.wharton.upenn.edu/fic/Policy%20page/RealWorldReturns.pdf.

Page 7 of their study showed the return ranges for various time periods. The table below is republished from this paper.

Annualized Five-Year Returns

Period	S&P return	FIA avg. return
1997-2002	9.39%	9.19%
1998-2003	-0.42%	5.46%
1999-2004	-2.77%	4.69%
2000-2005	-3.08%	4.33%
2001-2006	5.11%	4.36%
2002-2007	13.37%	6.12%
2003-2008	3.18%	6.05%

We think that the returns of the 1997-2002 periods are unlikely to repeat again as index caps have been cut significantly since that time. These returns in the best 5 year periods are 1-2 points better than Fixed Interest Annuity rates during those periods. In other years, the returns appear to be no better than Fixed Annuity rates at that time. We think that the risk return profile of the Indexed Annuity is attractive and would have the investment properties similar to an intermediate term (7-9yrs) investment grade bond in return.

The important point we like to make is that investors have to have realistic expectations of these instruments. At best, they have provided a couple of additional points over Fixed Income Annuity alternatives with no guarantee that they will do so in the future. The guarantee of return of principal at the end of the term is a strong aspect of the risk return profile.

Claims Paying Ability Guarantees the Annuity Principal and Interest:

An Index Annuity is backed by the claims paying ability of the insurance company issuing the contract. Unlike a Variable Annuity that invests in separate accounts, Index Annuities are fixed annuities that are invested in the general account of the insurance company. It is therefore important to invest in stronger companies. Buying an annuity is like buying a bond. You get paid more in a bond for accepting greater risk. The same is true in an annuity. We are quite surprised at how little attention investors pay to the credit ratings of the insurance company in their selection of companies.

Fees, Surrender Charges, and Other Costs:

Generally, Index Annuities have no front end sales charge and no deductions for expense charges except for special optional features such as guaranteed lifetime income. The insurance company makes its money on the spread between what it earns on your money and what they pay you. These plans do have surrender charges and market value adjustments should you surrender your plan before the end of the term. The surrender charge reimburses the company for its underwriting costs including commissions and the market value adjustment compensates the company should interest rates rise before the end of the term and compensates the investors should they decline.

The **Market Value Adjustment** is similar to a premium or discount on a bond where the interest rate has changed. Most companies allow a 10% penalty free withdrawal each year. In addition, most companies waive the penalties at death and other events like nursing home admission should a withdrawal above the 10% occur before the end of the annuity term. Most annuities also allow the Index Annuity to be converted to an Immediate Annuity without penalty.

Bonus Annuities:

Some companies market their annuities with a bonus which is usually calculated as a percentage of the initial investment. A bonus annuity of 5% for example credits 5% of the initial premium to the capital account. For example, a 100,000 investment with a 5% bonus would start with an immediate credit to the capital account of $5,000. Therefore, $105,000 gets invested to start with. The bonus is a big marketing tool for insurance companies. Initially they were used to help offset any penalty an investor may have from surrendering another annuity to buy the Index Annuity. Soon, sales people saw the merit of using the bonus to attract new investors in search for something special. It sounds pretty good to start your account off with an immediate gain. The bonus also is an inducement to get the client to commit more years to the investment.

Insurance companies are masters at actuarial equivalence. Investors should beware that insurance companies are in business to make money on managing money and are not going to give something that does not work to their benefit. The bonus itself usually has a vesting schedule and comes with some sacrifices that make it actuarially equivalent to Non-Bonus Annuities. First, the bonus usually requires a long term commitment between 10 and 15 years. Penalties to withdraw during the early years are usually very steep when a bonus is applied. Also, **Bonus Annuities** generally have lower market participation caps than similar plans without a bonus. The insurance company has to earn its money back and the longer time commitment and or a lower cap rate may be the result of the application of the initial bonus. Generally, if you stay for the term of the contract, the bonus annuity provides a better total value in the capital account than a similar Non-Bonus Annuity. However, the difference is not large unless the early years of the contract prove to be consistent market up years at the maximum cap rates.

Our concern with these annuities is the stiff penalties for early surrender. Since cap rates are not guaranteed, should a company end up under water on their index annuity book, they have more latitude to change longer surrender period policies, than those with short surrender periods. For the investor, a long term commitment may not be wise. At this writing, Index Annuities are no considered securities and do not require a securities license on the part of the agent. Therefore, these annuities do not receive the same disclosure requirements as variable annuities which are sold subject to a prospectus. Market abuses have led to many failed attempts to regulate the Index Annuities as a security. If your agent is also licensed to sell securities, then he/she is probably being supervised and subject to the same rules as other security products in the sale of Index Annuities. We generally recommend the Bonus Annuities when they are used in combination with life income guarantees. Our logic is that the client is committed to the life income and therefore is not worrying about longer surrender periods. Bonus plans that do not vest in 10 years or have commitments longer than 10 years should usually be avoided. In any event, the investor needs to carefully think about the long range commitment and steep surrender charges required by the Bonus Annuity.

Minimum Guaranteed Value:
Index Annuities credit their interest based on one of the index crediting formulas. It is conceivable that an investor can invest in one of these annuities and have little or no interest credited from the formula (point to point monthly or annual crediting). This would be the case if the market never went up during the term of the annuity. When interest is credited each year to the annuity, it is never given back. Therefore, if the market never went up during the term of the annuity, there would be no crediting of interest to the capital account and since there is no surrender charge of penalty assessed on the capital account at the end of the policy term, the capital account would be equal to at least the initial investment less any withdrawals.

To provide some interest in the unlikely event that the market never goes up during the term, most policies come with a **guaranteed minimum value**. If the guaranteed minimum value is greater than the value of the capital account using the interest crediting formula during the policy term, the capital account is reset to the minimum value and the owner can surrender the policy for that higher value, move it to another Annuity Tax Deferred or renew the policy for another term. The minimum value is a guarantee based on a schedule. The investor at the end of the term gets the greater of the capital account with the index interest crediting over the years based on the formula or the minimum guaranteed value.

Minimum values vary from company to company and are usually stated as a % of the premium. For example, a 2% minimum interest rate on 100% of the premium creates a schedule of 2% compounded interest. If at the end of the term, that minimum value was greater than the capital account value with the index crediting formula, then that minimum value is what the investor can withdraw without penalty, exchange for another annuity with another company or bring over to a new term for the annuity. What is tricky about these minimum guarantees is that they may be stated as a % of a partial premium. For example, a guaranteed minimum value could be 3% on 90 % of the initial premium. What this means is that they create a schedule for the term where they take 90% of the initial premium and compound it by 3% per year. This methodology requires many years before the value catches up with the original premium. Bonus Annuities are notorious for using this minimum guaranteed value. It is important to remember, that since negative market performance does not result in losses to the capital account and there are no surrender charges or market value adjustments at the end of the policy term, the capital account at the end of the policy term will at least equal the value of the original investment less any withdrawals before the application of the minimum value provision.

Index Annuities May Be Good Vehicles to Protect Against Inflation:
Historically, over longer periods of time, stocks have tended to keep pace with inflation. This occurs because companies are able to raise prices in the long run to have their sales revenue

and hence their profits increase to new levels to catch up with inflation. However, during the initial phases of inflation and until it subsides, stocks typically take a severe beating. When the inflation subsides, stock prices tend to rise to catch up. The Index Annuity assures the investor that the capital will not decline during the market declines (high inflation years). When the market comes back, the cap on the index of course subdues the return. However, the Index Annuity does not have the large losses to make up. Therefore, the lower return from the cap on return can still bring about a desirable result for the most part.

Consider 1973-1974 when the inflation driven economy brought stocks down by over 37%. To get back to even, an investor would have to earn over 57%. In the following two years, the market went up 37% and 23% respectively. The Index Annuity investor had the peace of mind of no capital drawdowns during the inflation driven downturn and earned the cap maximum for 2 years, exceeding the overall return without the drawdown in capital. While there is no guarantee that this positive inflation action will work in the future, we do think that Index Annuities, by protecting the capital during down turns in the market, take the pressure off of the cap rates when the market rebounds.

Pluses and Minuses and Things to Consider with an Index Annuity:

The major attraction of the Index Annuity is that you can only lose money if you surrender the plan before the end of the term. It participates only in the positive performance of the market and eliminates the negative. While it eliminates downside volatility, it may not capture much of the upside, particularly in a big return year. We think that investors need to have reasonable expectations when they consider these annuities. With an annual cap, they are not going to earn more than the cap and a couple of negative years in the market will not lead to losses but will bring their return down.

We think that these vehicles over long periods of time are likely to do better than fixed annuity interest rates although there can be no guarantee of that. Investors in Index Annuities however need to be prepared of the uncertainty of the market. Index Annuities perform reasonably well during large market losses followed by large market gains in the following year as they do not have to earn back their losses. When the market is down consistently for several years it will not result in capital losses for the annuities. However, the lack of growth during those years needs to be considered as a possibility by the investor, particularly if the investor will have to withdraw money during the term of the annuity.

For investors that can’t afford to wait for the return, a **Fixed Annuity** that guarantees the interest rate should be considered. During the period from 2000-2002 when the stock market was down for three consecutive years, index investors had no drawdowns in capital but earned nothing as well unless they had an allocation to the fixed interest account. If the investor were drawing income from the annuity during this period, the principal would be diminished. Investors needing income from the annuity during the policy term should consider a **Fixed Deferred Annuity** where the interest rate is guaranteed or **Immediate Annuity** which provides better guarantees and certainty. The exception would be an **Indexed Annuity** with a guaranteed income rider. The **guaranteed income riders**, also known as the guaranteed withdrawal benefit, provides a guarantee that the income will continue for life or lives in the case of married investors. This guarantee comes with a cost or deduction against the annuity and is discussed separately.

The fact that the caps are not guaranteed for more than a year at a time and the lack of dividends in the index calculation need to be considered by investors. Investors need to be certain they can live with the policy term length they select, particularly in the case of Bonus Annuities. From our experience, the most common complaint we get from index annuity investors is that their money was locked up too long. Since long lock ups are typically associated with Bonus Annuities, we are led to believe that investors focus too much on the instant crediting of the bonus and not the practically of keeping the investment
for the long time period.

The fact that commission rates are higher on these longer term commitments does not help. While we favor shorter terms in the 5-7-year range, the longer terms do have their place provided the disclosure is adequate and the client is willing to accept the longer term. We think that **Index Annuities** provide an edge during periods of high inflation. They do so by eliminating losses during the large market declines that occur during the rapid inflation. By eliminating losses during the big down years, the Index Annuities do not have to earn back their losses and therefore, the ensuing positive years after inflation are likely to result in the index caps being credited to the capital account.

Finally, company strength should not be taken for granted. The largest cap rates are usually provided by weaker companies and investors will be wise to consider financial ratings. In the end an annuity guarantee to you is only as good as the company making that guarantee. Index annuity investors are attracted to the products because of their desire to eliminate risk. The largest risk the investor may be assuming maybe a weak company that can’t make good on its promises. Company ratings are important and should not be taken for granted. In looking at ratings, investors should take note that the rating agencies use different schemes to report their ratings. A+ is the second highest rating by A.M. Best. However, A+ is the 5th highest rating on S&P.