

## Equity Indexed Annuities

**Overview:** Equity indexed annuities (EIAs) are commonly described by those selling them as “the best of both worlds” — providing the potential rewards of equity investing without the downside risks (because of the presence of a guaranteed minimum return). We are reminded of the adage about something being too good to be true, and feel that EIAs are another product meant to be sold, not bought. David Swensen, Yale University’s chief investment officer, commented in his 2005 book, *Unconventional Success*, “As a general rule of thumb, the more complexity that exists in a Wall Street creation, the faster and farther investors should run.”<sup>1</sup> Many EIAs have significantly high surrender charges and other hidden fees. For this and other reasons, we feel that it is not prudent for investors to purchase EIAs for their portfolios.

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### Introduction

According to LIMRA International, an association that provides research to financial companies, sales of equity indexed annuities (EIAs) totaled more than \$23 billion in 2004.<sup>2</sup> The typical EIA has the following characteristics:

- A link to a **portion** of the positive changes in an index (typically the S&P 500 Index)
- Principal protection
- A minimum guarantee, regardless of the performance of the index
- Tax-deferred growth potential
- Income options to meet specific needs
- A death benefit guaranteeing beneficiaries 100 percent of the annuity’s indexed value

Investors seem to find these characteristics irresistible — and increasingly so. In 2001, EIA purchases totaled \$6.5 billion. In 2003, that figure rose to approximately \$14 billion. In the first half of 2005 alone, EIA investments of \$13.8 billion nearly matched the total for all of 2003.<sup>3</sup>

One explanation for the growth may be that investors are generally only aware of the features listed above and are not necessarily familiar with the potential downsides of the vehicle. That is, they might not understand exactly how EIAs work. In June 2005, the National Association of Securities Dealers (NASD) issued an alert about EIAs, “describing the products’ complexity and explaining their potential pitfalls.”<sup>4</sup>

Another explanation for the explosion in sales might be commissions on EIAs, which averaged 8.5 percent and reached as high as 10 percent, according to an October 2005 article in *Financial Planning*. There is a conflict of interest created by large commissions. In addition, most of the fees are hidden in the form of high internal expenses and surrender charges. We discuss some of these fees in this article.

### **Who's Regulating EIA Sales?**

It is estimated that insurance agents sell 95 percent of EIAs.<sup>5</sup> Because they are considered insurance products, the U.S. Securities and Exchange Commission (SEC) does not regulate their sale, but it could. Although the SEC has argued that EIAs are securities, and they should fall under SEC-regulatory supervision and control, it is uncertain whether the SEC will be able to stop unregistered agents from offering them.

Depending on the features included in the EIA, it may or may not be a security. Because of this, the typical EIA is not registered with the SEC. The following section looks closely at some of the features that may be included in an EIA.

Regardless of how strictly EIAs are being regulated, because their guarantee is only as good as the credit of the company providing the guarantee, the credit quality of the issuer is a vital consideration. If investors do not verify the investment grade rating of the company before purchasing an EIA, they may be putting their portfolios at risk. An October 2005 editorial in *Investment News* commented on this subject, observing that, "We'll still hear of cases in which an elderly couple transfer their million-dollar portfolio into an illiquid equity-indexed annuity that will ultimately give them a low single-digit return with a double-digit surrender charge."<sup>6</sup>

### **Investors May Not Receive Returns Comparable to the Index**

In the case of EIAs, investors should concentrate on the fine print. A typical EIA provides less than 100 percent of the index's return. Several restrictions may be used to decrease the expected returns to investors, six of which are discussed here.

**1) Participation Rates** — EIAs typically have participation rates below 100 percent. According to the NASD, "A participation rate determines how much of the gain in the index will be credited to the annuity."

**2) Annual Cap** — This is the maximum rate at which the EIA can be credited. This means that there is an upper limit on possible returns. For example, although the S&P 500 Index rose almost 29 percent in 2003, an investor with an EIA capped at 11 percent would only have been credited for that amount, instead of receiving the actual gain of the index linked to the EIA.

**3) Changes in the Index** — Another method of keeping the payouts lower is to credit an investor with the price-only change of the index, not with its total return. Thus, the return received from an S&P 500 Index fund will be greater than the change in the index by the amount of the dividends received.

**4) Spreads** — Use of a margin called a spread can also reduce payouts. If this feature is part of an EIA, the return would be determined by subtracting a percentage from any gains made by the index. For example, if the index gained 9 percent, an EIA with a spread of 3 percent would receive 6 percent.

**5) Interest** — The EIA may credit its return based on simple interest, instead of compound interest.

**6) Calculations** — Instead of basing the return on the actual change in the index, the calculation of return is sometimes based on the change in the average daily closing price of the index throughout the year. Consider this example. The index begins the year at 10,000 and ends the year at 12,000 (a gain of 20 percent), increasing in a perfectly straight line. The average price during the year would then be 11,000, but investors would be credited with a gain of just 10 percent.

According to the SEC, some EIAs allow the insurance company that issued the EIA to change the following features: 1) participation rates, 2) cap rates or 3) spread and margin fees, either annually or at the beginning of the next contract term. Some of these changes could adversely affect an investor's return. Therefore, investors should read their contract carefully to check whether an insurance company can change these features.

### **Different Methods for Determining How Interest Is Credited to an EIA**

Several methods by which the amount of change in the relevant index is determined include the following:

- **Annual Reset (or Ratchet)** — Credits the EIA with index-linked interest based on any **increase** in index value from the beginning to the end of the year with any declines ignored. This method has the advantage of “locking in” any gain each year.
- **Point-to-Point** — Credits the EIA index-linked interest based on any increase in index value from the beginning to the end of the contract's term. This method relies on a single point in time to calculate interest, which is typically a disadvantage for the investor. Even if the index increases throughout the term of the investment, if it were to decline dramatically at the end of the term, earlier gains would be lost. Because interest is not credited until the end of the term, investors may not receive any index-link gain if they surrender the EIA early.
- **High Water Mark** — Credits the EIA index-linked interest based on any increase in the index value from the beginning of the contract's term to the highest index value at various points during the contract's term (often the annual anniversary). Advantages of this method include: 1) the EIA may be credited with more interest than other indexing methods, and 2) it protects against declines in the index. One disadvantage is that, because interest is not credited until the end of the term, the investor may not receive any index-link gain if he or she surrenders the EIA early.

### **When Minimums Are Not Minimums**

Typically, EIAs come with a guaranteed minimum return of at least 3 percent. However, that guarantee is not always on the entire investment. More often, the company guarantees that the investor will receive at least 3 percent on just 90 percent of his or her investment. The result is that investors can still lose principal investing in an EIA, especially if they need to cancel their annuity early. If there is a bear market, it may take more than a few years for the minimum guarantee to allow investors to break even on their original investment.

### **Penalties for Early Withdrawal**

EIAs can have significant early surrender charges. Some charges have even been assessed at nearly 22 percent of the contract value.<sup>7</sup> This is in addition to the problem of how the guarantees are calculated. Some insurance companies may not credit investors with index-linked interest if they do

not hold the contract to maturity. It is also important to note that EIAs (as annuities) are generally subject to a 10 percent tax penalty on any withdrawals before investors reach the age of 59½.

### **Tax Inefficiency**

While EIAs and other annuities do provide the benefit of tax deferral, all withdrawals are taxed at ordinary income tax rates. Thus, when individuals invest in EIAs, they are converting what would otherwise be capital gains into income that will be taxed at ordinary income tax rates. Given the wide disparity in rates between ordinary income and capital gains taxes, unless individuals expect to be in the lowest tax bracket when withdrawing, this is a distinct disadvantage.

Another disadvantage is that if the same equity investment were in a taxable account, instead of in an EIA, and the investment experienced a loss, a taxable investor would be able to sell the investment and harvest the loss for tax purposes. If there were a gain, the investor could use the appreciated shares to make charitable contributions, totally avoiding any taxes. Finally, if the EIA were inside a tax-advantaged account such as a Roth or traditional IRA, there would be no additional benefit from the deferral.

For beneficiaries, there is another potential tax inefficiency. When beneficiaries inherit mutual funds, they receive a step-up in cost basis, which reduces their capital gains tax. However, when inheriting an EIA, beneficiaries must pay the IRS at their own ordinary income tax bracket.

### **Summary**

Primarily because of the many disadvantages described above, we feel that EIAs are investment products that favor the designer and seller of the product, not the buyer. Several disadvantages are notable, including the following:

- σ Poor credit quality of an issuer could put an EIA's potential returns at even greater risk.
- σ The SEC does not regulate EIAs.
- σ EIAs are tax inefficient for investors when withdrawing funds and to beneficiaries who inherit them.
- σ Many EIAs have significantly high surrender charges and fees.
- σ Many EIAs include restrictions that decrease expected returns.

It is prudent to investigate any investment vehicle before including it in a portfolio. We would suggest that investors who are considering EIAs speak to their advisor before purchasing them. It is highly likely that another investment vehicle — without the various restrictions and many drawbacks typically associated with EIAs — would be more appropriate.

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<sup>1</sup> David Swensen, **Unconventional Success: A Fundamental Approach to Personal Investment**. Free Press, 2005.

<sup>2</sup> Humberto Cruz, **Annuities Promising 'Best of Both Worlds' Harbor Some Hazards, Too**. *Milwaukee Journal Sentinel*, July 23, 2005.

<sup>3</sup> Joan Warner, **EIAs: Behind the Hype**. *Financial Planning*, October 2005.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

<sup>6</sup> **On Your Own with the Indexed Annuity Mess**. *Investment News*, October 17, 2005.

<sup>7</sup> Joan Warner.

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