Hey, Wall Street: You Can't Handle the Truth

By Sheryl Moore
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Feb.21, 2011 -- For too long, indexed annuities have been the "red-headed stepchild" of the insurance industry. Scandals over surrender penalties, commissions and lawsuits have plagued this business since it existed.
Much of the "scandal" has been misinformation or isolated incidents of agents behaving badly, which have been fueled by the media. Who runs financial services media in this country? Wall Street -- and it is in their mutual fund advertisers' best interests that indexed annuities come out smelling not-so-rosy. Well, Wall Street, I'm here to set the record straight. You may not be able to afford losing your clients to insurance agents, those who can protect them from loss in the event of market downturn, but you need to face the truth.

Truth No.1

Indexed annuities are not investments. Variable annuities are the only type of annuity that can be called an "investment," as these products place the purchaser's principal and gains at risk due to market volatility. Stocks, bonds and mutual funds are also investments. The Securities and Exchange Commission is responsible for the regulation of such investment products.

Fixed and indexed annuities, by contrast, are insurance products -- similar to term life, universal life and whole life. Insurance products are regulated by the 50 state insurance commissioners of the United States (collectively referred to as the National Association of Insurance Commissioners, or NAIC). Insurance products do not put the purchaser's money at risk; they are "safe money products," which preserve principal and gains. Investments, by contrast, can put a purchaser's money at risk and are therefore appropriately classified as "risk money products;" they do not preserve principal. The NAIC does not permit the use of the word "investment" when referring to indexed annuities, as such.

Truth No.2

Indexed annuities *used to* be called "equity-indexed annuities" or "EIAs." They aren't anymore. They have not been called "equity-indexed annuities" or "EIAs" by those in the insurance industry since the late 1990s. The insurance industry has been careful to enforce a standard of referring to the products as merely "indexed annuities" or "fixed indexed annuities," so as not to confuse consumers. This industry wants to make a clear distinction between these fixed insurance products and equity investments. The interest potential of these products is limited, unlike equities investments. In addition, it is the safety and guarantees of these products which appeal to consumers, particularly during times of market downturns and volatility. If everyone could stop using the word "equity" when referring to these products, it would help in avoiding any such confusion in the future.

Truth No.3

Indexed annuities don't have "costs" or fees. Some optional benefits may have an annual charge, but the only "cost" that the client pays on an indexed annuity is **time**, via a surrender charge. *The surrender charge on a fixed, indexed, or variable annuity is a promise by the consumer not to withdraw 100 percent of their money before the end of the surrender charge period.* This allows the insurance company to make an informed decision on which conservative investments to use to make a return on the clients' premium (i.e. seven-year grade "A" bonds for a seven-year surrender charge annuity or 10-year grade "A" bonds for a 10-year surrender charge annuity). Investing the consumer's premium payment in appropriate investments allows the insurance company to be able to pay a competitive interest rate to the consumer on their annuity each year. In turn, it also protects the insurance company from a "run on the money" and allows them to maintain their ratings and financial strength.

Truth No.4

Dividends are never included in the index calculation of indexed annuities, for good reason. The insurance company never receives the benefit of the dividends on the index on an indexed annuity, because the client is never directly invested in the index. The insurance company invests the indexed annuity purchaser's premium payment in the general account, which protects them from declines in the index. *The premiums are never invested in a pass-through account, which would provide the benefit of the dividends, but also expose the client to risk should the market decline.* For this reason, the dividends cannot be passed on to the consumer. By not directly investing in the index (which would pass on the dividends), the insurance company is protecting the purchaser from losses. **So, you see -- this is a benefit to the indexed annuity purchaser, not a disadvantage, folks.** And while it is true that annuitants will not "benefit from dividends in an indexed annuity," they also won't risk losing their money as a result of market volatility.

Truth No.5

Indexed annuities are not intended to perform comparably to stocks, bonds, mutual funds or the S&P 500 because indexed annuities provide a minimum guarantee where investments do not.

Indexed annuities are priced to return about 1 percent to 2 percent greater interest than traditional fixed annuities are crediting. In exchange for this greater potential, the indexed annuity has a slightly lesser minimum guarantee.

So, if fixed annuities are earning 5 percent today, indexed annuities sold today should earn 6 percent to 7 percent over the life of the contract. Some years, the indexed annuity may return a double-digit gain and other years it may return zero interest. However, what is most likely to happen is something in between. Were the indexed interest not limited, the insurer could not afford to offer a minimum guarantee on the product, and that is a variable annuity, not an indexed annuity. On the other hand, the client is guaranteed to never receive less than zero interest (a proposition that millions of Americans are wishing they had during that period of March 2008 and March 2009!) and will receive a return of no less than 117 percent worst-case scenario on the average indexed annuity. **In addition, no indexed annuity owner has ever lost a penny as a result of market downturn.** This is a strong value proposition that cannot be offered by any securities product with unlimited gains.

Truth No.6

Companies like Met Life and New York Life do not sell indexed annuities and are not going to be able to offer credible information on the products. These companies sell variable annuities -- lots of them. When the stock market declines, sales of variable annuities drop overnight. Likewise, when the market declines, indexed annuity sales increase. I would hardly consider companies that compete against those selling indexed annuities to be a credible source of information on the products.

Now that you have the truth -- what will you do with it? My guess? Go out and buy an indexed annuity…

Sheryl Moore is president and CEO of AnnuitySpecs.com, an indexed product resource in Des Moines. She has more than a decade of experience working with indexed products, and provides competitive intelligence, market research, product development, consulting services and insight to select financial services companies. She may be reached at sheryl.moore@annuityspecs.com.