Equity Indexed Annuities

Introduction

There are many critics of the insurance industry; some of their views are valid, others are merely opinion stated with self-imposed authority. Only educated or experienced opinions should ever be given a second thought, although it can be very difficult to know which opinions actually come from education and experience. There are many published authors who are not fully educated in the insurance marketplace but that seldom stops them from expressing their views. Insurance producers who plan to read and perhaps even follow a published author’s advice must always investigate his or her background. Does the author have any time in the insurance field? Does the author have a personal agenda? We know, of course, that the author wants us to buy their books but there may be an additional agenda as well that is neither suitable nor expert in nature.

A Complex Product - Not Suitable for the Inexperienced Agent

This course will address equity indexed annuities. In order to properly do that, we found it necessary to give some information on annuities in general. Although this course is designed for agents with a minimum of five years annuity field experience we realized that newer agents might choose to complete the course. We apologize for the agent who already knows the traditional fixed annuity facts, but we could not risk leaving a less experienced agent in confusion. As a result there will be paragraphs throughout the book that lead into the more detailed EIA information.

Annuities have gained and lost favor as the market has risen and fallen. Annuities are promoted by professional money managers when stocks are down and criticized when stock gains are up. It is simply the nature of financial planning to ride whatever wave is currently high. Annuity criticism should be taken for what it often is: one person’s opinion.

Equity indexed annuities are quite new when compared to traditional annuities that are more than 2000 years old. EIAAs are not variable annuities, but rather fixed rate annuities. Even so, they are quite complex. As their popularity has grown so have the problems faced by state regulators. Too often these complex annuities have not been fully understood by either the sellers or buyers. Only a foolish person would sell what he or she does not fully understand.
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The insurance industry will probably always face some amount of criticism. Most people resent paying insurance premiums for events they hope never happens. No one wants their house to burn down. We don’t want to experience an automobile accident. We certainly don’t want to die prematurely. Still, we feel forced to pay continual insurance premiums to protect us just in case the worst does become reality. No wonder the insurance industry is so criticized. We are taking money for events no one wants to have happen. The only products that seem positive are in the fields of financial planning. There will always be those who insist upon criticizing the industry we all rely on.

Consider the following quotes:

“In reality, equity indexed deferred annuities are extremely complex investment products and can contain many detrimental features such as hidden penalties, costs fees, and massive, multi-year surrender charges. Despite their complex nature, equity indexed annuities are typically not considered securities and are not required to be registered with the SEC, as is the case with variable annuity products. This means that most equity indexed annuities are not required by law to have an accompanying prospectus with disclosures regarding risk.” The Florida Insurance Department website ALERT.

“If you own an annuity and have concluded that the benefits of tax-deferral and performance guarantees are insufficient to justify its expenses, liquidate the annuity and move the money to institutional mutual funds and exchange-traded funds as outlined in this book.” The Lies About Money by Ric Edelman, 2007 (page 281).

“Today’s fixed-indexed annuity and the equity-indexed annuity are essentially the same thing. However, the word “equity” is a misnomer because it implies that the annuity may be some kind of equity product: it is not.” Don’t Die Broke by David J. Reindel, 2009 (page 27).

“When the odds of a claim happening are virtually zero, and the insurance costs are inappropriately high, don’t buy the insurance.” Insurance for Dummies by Jack Hungelmann, 2001 (page 13).

“Fixed-rate annuities are one of the few investments you can go into in which your principal is guaranteed each and every day.” Low Risk Investing by Gordon K. Williamson. He also wrote The 100 Best Mutual Funds You Can Buy.

“There is no asset category that outperformed them. We were extremely surprised, really just amazed.” David Babbel, professor emeritus of insurance and risk management, who conducted a study of equity-index annuity returns beginning in 1995.

“One possible downside is that the insurance company with whom you contracted for the annuity can set limits on the amount of market gain you actually receive. While you still have an opportunity for adequate growth, it may not always be at the same level as the index.” Money Alert online article
Author’s Note

As author of this course, I feel there are many positive aspects to equity indexed annuities, which is why I personally own one. However, no agent should think they are without disadvantages. Like all investments, they are not suitable for all investors.

I consider equity indexed annuities to be complex; certainly more complex than traditional fixed rate annuities. EIAs will not always perform as well as the stock market but they do guarantee principal if funds are left to maturity. Early withdrawals may cause principal losses however, so only money that will not be needed for the duration of the surrender charges should be deposited into an EIA. Like most annuities, these are long-term investments.

Only agents who understand the products he or she is representing should be marketing equity indexed annuities. If the marketing agent is not fully comfortable with the product he or she absolutely has no business selling them. There are no exceptions to this statement. Agents should first have history with traditional fixed rate annuities prior to entering the equity indexed annuity market. While there are similarities (EIAs are fixed rate annuities, not variable annuities as some believe) there are significant differences as well. In fact, equity indexed annuities could be termed “distinctive” since they have unique factors that other annuity products do not have. Understanding how EIAs work is necessary to avoid investing errors. Agents must always follow their state’s laws; if they include suitability standards, all the better.

This course is not meant to offer any type of tax or legal advice. Each investor brings with him or her unique circumstances that this course cannot address. This course may not be used as a selling tool. This course has been copyrighted and may not be reproduced in part or whole without the express written permission of United Insurance Educators, Inc. We reserve all rights. Of course, each student must personally complete his or her own course material, including the final exam, without help from any other person or entity. Only when the student has completed all of his or her own course work may a Certificate of Completion be issued.

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# Equity Indexed Annuities

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Investment Vehicles

There is no “perfect” investment vehicle. Each vehicle carries some type of risk. This is true of everything from stocks to the savings accounts at our local banks. In some cases the risk has to do with the type of investing, but in other cases it is inflation that robs us of our savings and growth. The ideal investment vehicle would provide interest rates that are higher than the rate of inflation, without the risk of investment loss. Such “ideal” investment vehicles do not exist.

While there is no ideal investment, there is also no specific type of investment that is always wrong. Each investment vehicle has qualities that work well in some specific conditions and qualities that make it unsuitable in others. The goal is to identify the type of investment vehicle that best suits the investor’s needs and goals.

This course deals with equity indexed annuities. This is a type of contract between the investor and an issuing insurance company. This is an annuity product, but it has aspects that are not like the traditional fixed rate annuities. Equity indexed annuities are not variable annuities; they are fixed rate annuities, but very complicated fixed rate annuities.

Due to the complicated nature of equity indexed annuities we must emphasis that no investor should utilize any investment vehicle he or she does not fully understand and agree with.

The first equity indexed annuity was offered by Keyport Life in 1995. At the time it did not receive much attention and relatively few investors utilized it. There were so many other ways of investing that seemed to produce higher returns, which was partially responsible for the disinterest. The complicated nature of equity indexed annuities probably also played a role in the slight attention they received. Following the 9/11 terrorist attack and the collapse of a few major corporations many people realized that their current financial investment vehicles were less than perfect. Mutual funds were plunging down as well as stocks, so even they were no longer perceived as a “safer” form of the stock market.

In 2001 and 2002 equity-indexed annuities began to receive rising investor attention. It did not take long for sales to move into the billions of dollars. As a result, many states began to require agents selling annuities to receive training in the mechanics of indexed products. Few consumers understood how equity-indexed annuities operated so they did not comprehend the risks that were involved. Unfortunately, even many agents lacked sufficient training in the products. Like all financial vehicles, equity-indexed annuities
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can adequately meet a client’s needs or they can be completely wrong for the particular circumstances. There is no perfect financial vehicle that is right for every person. Each situation is unique in some way because each investor is unique in some way.

This course cannot and does not completely address all tax issues or all regulatory laws involving equity-indexed annuities. Our hope is to address EIA suitability questions and offer training for agents who have little past experience with equity-indexed annuities. At all times tax consultants should be involved to analyze each investor’s personal situation. It is a foolish agent who attempts to act as both insurance agent and tax advisor to his or her clients.

The Test of Time

Although some variations of annuities are fairly recent, annuities themselves have been in existence for over two thousand years. That does not necessarily mean that annuities are right for every person in all situations, but it does mean that annuities have history on their side.

In Roman times annuities were called “Annuas”. Those issuing annuities were called financial speculators. Generally only single premium annuities were available at that time. When an individual purchased a single premium “annua” the annuity dealer provided a yearly payment to his client, including interest earnings, for the investor’s lifetime or for a pre-determined period of time, similar to our current annuities?

Of course, just like our modern day insurance companies, the financial speculators were betting they could get a better earning rate by combining the payments of many investors and investing in a higher yield investment. Additionally, if his client died early the annuity speculator kept all unpaid proceeds; in most cases beneficiaries were not part of the early annuities.

Many speculators did go broke however. If the client died early, he made additional profit; if the client died as expected he could still plan on making some profit, but if the investor lived longer than expected the financial speculator may not be able to meet his financial obligations so he would go broke. As a result of the final possibility, mortality tables were created, with the first mortality table attributed to Domitius Ulpianus.

The first life expectancy tables were only based upon and applicable to Romans, but the creation of this table changed the way annuities were issued. Since that time actuaries have repeated modified and updated the tables we use but the importance of them has never been questioned.

Over the centuries wealthy people from royalty to warlords have used annuities to fund multiple projects, including but certainly not limited to retirement.
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During America’s Great Depression insurance companies were among the very few stable institutions. Although insurance companies, like other big businesses, can go broke relatively few have done so when compared to the total number of insurers in business. Even during our most recent financial upheaval (2008 and 2009) annuities remained stable when few other investments were able to do so. During this time annuities exceeded $200 billion in annual sales. Of course that was not surprising since many investors were fleeing higher risk investments in favor of those guaranteeing principal deposits. Although annuities are often the target of criticism from those who feel their guaranteed interest rates are too low, they have continued to withstand the test of time and financial turmoil. Will Rogers was quoted: “It is not so much the return on my principal that interests me, but rather the return of my principal.” That may sum up the reason so many investors are moving their funds these days.

Hundreds of companies offer annuities with some specializing only in annuities and life products. Many of the companies are highly rated from a financial standpoint. Most Americans are only familiar with the companies they see advertising on television or radio but many more companies exist, many with high ratings and excellent products.

Finding the Right Products

Americans, and really citizens around the world, have become dependent on the internet. We go to the internet for just about everything from household goods to investment products. However, it is important to realize that just about anyone can proclaim their views online; that does not necessarily mean the information is correct or even fairly stated. While we are not advocating discontinuing the use of the internet it is important that individuals verify the information they receive. Insurance producers may face obstacles created by the internet if prospective clients have done “research” on their own.

Perhaps the greatest failing of the internet is that it provides an incomplete picture of investing and investment vehicles. Yes, there is some information provided (some even good information) but it is seldom complete. There is a logical explanation for this incomplete financial picture: it would take a book to completely explain any financial investment vehicle. It simply is not possible to give a total look at a complicated financial vehicle in a few paragraphs or even a few pages of text. Make no mistake about it: equity indexed annuities are complicated and the choices required of the investor are not always simple.

To make matters even more confusing for the consumer, every author, every agent, and every well-meaning next-door-neighbor claims to be an expert. Who should the average person believe? If you are the selling agent, you hope your clients believe you, but it will only take one mistake to convince your clients otherwise.
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The wise agent will carry E&O insurance: errors and omissions coverage. Even a fully educated annuity specialist can make an error or forget to give a vital piece of information. Additionally, even if full disclosure was made, the client may claim otherwise. When it is the agent’s word against his or her client’s the outcome is uncertain. This is also a strong argument for agent documentation. Equity indexed annuities can be confusing and choices can have adverse consequences. Even when principal is preserved a client who receives zero growth may become unhappy.

The first step is always to realize that although annuities are an excellent financial and safe investment that still does not make them right for every person and every situation. The length of annuities and the age of the investor are of great importance. Annuities are designed to be long-term investments so they are seldom a wise choice for short-term goals. The Internal Revenue Service considers annuities a retirement vehicle so they will impose a 10% penalty on withdrawals made prior to age 59½ (it is an early withdrawal penalty).

If the length of the investment (often up to ten years) and the age of the investor seem to favor annuities, the next step is always to find the annuity product that best fits the investor’s needs and goals. Your clients may attempt to find the so-called “right” product themselves by going to their computer. Ninety percent of what they find will be insurers and insurance brokers advertising the products they sell. There is nothing wrong with that; this is the age of advertising. Even attorneys advertise now. Unfortunately it also means that most of what your clients see will be promoting sales with a company other than yours. Therefore, only those insurance producers who understand the products and can relay that understanding clearly and precisely are likely to maintain their clients. The states have various continuing education and/or training requirements, with some states requiring education in equity indexed annuities. While this may sometimes feel like punishment it is actually intended to help all parties involved. The agent who seeks out education that furthers his or her abilities will benefit and the consumers he or she meets will benefit from the agent’s product understanding.

One important annuity distinction is between fixed annuities and variable annuities. Fixed rate annuities are marketed only through insurance companies although banks and other entities may be selling them. In all cases, however, it is an insurer who underwrites and issues the final product.

Variable annuities are classified as securities just as stocks, bonds and mutual funds are. Although underwritten by insurance companies, variable annuities are offered through securities licensed registered representatives. Simply having an insurance license does not necessarily allow the agent to market variable annuities. They do not (repeat: do NOT) give the same safety, security and guarantees fixed rate annuities offer. Equity indexed annuities are not variable annuities; they are fixed annuities.
Diversification

Investment diversification can mean many things: it might mean diversity among various annuity types. It might mean diversity between various stocks, bonds, and mutual fund accounts. It might mean diversity between types of investment products.

When a financial portfolio achieves appropriate diversification it is likely to have various types of investment vehicles, not just diversification among vehicles of the same type. Appropriate diversification will protect the investor in all kinds of markets, in good financial times and in bad financial times. When one investment vehicle suffers, another will prosper offsetting the product that is currently losing. Some types of investments will be appropriate for one age, but not appropriate for another age group. As we age, for example, our investment vehicles should move out of risk towards security and guarantees. Diversification must take all circumstances into consideration.

Before any person of any age begins buying investment vehicles their day-to-day financial picture must be considered. An individual who is having trouble meeting his or her mortgage payment each month should not, for example, try to also deposit monthly into an annuity, no matter how good that annuity product might be. First the individual must become financially secure in meeting monthly obligations, and then he or she must set aside a “rainy day” account that is sufficient to cover no less than three months living costs (today most professionals feel there should be sufficient funds to cover six months of living expenses).

Once the individual has enough income to cover monthly living costs, has established a budget to stay on track and avoid frivolous spending, has their emergency fund set aside and has maxed out other types of investments, then they may be ready to invest in an appropriate annuity. Note that we said he or she should first max out other types of investments; we are referring to such things as 401(k) investments that his or her employer may match. In other words, Eric Employee’s company will match 50 percent of what he deposits (usually up to some specified maximum). If Eric deposits $10 each week, his employer will match that at 50 percent or $5. Obviously Eric should max out his opportunity, so if he is allowed to deposit $150 each week he should do so if at all possible since the matching $75 is essentially “free” money. Even if that means Eric delays some other types of spending or personal pleasures he should attempt to deposit the maximum allowed by his employer. It would be foolish to invest in an annuity and miss out on the free funds offered through his 401(k) plan or any other type of employer-sponsored fund that gives him money he would not otherwise have access to.

Age has a great impact on how investments should be made. During 2008 and 2009 it was not unusual for investors to have lost between 35 percent and 50 percent of their portfolio. Those between the ages of 18 and 45 are likely to recover over a period of time but older investors, especially those nearing retirement, have little chance of recovery. Time simply is not on their side. Those who lost 50 percent would need to make 100 percent return to recover which is not likely to happen even under the best of
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circumstances. Those who lost that much of their total financial portfolio likely had all their funds invested in stocks, bonds and mutual funds. While that may sound like diversification, it is far from diversified because all investments were in the same investment product-type. Even though the market is likely to recover at some time in the future, those near retirement do not have time on their side so that “somewhere in the future” thing just isn’t going to work well for them.

Investors must realize the risks they take in their investments, especially as the investor ages. During 2008 and 2009 it became obvious that many near-retirement age investors were 100% invested in the stock market in one way or another. Did they not understand the risks? Chances are they had began saving for their retirement late and were trying to maximize their return but it was a foolish choice to attempt maximization in this manner. We are not advocating that older-age investors never use the stock market but it is important to diversify between risk and safety with the emphasis at older ages on safety.

Although opinions vary even among the best financial planners, generally speaking the rule of thumb says most individuals can afford to be aggressive up to the age of 50; after that age safety should be a primary investment goal. Between the ages of 50 and 60 there must be a balance between growth and income funds. After age 60 there should be every attempt to be conservative and preserve principal. By this age, it is better to gain no earnings than to lose principal.

Rule of 100

The Rule of 100 relates to investment risk. Take the investor’s current age and subtract it from 100. The balance is the maximum percentage that should be subjected to market risk.

For example, Betsy is 60 years old. Subtract 60 from 100 for a resulting figure of 40. Therefore, no more than 40 percent of her investments should be subject to market risk.

Who is Managing the Money?

Relatively few people actually manage their retirement accounts. They are more likely to have a mix based on which salespeople knocked on their doors. If the investor is lucky there was at least one insurance agent who talked them into purchasing a fixed rate annuity or a fixed equity indexed annuity. If the investor is really lucky he will have at least one of each type. Fixed annuities will provide a guaranteed rate of return and fixed indexed annuities will provide maximization of return. Using both will hedge against deflationary interest rates and trends.

Few investors really know or understand how to determine their risk tolerance level although it is something that each investor should know. Risk tolerance is based upon
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both the person’s personality and views towards risk and their total investment portfolio. Just about any sane person would say they do not want to lose any of their principal but that does not necessarily mean they are risk adverse. Most financial planners have a specific list of questions they ask a new investor to determine the amount of risk they can comfortably live with in their investment portfolio. Aside from age, which has specific risk criteria, individuals often say they want no risk yet are willing to buy stocks. Does that mean they do not understand the risks stock purchase automatically brings with it? Or does it simply mean they hope not to lose any principal but are actually willing to risk a loss? The financial planner or insurance producer must determine such things prior to placing their clients into a risk vehicle. Risk tolerance and asset allocation are intended to be very methodical but investments are often not viewed that way; instead they may bring an investor’s emotional feelings with them. Bottom line: the investor must know how much of their principal they are willing to lose if everything goes wrong. If the seller has not established this prior to placing their clients into stocks, bonds or mutual funds or any other type of investment (including variable annuities) then he or she could be facing a future lawsuit.

Ideally the investor would review their investment portfolio at least twice each year and four times each year may be better in the current financial climate. Most people are now living longer and their money must last as long as they do. While part of that longer life means obtaining gains that will provide adequate income to the end of life, it also means providing a type of income that pays until death occurs, such as an annuity’s lifetime annuitization offers. Of course, the annuity will only provide income based on the amount of money placed in the policy.

An annuity will only provide income based on the amount of money placed in the contract.

Most states have some type of product suitability requirement that salespeople are required to use. The states hope to prevent loss of principal that severely impacts senior investors but really all investors should use some type of suitability standard before selecting their annuity investments.

There are very few restrictions on who can place the words “financial advisor” on a business card or office entry sign. Unfortunately for many insurance producers they do not realize the legal liability they immediately place on themselves by adding those words to a business card or on a door logo. According to Cheryl Toman-Cubbage, the primary reason an agent is sued is for negligence. It takes only a few moments online to see the number of advertisements by attorneys and their corporations offering to sue agents who placed them into a losing financial situation. Variable annuities are often specifically listed as potential lawsuit vehicles. We are not suggesting that such financial investments never be sold; we are advocating that only those who can prove they are financial planners by virtue of schooling or experience advertise as such.
There are few standards specifically identifying who is and who is not a financial advisor. Part of this has to do with deregulation, especially since 2008. In 1999 President Bill Clinton signed the Gramm-Leach-Bliley Act, also referred to as the Bank Deregulation Bill. Before this bill banks were limited by the “Glass-Steagall Act of 1933 which separated banks providing basic lending procedures from other banking institutions that offered investments considered riskier. This made insurers, banks and investment firms equal in many respects. The line between each entity was essentially erased with the Bank Deregulation Bill.

We are seeing many other types of entities joining financial planners as advisors. For example, it is not unusual to see Certified Public Accountants also selling annuities and other types of investments or at the very least, offering advice. He or she may now, in addition to filing your taxes and trying to stay current on tax laws, manage your investment portfolio, open bank accounts in your name, provide investments such as Certificates of Deposit or place an annuity.

It takes extensive time and experience to be an effective financial planner. While other industries, such as medicine and law, are specializing, the financial planning industry seems to be doing just the opposite. Effective financial planning is more than placing stocks or annuities for retirement. Professional planners (those that specialize in just that and nothing else) also look at future needs such as long-term medical care (nursing home insurance) and during the working years, disability coverage. Specialization requires knowledge and experience to cover all possible and probable risks.

Today banks still offer mortgage and automobile loans but in addition to that they may be selling term life insurance (perhaps online), various annuity products, and investment advice in other products. Security firms now offer online banking, variable insurance products, and advanced investments for those they feel are qualified. Insurance companies have a new role as well. They often partner now with other financial institutions, even administering retirement plans.

Who can say whether the changes are best for consumers or not? It will probably take many years to really know. We have seen the selling and buying of life and annuity contracts turning them into a different kind of investment for many firms. Debt has been sold for years as a type of investment.

Perhaps what all consumers really need to understand is that there is no longer any such thing as a financial advisor. We do have agents that are very proficient in annuities and life insurance; we have bankers who have a great understanding of the debt markets, and we have accountants who may understand how to leverage investments for the best tax

In 1999 President Bill Clinton signed the Gramm-Leach-Bliley Act, commonly referred to as the Bank Deregulation Bill.
circumstances. The term “financial planner” is really a general term applying to many different aspects of specialization.

There are companies who offer schooling for individuals who want to be specialized in insurance and related financial fields. We are referring to Certified financial Planners, Registered Investment Advisors, Registered Representatives, Chartered Life Underwriters, Chartered financial Consultants, and other organizations that offer specialized training and ongoing continuing education in the financial fields. We recommend consumers seek out these specially trained individuals although it is unlikely that the general consumer is even aware they exist.

One area may have benefited from the deregulations; consumers can seek products from multiple sources to find the best competitive rates and vehicles. Generally, banks will still primarily be concerned with banking issues and accountants will still be primarily concerned with keeping abreast of current tax laws. Even so, there will be those who also try to do it all. Consumers do need to become better educated to seek out the best individuals in the financial fields, but chances are that will not happen to the extent it needs to. Most consumers will continue going with whoever knocks on their door and seems to fill some need they believe they have.

Some individuals will always manage their personal affairs as they would a business and others will continue listening to every person who thinks they know something about money and investments. The rich get richer because they have learned how finances and investments work and they treat them as a professional money-manager would. They are seldom (and probably never) reckless with their money. They are not necessarily out to get the highest return but they are out to get a good return with acceptable levels of risk.

The Annuity’s Investment Role

Most people having financial independence will benefit from purchasing some type of annuity, probably more than one type. There will always be critics of the annuity industry just as there will always be critics of most things in this world. The critics often simply don’t like the “big business” aspect of insurance companies. Educated financial analysts however understand the annuity’s role in financial planning. Although it should not be the only financial vehicle used, it should be among those used.

There are many reasons annuities offer safety of investment, but one of the reasons has to do with capital reserve issues.

There are many reasons annuities offer safety of investment, but one of the reasons has to do with capital reserve issues. Our government gave money to maintain many of the banks following their poor lending practices and resulting money problems. Most experts felt it was necessary to ease the credit markets so our society could move
forward. In most cases, the banks did not begin loaning again, as was desired, but instead used taxpayer money to improve or maintain their own capital reserve requirements.

Insurance companies have the same capital reserve requirements as banks but fixed rate annuities must reserve the capital required to meet their financial obligations, which are contractually guaranteed to protect their policy holders. These reserves cover not only the rate guarantees but also minimum guarantees, income guarantees and living benefit guarantees. As a result, investors should not only be looking at potential lifetime income, but also at the safety of principal annuities offer.

Annuities are often the financial vehicle of choice for structured settlements. These are often mandated by courts, but need not be. Usually it is court ordered or agreed to by two or more parties and then accepted by a presiding judge.

A structured settlement is a settlement amount that is structured to pay a specified sum over a specified time period or lifetime of an individual. Annuities are typically used to guarantee that the payments will be made as agreed upon. They take the payment out of the hands of the liable party and place it with a legally-disinterested third party. The amount of payment will depend upon the settlement amount placed with the insurer and the expected lifespan of the annuitant. Usually the court is not concerned with the amount of periodic payment but rather with the total of principal deposited in the annuity since it is that premium that represents the legal settlement.

Insurance companies know how analyze risk; it is part of their job and they do it every day. Not all insurers offer identical payouts derived from the same amount of principal however. Some companies may charge more for their overhead or there may be other conditions that affect annuity payouts, including the amount of credited interest. Agents are wise to represent more than one annuity company so he or she can compare rates and payout to give their clients the best opportunity possible.

Agents must constantly check facts and figures since annuity companies can and do change how they formulate payout amounts on newly annuitized contracts. Previously annuitized contracts would seldom, if ever, be affected by changes. Once a product is annuitized, the payout amount and conditions become contractual.

Once a product is annuitized, the payout amount and conditions become contractual.

There is often a difference between annuity old money and new money rates. It may depend upon multiple factors including current investments available to the issuing insurer. Newly issued policies may earn more or less than previously issued contracts. Some new contracts offer higher rates to be competitive if other insurers have come out with better contracts than previously offered. Like all types of businesses, insurers must attract new clients as well, so higher rates on new money may be a way of gaining new policyholders.
Equity Indexed Annuities

Defining the Equity Indexed Annuity (EIA)

Unfortunately, indexed annuities are often thought to be a form of variable annuity, which they are not. Rather equity-indexed annuities are a type of fixed annuity product. For this reason equity indexed annuities are sometimes referred to as fixed equity-indexed annuities. They may be one of the best retirement tools developed in recent years, especially considering how the stock market has recently performed. EIA's typically guarantee at least one year of initial premiums returned if the product is held past the surrender period. Since the indexed annuities have a link to a major stock index, there is the potential of growing faster than a traditional fixed annuity product. However, their complexity means they are not for all investors. Any person who does not fully and completely understand how the product works should neither sell equity indexed annuities nor buy them.

Many agents market the unique safety features of EIAs. No, they are not perfect (as no investment product is), but they can protect the investor from premium loss if the markets crash, while allowing gains if the stock markets perform well. Like most annuities, these should be considered long-term investments; they often work well for retirement funding.

An equity indexed annuity is first and foremost an annuity product. When annuitized, an annuity can produce an income stream for life or, depending upon the payout option chosen, for a fixed period of time. How funds are received will depend upon the annuitization option selected. The amount of money received will also depend upon the amount of funds invested in the annuity. It should be no surprise that inadequate investing will mean inadequate income.

There can be both an annuity owner and an annuitant. This is often the same person, but it does not have to be. The owner is the individual who owns the “rights” to the annuity income. The annuitant is the person whose life is measured by the annuity. In a life insurance policy he or she would be called the insured but in an annuity product they are known as the annuitant.

Although annuities are routinely used for other purposes, the intent is to provide income at a later date, which is why they are often considered a retirement vehicle. The federal government considers annuities a retirement vehicle and imposes a 10 percent penalty for withdrawing funds prior to age 59½ but of course the funds can be used for any purpose.

Although annuities are issued by life insurance companies, they do not insure against premature death as a life insurance policy would. Annuities do have beneficiary
Equity Indexed Annuities

designations but their intent is not to provide money for heirs; the intent is to provide income during the life of the contract owner. As every agent knows, insurers measure risk. For example, under a life insurance policy, the insurer “loses” if the insured dies prematurely (meaning they pay out funds prior to receiving the time they need to earn a profit) but “wins” if the insured lives longer than expected. In an annuity where a lifetime income is selected, the insurance company retains any undistributed funds. Therefore, under the lifetime annuitization option, the issuing insurance company “loses” if the annuity owner lives beyond his or her lifetime expectation (collecting funds beyond what was deposited into the account) and “wins” if the contract owner dies prior to collecting all the funds he or she deposited. Unfortunately, many annuitants do not realize (so therefore fail to notify their beneficiaries) that lifetime annuitization selections eliminate beneficiary rights to unused annuity funds. Since annuity products are intended for contract owners – not for heirs – this should not be surprising but it continues to be overlooked and unexplained by agents.

The annuity’s intent is not to provide money for heirs; the intent is to provide income during the life of the contract owner.

As we continue to live longer we are justified in fearing we might run out of money before we run out of life. In other words, Americans are at risk for having too little money set aside for the last years of their life. As we continue to have smaller families we may not be able to count on our children to care for us both physically and financially in our last years. A major cost to our Medicaid system is nursing home care for our nation’s elderly. As our senior Americans spend all they have, they must turn to Medicaid (which is basically medical welfare) for their health care needs. Few people are saving adequately for their retirement years so annuities, with lifetime annuitization options, make good sense.

As we previously stated, an equity-indexed annuity is a fixed annuity, not a variable annuity. The investor deposits an amount of money, which the insurer will pay back to the investor at some future date, often through installment payments. It is possible to take a lump sum at contract maturity but that would make little sense. The point of an annuity is to provide income over a long period of time. Taking a lump sum would defeat that goal. Many annuities are never annuitized but they were designed with annuitization as the product’s final phase.

Contract maturity varies by annuity, but most require several years to mature. Actual surrender penalties can be anywhere from 12 months to ten years or even longer. When surrender penalties end the contract has achieved contract maturity. Withdrawals made prior to maturity might be subject to insurer penalties, unless a provision allows partial withdrawals. Many contracts allow the interest earnings or 10% of values to be withdrawn without incurring penalties. Some annuities reward investors for not withdrawing any funds with bonus interest points if they do not withdraw funds within specified guidelines.
Most equity-indexed annuities are a declared rate fixed annuity, meaning the annuity’s rate of interest is re-set each anniversary date. For example, the first year might guarantee an interest rate of no less than 3 percent; the second year could adjust down or up, depending on current markets. Whatever subsequent years might be, the declared interest rate can never be a negative number. Like all annuities, as long as the investor holds the product to maturity, he or she will receive at least all they paid in; the investor will never lose principal, as can happen in stocks and mutual funds. For many investors, the absolute guarantee of principal is the major reason annuities are chosen for retirement investing. This might especially be true for those with past experience in the stock market.

When an EIA is held to maturity all principal is guaranteed.

While annuity contracts are not all the same, generally EIAs do not have internal expenses, meaning there are no fees, or front-end or back-end loads that could retard the product’s performance. While we must always stress that contracts can and often do vary, most equity indexed annuities have clarity in that what is presented by the insurer is what is actually charged. This is different than variable annuities, mutual funds, and managed accounts that typically have various management fees and expenses.

Typically equity-indexed annuities are deferred annuity vehicles because they do not begin providing income for several years. An annuity that begins paying income within a year of contract origin is considered an immediate annuity. The insurance companies need a period of time to earn a profit and the annuity needs a period of time to earn enough interest to adequately perform. The period of time during which the annuity is growing, earning interest, and perhaps receiving additional deposits from the investor is called the accumulation phase. Once systematic payments begin (upon annuitization), the contract moves into the distribution phase.

Equity-indexed annuities often allow free withdrawals during the accumulation phase without charging surrender penalties, but it is always necessary to read the contract for details. Depending on the contract, it may be possible to withdraw up to 10 percent of the account value during the accumulation phase. However, it is important that contract owners realize that any time funds are withdrawn there is less money in the account earning interest. Even so, this can help with occasional financial needs of the investor. If the investor is not yet age 59½ any withdrawals are probably subject to the 10% Internal Revenue Service early withdrawal penalty.

Once the distribution phase begins, the annuity’s account value will be declining steadily, as monthly or quarterly payments are made. Investors typically take distribution payments monthly or quarterly, but many contracts allow semi-annual or even annual payments through the annuitization process.
What we have been discussing is true of all fixed rate annuities so why would an indexed annuity be better than any other fixed rate annuity? If the stock market crashed or simply underperformed the equity-indexed annuity, like other fixed rate annuities, would simply continue to operate as they always do, paying the pre-set rate of interest on the investment exactly as the contract promises. However, with an indexed annuity, if the stock market is performing well, the fixed equity-indexed annuity will earn more than it otherwise would.

All EIAs track some specified stock market index; commonly it is Standard & Poor’s index of the stock values in 500 of the largest corporations known as the S&P 500. The S&P 500 is a registered trademark of McGraw-Hill & Company. Whatever index is used if it substantially increases during the term of the equity-indexed annuity, the annuity’s value will increase to the extent specified in the annuity contract. It would be unusual for the equity-indexed annuity to grow exactly as the index it is based upon grows. Most do not track the index exactly and there are various methods used to correlate gains. It should surprise no one that some contracts are more generous to the investor than others. It is important to realize that this added value should be considered a “bonus” since there is no loss if the markets perform poorly. No investor should buy with the expectation that there will always be bonus earnings either. EIAs are first and foremost a fixed annuity product, but there may be additional earnings if the markets are favorable.

While it may not be so prevalent today, at least initially, equity-indexed annuities were constantly compared to variable annuities. They are not and never were variable annuities. Critics of equity-indexed annuities may still try to compare them and that does a disservice to the product. More importantly, it confuses investors.

A variable annuity tracks the stock market directly so its values go up and down with the stock market. That is not the case with an equity-indexed annuity. Just like all fixed rate annuities they perform based on the contract with a bonus earning if the index it is based upon performs favorably. Variable annuity values are determined by a separate account that holds various investments, often similar to mutual funds, for each contract owner. Many allow contract owners to choose their own funds but in most cases it is important that the portfolio be well managed for maximum performance. Variable annuities experience full stock market risk while equity-indexed annuities do not. This distinction should not be taken lightly since it is a tremendous difference in product types. Just as stock market managers are unable to provide long-term financial guarantees variable annuities cannot give long term performance guarantees either. Experienced money managers may be able to forecast but it is just that: a forecast – not a guarantee. Some variable annuities do guarantee the investor’s return of principle in the case of premature death or during a specified time following the contract’s issue date. A variable annuity has the potential of total loss; that is, the investor could lose the entire...
amount he or she invested if the market takes a dive and remains down. A fixed equity indexed annuity would not be affected by a market dive; the investor simply would not earn any “bonus” earnings. As long as the investor holds the annuity contract past the surrender period (maturity date) he or she would receive all principal sums and any guaranteed interest earnings.

Another important difference between variable annuities and fixed equity-indexed annuities are the fees charged. While every contract can vary, typically variable annuities have several types of fees and expenses, many of which are tied to the buying and selling of stocks. Obviously fees and expenses (often referred to in the contracts as management fees) will retard potential earnings. Equity-indexed annuities generally do not have internal fees and expenses beyond what is prominently stated in the contract. Any fees that do exist would be minimal so the investor knows exactly what his or her contract earnings are.

**Annuity Surrender Fees**

It would be unusual to see an annuity contract that did not have surrender fees. The length of the fees will vary, with seven to nine years being common. The reason insurers can guarantee interest rates is because they expect to have the funds for a specified period of time. To discourage early withdrawal of funds or a complete surrender of the contract insurance companies impose early surrender fees. Surrender fees are a type of penalty for withdrawing money sooner than agreed upon at the time the contract was issued.

Surrender charges start off high and decrease a percentage point each year. For example, in a nine year contract, the first year would experience a nine or ten percent penalty fee, and then decrease by one percentage point each year. It might look like the following:

<table>
<thead>
<tr>
<th>Contract Year</th>
<th>Surrender Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>9%</td>
</tr>
<tr>
<td>Year 2</td>
<td>8%</td>
</tr>
<tr>
<td>Year 3</td>
<td>7%</td>
</tr>
<tr>
<td>Year 4</td>
<td>6%</td>
</tr>
<tr>
<td>Year 5</td>
<td>5%</td>
</tr>
<tr>
<td>Year 6</td>
<td>4%</td>
</tr>
<tr>
<td>Year 7</td>
<td>3%</td>
</tr>
<tr>
<td>Year 8</td>
<td>2%</td>
</tr>
<tr>
<td>Year 9</td>
<td>1%</td>
</tr>
<tr>
<td>Year 10</td>
<td>Zero</td>
</tr>
</tbody>
</table>

When there is no longer a contract surrender fee the policy has reached what is called the “**term**” of the policy; this is also called policy maturity, although actual maturity is not the end of the surrender period. Most contracts state a specific age for maturity, such
as age 100. Since “maturity” is so often used for “term” many professionals use the two terms interchangeably, even though “maturity” actually means something else.

Surrender penalties or fees do not apply if the contract is annuitized or when death benefits are paid due to the annuitant’s death. If the contract is annuitized, an income stream begins and the contract is then “locked in” based on the payout option selected. Once a payout option is selected and the first check has been cashed it is generally too late to make any changes; the contract owner cannot change their mind later on. Whatever payout option was chosen determined length and amounts of systematic income.

Annuity critics seem to concentrate on commissions earned by the selling agents, an odd concern to say the least. This is odd because the rate of commission has no direct effect on the contract terms. As long as the investor is aware of the guaranteed rate of interest and is content with the guaranteed rate stated, whether or not the agent earns a commission has no direct effect on the product’s performance. This is true of all fixed rate annuities, and the fixed equity-indexed annuity is no exception.

Sometimes annuity critics argue the annuity product would pay a higher rate of return if the agent received less commission and this may be true to some extent. However, the overall performance is stated in black-and-white for the investor to view. If he or she is happy with the contract terms there should be no concern for the amount of commission his or her agent will receive. The first and primary concern is simple: does the investment suit the investor’s goals and requirements, including risk tolerance?

The commissions paid to agents may affect the bottom line since the more the insurer pays their agents (or to any other operational expense for that matter) the less there is for other insurer costs. To this extent, commissions may affect interest rates that are guaranteed (it will not affect rates based on market performance in most cases), participation rates, caps and the length of surrender periods. Since these terms are already set when the product is offered the investor will not get a better contract by bargaining for lower commission rates. The investor would be wise to shop the marketplace for the best product but that is wise regardless of commissions paid. Many critics feel agents only present products that pay higher commissions and there may be some truth to this. That does not prevent consumers from shopping around since many available products are offered through varieties of online websites and through local agents. Since commissions have already been built into each product commission differences may be hard to see. It would be foolish to get so sidetracked by what agents earn that the important issues are overshadowed: safety of principal, insurer financial stability and satisfaction of investment goals.

Many professionals advise consumers to simply find a product that fits their needs and leave commissions between the insurers and their agents. Many elements of how insurance companies determine commissions have nothing to do with the actual product so price shopping, while always advisable, may have no bearing on what the agent
receives in compensation. Some insurers pay a higher commission for the same reason a
department store pays higher salaries: they want the best people representing them. As it
applies to equity-indexed annuities, higher commissions may be paid to compete with
management fees financial planners would lose if they recommended EIA products.
Financial planners stand to lose a substantial sum over the life of the EIA since he or she
would have made multiple fees if they were managing a mutual fund, for example.

As it applies to equity-indexed annuities, higher commissions may be paid to compete
with management fees financial planners would lose if they recommended EIA products.

Agents do have an ethical responsibility to represent and recommend suitable annuity
products. It would certainly be unethical to recommend a poor product simply because it
paid a higher commission. Many states already have or are in the process of
implementing suitability requirements for annuities because there has been fear that
agents might place unsuitable products, especially with older investors who do not have
time on their side if a mistake is made. Investors are always best protected by finding a
career agent with product knowledge and a desire to be in business long-term. Agents
who plan to be a career agent are probably more likely to select product quality over
commissions paid. They have to if the want to remain in business.

Annuity suitability must always be considered. Since they are long-term investments
any type of annuity product must suit the needs and circumstances of the investor. For
example, most professionals would feel it was unwise to place all of an investor’s funds
into an annuity (no matter how good the product is). If he or she had an emergency need
for cash there would be none available unless the investor paid an early surrender penalty
on the withdrawn funds. Therefore, agents must understand the circumstances of each
investor prior to making recommendations. Only if the investor refuses to provide full
information is the agent released from his or her ethical obligation to determine product
suitability.

Guaranteed Rates of Return – a Complex Issue

Fixed rate annuities, such as equity-indexed annuities, promise a guaranteed minimum
rate of return. This may be referred to as the “floor” rate since it is the lowest rate that
will be paid. The annuity might pay a higher rate than guaranteed, but never a lower rate.
Higher rates might be paid if market conditions were good. At each anniversary the
minimum rate is re-set, but that would not mean higher rates could not be credited if
circumstances warranted it. In the case of equity-indexed annuities, there is also the
possibility of bonus earnings if the market index does well.
Equity Indexed Annuities

Investors must always pay attention to the guaranteed or floor rate since it is the only return that is promised. *Higher rates or bonus returns are not guaranteed.* Some contracts do not give more than a zero percentage guaranteed rate of return. In these contracts, there is no guaranteed rate but the principal is still guaranteed. In other words, in the worst index situation the investor would not lose their principal but he or she might not gain any interest earnings. Generally fixed rate annuities (that are not equity-indexed vehicles) would guarantee at least a couple percentage points in interest but equity-indexed annuities do not necessarily do so. This is another good reason to compare products, although the guaranteed rate of return is only one element of the product and not always the most important. In some cases, the investor is better off with a lower guaranteed rate since the contract may offer better participation in the index-linked return if the interest rate is lower – maybe even a zero floor. The goal is an index-linked return that out-performs the guaranteed rate of return.

How returns are credited to the annuity contract can be important as well as the actual rate of return earned. Some contracts may credit guaranteed interest earnings quarterly while others do not credit them until the end of the surrender period (which could be ten years from the date of issue). If they are not credited until the end of the surrender period, then any penalty-free withdrawals will not have earned even a penny of interest. It will be as though the funds had never been deposited. Even if no funds are withdrawn, actual earnings are likely to be lower than a contract that deposits quarterly or even just yearly.

If the EIA does not credit interest until the end of the surrender period, then any penalty-free withdrawals will not have earned even a penny of interest.

Insurance companies will make early withdrawals unattractive in many cases because the point of buying annuities is for long-term investing. Agents should never deposit money the investor may need prior to the term of the annuity contract. Annuities, including fixed equity-indexed annuities, are not suitable for anyone who may need to make large withdrawals prior to the end of the policy surrender periods.

Most annuity owners and annuitants do not consider how rates are determined or credited; they largely prefer to have their agents select and present an appropriate and advantageous product for them. Crediting of participation rates can be complicated even for agents who work daily with the products. It might prove very difficult to fully explain the process to consumers. Despite the fact that it can be complicated, how earnings are credited can significantly affect the end results so it is an important consumer topic.

One might assume that each company will credit all their fixed annuity products the same but that is not always true. Even within each company, different products might credit earnings differently.
Some products will not apply the minimum guaranteed interest rate to 100 percent of the principal. It is possible that only 80 percent to 90 percent of the principal amount will be credited with earnings. Some EIA contracts give the insurer flexibility to even change its crediting rates, but most contracts specify certain minimum crediting rates that must be followed. As with all insurance matters, it is important that the selling agent be fully and completely aware of the products he or she is marketing. It doesn’t matter how sincere the selling agent was; if a major error is made it is the agent’s fault since he or she had an ethical duty to know the products he or she represented.

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**Important EIA Fact:**

While most fixed annuity products guarantee against loss of premiums paid in, that is not always the case. Some equity indexed annuities do not make this guarantee of the full amount, guaranteeing only a percentage, such as 90% plus whatever minimum interest guarantees exist. In these cases, if the investor does not receive any index-linked interest there could be loss of premiums. Of course, if the EIA was surrendered during the penalty period, that could also result in a loss.

In order to know how interest earnings will be credited, it is necessary to understand how the company credits premiums for the purpose of calculating interest payments. You must also know if the issuing company has contract limitations preventing them from changing crediting methods. So, first look to see how the insurer credits premiums and secondly, look to see if crediting methods may be changed. This will be found in the policy.

Every agent knows (or should know) the great difference between simple and compound interest. Simple interest applies only to the principal payments whereas compound interest applies to both principal payments and accruing interest earnings. In a way, that means that the interest applied in previous periods begins to act like principal, also earning additional interest. Investors should always seek compound interest products, never simple interest policies. In fact, a compound interest policy will often accrue more earnings even if it offers a lower rate than a simple interest product. It will depend on the point spread, but seldom do simple interest vehicles compete well with compound products.

According to NASD, the way an annuity company calculates interest during the policy term will certainly make a difference in the equity-indexed product. Some EIAEs might pay simply interest during the term of the annuity but change after that point. Anytime there is no compounding, similar rates of return will mean that the compound interest vehicle did better than the simple interest vehicle.
Equity Indexed Annuities

Some annuities might pay simple interest during an “index term”, when bonus points are possible. This means index-linked interest is added to the original premium amount but it does not earn compounded interest during the term. Others may pay compound interest during a term, which means that index-linked interest that has already been credited also earns interest in the future. In either case, the interest earned in one term is typically compounded in the next.

Although most professionals feel it is best to stay with compound interest vehicles, there may be reasons to go with the simple interest vehicle. Perhaps the simple interest product has some feature the investor specifically wants, such as a higher index participation rate.

Some annuities that are not equity-indexed products will offer bonus rates for one year, maybe even several years. Of course, if the investor surrenders his policy during the surrender period bonus rates will not apply. Alternately, some EIA products will offer a bonus to an older non-EIA annuity in order to draw in the business to an equity-indexed annuity product. If the bonus makes up for any early surrender penalties it may be worthwhile, but product replacement should never be considered without knowing all the facts.

Sometimes we may see a financial journalist suggest that any annuity bonus inducements are questionable. It suggests the insurer has an inferior product and is using the bonus to entice in customers they would not otherwise get. We do not generally agree with this statement, although each product must be individually considered to give an adequate answer. Just as department stores have sales to attract customers, insurers offer bonus points to attract customers. The cost of offering such bonus points is figured in to overhead; insurers are typically very good at analyzing profit and loss. After all, their business is based on risk factors. Although bonuses can give an EIA product a strong performance start, it is important to also look at any limitations on performance that might affect the final returns.

There can always be variations, although all products offered must comply with state and federal requirements. State requirements can vary so what works in Oregon may not work in Iowa or Minnesota for example.

If withdrawals are made, even if there is no surrender fee applied, it is likely that the amount withdrawn will not be credited with interest so this should always be considered prior to pulling money out of an equity-indexed annuity. Of course, withdrawals made prior to age 59½ will incur an early distribution charge from the IRS as well.

Index Crediting

There are various fixed equity index annuity products. The differences can be important as they apply to crediting.
Interest crediting provides a minimum return; index crediting provides the potential of a maximum return at the end of the term because it is measured in some specified way with the chosen index. Although interest guarantees can be zero, it is likely that at least some amount of interest earnings may be guaranteed, even if only one percent. If an investor was only interested in the guaranteed rate of interest earnings there would probably be no point in depositing funds into an equity indexed annuity contract; a traditional fixed annuity product would be sufficient.

The National Association of Insurance Commissioners (NAIC) has published a buyer’s guide for equity-indexed annuities. Although there are more elements to these products than just the potential maximum return, since consumers will be looking for products that produce greater returns, it is likely that this element is often the characteristic focused on.

The NAIC does not endorse any company or contract; their publication is intended to help the general consumer understand equity indexed annuities so that they may make the most prudent choice for their particular circumstances. Their publication states:

“What are equity-indexed annuities? An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indexes is Standard & Poor’s 500 Composite Stock Price Index, which is an equity index. The value of any index varies from day to day and is not predictable.”

Like all annuities, equity indexed annuities are insurance products and are issued by insurance companies. The buyers of these products are not directly purchasing stocks.

There are two very important aspects to equity indexed annuities: the indexing method and the participation rate.

Equity indexed annuities are fixed annuities, either immediate or deferred. They earn interest or provide benefits that are linked to an external equity reference or an equity index. The index value will be tied to some particular index, such as stocks, often the S&P 500 Composite Stock Price Index. This would be an equity index. The value of any index changes often, perhaps daily or even hourly. The changes cannot be predicted, so there is growth risk involved, although the principle is not at risk.

The indexing method is the method used to measure the amount of change in the index. While there is not necessarily going to be change, change is likely. The most common indexing methods are annual reset, also called ratcheting, high-water mark, and point-to-point. The original EIA used only a single method, usually the S&P 500. There are now many ways to calculate contract values.
Participation Rates

Participation rates can be a limitation on the base interest rate paid by the issuing insurance company. They can also limit the index-linked return. Since participation rates are primarily a function of equity indexed annuities consumers do not typically have experience with them and may lack understanding of an important product feature.

A participation rate will determine how much the gain in the index will be when credited to the annuity. How gains will be credited can be confusing. The annuity company may set their participation rate at various amounts (depending upon the product); for example, it may state a participation rate at 80%, which means the annuity would only credit the owner with 80% of the gain experienced by the selected index (the S&P 500 for example). If the calculated change in the index is 9 percent and the participation rate is 70% the index-linked interest rate would be 6.3%. This is figured by multiplying 9% times 70%, equaling 6.3%.

| If the calculated change in the index is 9 percent and the participation rate is 70%  
| the index-linked interest rate would be 6.3%.  
| This is figured by multiplying 9% times 70%, equaling 6.3%. |

Participation rates for newly issued annuities can change daily. As a result, initial participation rates will depend upon the date the insurance company issued the annuity. Participation rates are usually guaranteed for a specified period of time so additional deposits may receive the same rate as the initial deposit. When participation rates are guaranteed, they may range from one year on. It is always important to check the actual policy since products do vary.

Once the product period ends, the insurer will set a new participation rate for the next period. Some annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

Participation rates offering less than full value (100%) protect the insurers in some situations and may allow them to offer higher interest rates or caps. It may surprise consumers to learn that sometimes it is better to select products with less than full value (80% to 90% perhaps) in order to earn higher rates of interest. Although critics may imply that less than full participation rates are a product disadvantage, in fact they are often beneficial.

The NAIC states participation rates vary greatly from product to product and even from time to time within the same product. It is certainly important for agents to fully understand how they work but consumers also need a basic understanding of them. A high participation rate may be offset by other features, including simple interest,
averaging, or point-to-point indexing methods. Conversely, an annuity company may offset a lower participation rate while offering a valued feature such as an annual reset indexing method.

An important note: Some EIA contracts allow the insurer to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurer subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, returns could be adversely affected.

**Averaging**

Some equity-indexed annuities average the index (called averaging) based on the indexed-linked returns during the entire period rather than simply subtracting the beginning point from the end point. Averaging can protect consumers from index crashes or greatly fluctuating indexes. As is always the case in averaging, the highs and lows are smoothed out. While it does smooth out the peaks and valleys, there is the risk that some return will be lost, especially if highs outnumber lows. Averaging methods will vary. Some companies average daily, while others average monthly. The National Association of Securities Dealers (NASD) mentions in their brochure titled *Equity-Indexed Annuities – A Complex Choice* that averaging could reduce earnings. They also state a major challenge when buying an equity-indexed annuity is understanding the complicated methods used to calculate gains in the index the annuity links to. Returns vary more than a traditional fixed rate annuity but not as much as a variable annuity (equity indexed annuities are not variable annuities; they are fixed annuities). Because of the minimum guaranteed interest rates EIAs have less market risk than variable annuities.

**Caps**

Some equity indexed annuities will have caps. In other words, returns are capped or limited. Usually caps are stated as percentages; these are the highest rates of interest that can be earned. If the product’s index gained 9% but the cap was set at 6%, then 6% would be the most the investor could earn. Not all equity indexed annuities will have a cap, but it is something that agents and investors must be aware of.

Caps absolutely do affect how these products perform but that doesn’t necessarily mean investors must totally avoid them. Annuities with caps may have other features the investor wants, such as annual interest crediting or the ability to make penalty-free withdrawals. Caps often allow insurers to offer other benefits, such as higher interest rates. A professional agent will help the investor to decide whether it is better for their particular situation to have higher participation rates or higher caps.

The most common caps are annual caps and monthly caps but products vary so agents must view each contract individually. Some contracts allow the issuing insurer to change
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caps based on specific market conditions. If this is the case, investors need to be aware of the fact.

Spreads, Margins and Administrative Fees

Some products will deduct a percentage from the gains in the form of various fees. The percentage could be in addition to or in lieu of participation rates or caps. The fees may come under different names, such as spread, margin or administrative fee. These are not the only names it may come under, but they are the most common. The fees may be in addition to or instead of a participation rate. For example, an EIA might charge a 2% per year spread from the index-linked return. Figuring the cost over time can be difficult or at least complicated, but over ten years, with the index performing at an average of 12% per year, there would be a 2% loss, so earnings would be 10% rather than 12%. This is a simplification, but it does give the reader an idea of how it works.

Returns

Equity Indexed annuities will be linked to such things as the stock market, but that does not mean returns will directly reflect a stock market purchase. EIAs are linked to the performance of the index – not to the actual stocks that the index is based upon. As a result, the annuity does not give credit for dividends that could have been reinvested if the actual stocks had been purchased. The NASD states that most equity index annuities only count equity index gains from market price changes, excluding gains from dividends. An investor that is not earning dividends will not therefore have the same gains he or she would have if he or she had directly invested in the stock market. On the other hand, the investor also will not experience some of the losses that would have occurred with directly investing in the stock market. Those who oppose investing in EIAs will point to this potential loss of growth, while those who support EIAs will point to the protection from principal risk. The investor is trading the dividends that might have occurred for their safety of principal. There is no investment that will be ideal. High risk means potential high loss; low risk means less earnings.

The NASD states that most equity index annuities only count equity index gains from market price changes, excluding gains from dividends.

Most equity indexed annuities use something simple, such as the S&P 500 and do not take into account reinvested dividends. While the loss in value of reinvestment of dividends can be significant, especially over a number of years, those who invest in these types of annuities are typically more concerned with the safety of their principal and are, therefore, willing to earn less. Even without reinvested dividends, indexes still perform pretty well. EIAs usually they do better than certificates of deposit or bond rates, although that is certainly not guaranteed.
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It should never be assumed that every client will appreciate the benefits of equity indexed annuities, especially if higher earnings are important to them. It is always a question of suitability and risk. Those who want higher earnings will probably not be happy with EIAs; such investors will probably want to benefit from dividends for example. Some advocates argue that the loss of reinvested dividends is offset by the annual reset (ratchet) annuities that credit the index return with only a zero in negative years. However, many feel it is unwise to push any investor into any vehicle that they seem unsure of.

There are variables in equity indexed annuities; all products are not identical. For example, an EIA that is back-tested does not ensure financial performance. Back-testing means that the annuity was tested against historical returns, perhaps as far back as twenty years. Future performance will not always mimic past performance. We have seen our markets change dramatically and they are likely to remain unpredictable. Additionally, there is no guarantee that the back-testing is reliable since reliability is often determined by those doing the testing.

Back-testing can help to illustrate the annuity, so it is not without merit. However, agents and investors must remain aware that past performance does not guarantee future performance. Professionals generally prefer the use of Monte Carlo analysis, which uses multiple samplings of random hypothetical market returns. This may present a more accurate visualization of the product and will not leave a false impression of how the annuity is likely to perform.

Indexing Formulas

Equity-indexed annuities credit earnings differently than other fixed rate annuities. Where traditional annuities state a rate of interest and then apply those interest earnings at specified intervals, an EIA calculates its return against the index to which it is linked. This is called the indexing method. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any is earned, is calculated and credited. With traditional fixed annuities, interest gains are always earned, although how they are credited may vary. EIAs do not necessarily have interest gains, since they are based on the indexing method. The indexing method, or formula, decides how the additional interest, if any, is calculated and credited. The amounts earned, and when they are paid, depend on the contract features.

There are multiple formulas for indexing, with new methods appearing regularly. As a result we will not attempt to describe indexing formulas. New methods often are developed with the hope of attracting consumers, but in the end the amount earned is going to depend upon the performance of the index that is used. Even professional
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analysts cannot accurately speculate on market performance over several years and annuities are long-term investments.

Many investors find having multiple equity-indexed annuities, with each using a different indexing method, advantageous. By purchasing EIAs that use different indexing methods, the investor is likely to end up with good average performance between the various annuities. Additionally many investors consider having multiple EIAs as a means of diversifying their annuity portfolio. Some indexing methods work better under some conditions, and worse under others. Diversification prevents being affected adversely with no other annuity investment to offset the adverse conditions.

Some of the new equity-indexed annuities allow several indexing methods. The designated indexing method on these annuities can be changed at certain times, usually on anniversary dates. These allow consumers to select their indexing method at the time of purchase. Some of the newer EIAs allow consumers to use several indexing methods simultaneously, allowing investors to do with one contract what usually requires several to achieve.

Some equity-indexed annuities will allow the investor to see their progress (or lack of it) at specific times, usually annually. These annuities have “reset” features that lock in gains on some specific basis, such as once per year so that the investor knows whether he or she gained during the year. Generally EIAs held to maturity do not lose principal, but that does not mean it is guaranteed to have gains. Other equity-indexed annuities do not have the ability to see what returns are until the EIA has run its entire term, which may be many years after purchase. Investors who want to be able to view their returns should choose a reset product.

**Annual Reset Indexing Method**

For investors wishing to see their returns annually the annual reset indexing method is typically the best choice. Annual reset EIAs usually looks at the index at the end of each contract anniversary date and locks in gains made as of that date. This is called the annual reset method or may be referred to as the ratchet method. Under this method the gains posted at the end of the year (or at whatever point is in the contract) will remain even if the index goes down later. The ratchet method compares the changes in the index from the beginning to the end of the year, with declines being ignored. The advantage is a gain that is locked in each year. The disadvantage is the possibility of lower cap rates and participation rates that might limit the amount of available gains.

Under annual reset indexing methods it is possible that there will be no gains.

Under annual reset methods it is possible that there will be no gains. If the index declined from the previous year, the contract simply credits zero for that period. In the
next contract anniversary year there is then no place to go except up. The previous period’s end value for the index (not the annuity value) is used as the starting point for the new period, meaning that each period is looked at individually. It does not matter whether there were gains in previous contract years and will not matter in coming years what gains, if any, were given in the current year. Although there may be a lower contract cap rates and participation rates, investors choose this method for the locked in gains, meaning current profits will not be lost to bad years that may come in the future. Even if the stock market were to crash, any past gains are retained in the annuity values.

Investors often do not mind the lower cap and participation rates because they feel they will be offset by the fact that negative years result in zeros rather than value losses. While we would all like to see our investments increase in value we also do not want to lose values. A zero gain is better than an investment loss.

**High Water Mark Indexing Method**

Another indexing method is the high water mark method. It compares the index at various periods during the contract to the index level at the beginning of the term. Although the time periods can vary, typically the contract’s anniversary date is the time measure used. The high water mark indexing method takes the highest of these values and compares it to the index level at the start of the term. While the investor may be credited with more interest under this method than other indexing methods and receive protection against declines in the index, the disadvantage is that the investor may not receive any index-link gain at all if he or she surrenders their EIA early. That is because interest is not credited until the end of the contract term; if the contract is surrendered early, the contract term was not reached. Some of these contracts will still give the investor interest based on the highest anniversary value to date under a vesting schedule. Some high water mark indexing contracts might impose lower cap rates and participation rates. As always, it is important for investors to know and understand all policy terms. Certainly agents must know this as well.

If it were not for participation rates and caps, the high water mark indexing method would give investors the highest risk-adjusted returns of any indexing method, but of course there are caps. It is also important to realize that only the highs reached at the comparison periods count (usually policy anniversary dates). If a high is reached midway they will not apply. For example:

A contract is issued on June 1, 2000.
On June 1, 2001, the index had increased by 12 percent.
On December 15, 2001 the increase rose to 42 percent.
By June 1, 2002 it was down to 10 percent.

Because only the anniversary dates apply, the 42% index rate will not apply. Over the next ten years the percent at the anniversary date will be calculated. At the end of the ten
year term, the investor will receive the highest point recorded on an anniversary date during the term of the contract, up to any applicable participation or rate caps. It is not unusual to have a participation rate that is less than 100%.

**Point-to-Point Indexing Method**

The point-to-point indexing method compares the change in the index at two distinct points in time, such as the beginning of the contract and the end of the term. Although the investor may enjoy a higher cap and participation rate, which credits more interest, the disadvantage is that it relies on a single point in time to calculate interest. As a result, even if the index that the annuity is linked to is going up steadily during the contract’s term, if it happens to decline dramatically on the last day of the term, than part or all of the earlier gain can be lost. Since gain is not credited until the end of the term, the investor may not receive any index-link gain if the policy is surrendered prior to the end of its term.

**To recap**, the point-to-point index-linked interest, if any, is based on the difference between the index value at the end of the term and index value at the start of the term. Interest is added at the end of the annuity’s term.

Even though point-to-point contracts offer the potential for the best long-term returns the disadvantage is the inability to gauge the contract’s performance until the end of the contract’s term, which could be anywhere from five to ten years. Until that time, the growth will appear to be zero even if the market is significantly up. If the annuitant dies during the term, for purposes of measuring contract performance, the date of death will be used as the end of the term.

The point-to-point method may be best for the longest-term EIAs since we can expect the best gains over the longest period of time. However, since the ending value is based upon that specific point in time, a sudden or unexpected downturn could prove detrimental to the contract’s final value.

Some point-to-point indexing contracts charge a spread, stated as a percentage, per year. Others may limit participation to less than 100% or impose caps. The contract may limit or alter the way the means of crediting based on point-to-point. They may use the end point to average the index over the term of the contract and credit interest on a compounded basis based on the average rate, less some stated percentage defined in the contract. As always, all contracts should be fully understood by the selling agent and the investor.
Multiple EIAs with Diversified Indexing Methods

Diversification is not a new idea; agents and professional planners have been advocating that for years. Annuities may also be subject to diversification, which is something many investors may not have previously considered. Obviously we cannot know in advance which annuity indexing method will perform best over the coming years but investors who purchase several types of annuities are bound to average out their earnings. This is especially true of equity-indexed annuity types. Some indexing methods will do better in volatile markets and others will do best in steady markets.

Many professionals feel the indexing methods of the EIAs are not nearly as important as other issues and features, such as selecting highly rated insurance companies. While this is true, it is still important to understand the indexing feature chosen. Also important is choosing a product with competitive interest rates, participation rates, caps and other features. By purchasing several different EIAs with several different features the investor may minimize lower earnings due to market trends. Even professional investors realize that it is not possible to guess which indexing feature will perform best in the coming years, since it will depend upon how the markets perform. Therefore, buying different annuity products with different indexing methods is a good way to diversity within the annuity market.

Whatever annuity products are selected, they should be purchased from different insurers so that there is diversification of insurance companies. Of course, all companies should carry no less than an A rating from A. M. Best company.

Withdrawing Annuity Funds

Most insurance agents are probably familiar with the “income for life” ability of annuity products. Under this method, the investor can select to receive income for the duration of his or her life; they have an income that they cannot outlive. However, there is no guarantee as to the actual amount of lifetime income. Obviously if the investor saves too little in the annuity product, the amount of income stream may be very small (too little to actually support their income needs). Therefore, the first and most important aspect of saving is to save adequately. Still saving something is better than saving nothing, so even if the individual knows the amount they are setting aside is inadequate that does not mean he or she should abandon saving altogether.

Ideally each citizen should begin setting aside money from the time they first receive a paycheck, regardless of how young he or she may be. Parents are wise to encourage the act of saving a percentage of income from the very first check a child receives for his or her birthday or other occasions from Grandma and Grandpa. Establishing this financial trait is one of the most important gifts a parent can bestow upon their child since it sets up a habit that will benefit their children for the remainder of the child’s life.
Payout Options

Annuities are designed for pay-out after age 59½ since the Internal Revenue Service considers them to be retirement designated vehicles. They may still be used for other goals, but primarily they are considered retirement vehicles. Although annuities were designed for payout, they are overwhelmingly used for accumulation. In other words, the majority of annuities are not annuitized (turned into an income stream). Instead most investors accumulate funds in their annuity, and then simply withdraw the entire value or exchange it tax-free for another annuity, with the accumulation process starting over again. Often annuities are simply left intact year after year, eventually going to heirs.

Even though most annuities are not annuitized for systematic payout, it is always important for agents and their clients to understand the available payout options. When annuities were created the issuers assumed lifetime income would be primarily used. They were designed to pay a specified amount, based on the total dollars in the annuity, for the remainder of the annuitant’s life, regardless of how long he or she lives. Under this arrangement, beneficiaries receive nothing even if the annuitant happens to die soon after annuitizing the contract.

For example:

Annie Annuitant and Alvin Annuitant each have an annuity in their name of equal value (for this example let’s say each Annuitant has $50,000 in their annuity). Annie and Alvin both choose lifetime income when they annuitize their contract and each receives the same amount each month. Just to keep it simple, we will say that each Annuitant receives $1,000 per month (the actual figure might be far different, based on the age of each Annuitant and their “life” expectancy).

Alvin begins receiving his $1,000 per month on January 1. In June of that same year he becomes very ill, eventually dying three months later in September. Alvin received a total of nine annuity payments totaling $9,000. The remainder of his annuity ($41,000 plus accrued interest) will stay with the insurer that issued the policy; Alvin’s heirs will receive nothing.

Annie also begins receiving $1,000 per month on January 1 just as Alvin did. However Annie Annuitant lives to a very old age. She eventually receives every penny of the $50,000 in her annuity, but she continues to receive the $1,000 monthly payment even though her own funds have been depleted (that’s what “income for life” means). By the time Annie eventually dies she has received $75,000 from her annuity contract. As a result, the insurance company paid out $25,000 more than it received. However, the company also retained $41,000 from Alvin so the insurer still made a profit based on these two people.
Insurance companies use analysts to determine expected longevity of their policyholders because their goal is always to earn a profit. While it is not possible to know for sure how long each person might live, there are indicators that suggest the likelihood of longevity. Alvin’s beneficiaries are likely to be unhappy about the loss of the remaining $41,000 but Annie’s family will be very happy to see how her annuity paid out.

Once an annuity contract is annuitized it cannot be changed; the annuitant or policy owner cannot change their mind down the road. Usually the point of no return is when the first annuity payment is cashed, or if a direct deposit is used, the date the check is deposited. Each contract may vary so it is important to consult the actual policy for details. Since the payout option is locked in agents must be certain their clients understand the advantages and disadvantages of each payout option.

It is very important to realize that all annuities may not necessarily offer all payout options. If a particular payout option is important to the buyer, he or she will want to specifically examine the available payout options listed in the policy. Any questions should be addressed prior to purchasing the annuity.

**Nonhuman Payees Under a Settlement Option**

Many contracts require the payee under a settlement option to be a human being, meaning they will not make payments to an entity such as a business. All settlement option payments during the life of the contract owner are typically made by check to the primary payee or by electronic transfer directly into their bank account.

**Lifetime Income Payout Option**

Different contracts may call lifetime income by different names, such as “Life only”, “Annuitant Lifetime”, “Straight Life” or other similar names. In each case, a definition will be in the policy. As discussed, annuities were designed to provide a systematic income at some point in time. When a policy owner annuitizes their contract, surrender penalties will not apply even if the contract is still in the early years of the surrender period. Annuitization is the process of beginning systematic payments to the annuitant. Some EIAs allow the investor to vary the frequency and amount of the payout to meet the investor’s particular needs. Other than surrender charges, which are waived if the contract is annuitized, the only real limitation regarding payments applies to taxes. It is necessary to wait until the attained age of 59 ½ to avoid a 10% early distribution federal tax.

One of the most important benefits of deferred annuities is the ability to use the built up values during the accumulation period to provide income during the payout period. Income payments are typically made monthly, but it is possible to choose some other systematic time period, such as quarterly or even annually. Annually may allow the investor the ability to pay debts that occur only once per year, such as property taxes or
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some types of insurance (long-term care insurance for nursing home coverage for example).

It is very important that annuitants and annuity contract owners realize that the lifetime income option does not consider beneficiaries. However, since the insurer does not have to consider beneficiaries the payout option is often higher. In other words, the systematic payment to the annuitant will be higher because, as in Alvin’s case, the insurer will keep any unused funds.

Life Annuity, Period Certain Payout Option

The Life-Annuity-Period-Certain option will pay the annuitant less in each systematic payment than would have been received under the Lifetime Option. That is because there is a specified time period involved (Period Certain). Under this payout option the annuitant is guaranteed to receive a specified amount, as determined at the time of annuitization, for his or her lifetime regardless of how long he or she lives. The annuitant is also guaranteed that if he or she dies prior to the stated time period his or her heirs will receive the remainder of the funds.

In Alvin’s case, if he had chosen this option, he would have received less each month; he might have received $750 each month rather than $1,000 for example. If he chose a ten-year period certain his beneficiaries would have received the remaining $41,000 because he did not reach the selected ten year time period. The time period does not have to be ten years of course; the period of time will depend upon what is selected at the time of annuitization. Many insurers will offer a variety of time periods, perhaps 5, 10, and 15 year periods. The amount of money received on a systematic basis will reflect the “period certain” selected. The longer the “period certain” the less the annuitant will receive as income each month. That makes sense since the insurer increases its risk when longer periods are selected that guarantee beneficiaries will receive remaining funds. Once the guaranteed period (period certain) expires beneficiaries will no longer receive any remaining funds.

If the annuitant dies during the period certain, his or her beneficiaries will receive the remaining funds based on contract language. In other words, the contract may state that a lump sum will be paid to the beneficiaries or it may state that the beneficiaries will continue to receive funds as the annuitant would have based on his or her income selection. In Alvin’s case he was receiving monthly income (the most common selection) so his beneficiaries would continue to receive monthly installments if that was the beneficiary terms of the contract. Many contracts allow the beneficiaries to make their own choice between two or three options, including a lump sum distribution.

Joint-and-Last-Survivor Payout Option

When there are two people in the household, such as husband and wife, the joint-and-last-survivor payout option is often selected since it pays an income to two named
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individuals. Of course they are not required to be husband and wife, but that is commonly who uses this payout option. Since two people are guaranteed a lifetime income it is not surprising that the monthly installments are less for two people than they would be for a single individual. In some annuity contracts utilizing this payout option, the amount of systematic income is reduced upon the death of the first named individual; others continue paying the same amount. Some contracts offering this payout option will give a refund to heirs if both named individuals die within a stated time period. If this is the case, the payout option might be called Joint-and-Last-Survivor-Period-Certain. As with other payout options, there might be variances in the name the contract uses, but they will be similar enough to the name we have used that there should not be any confusion. As always, the contract definitions will also state how the payout option works so agents and insureds should refer to their policy.

**Required Distribution**

Most annuities have some point in time when the contract must be annuitized or closed. The contract may be closed simply by withdrawing all funds. Mandatory distributions will be after the surrender period has expired, so such penalties will not apply. If the annuitant has not reached age 59½ the IRS early distribution penalty would apply on any funds that were withdrawn.

Annuitants and contract owners could choose to simply roll the annuity into a new contract, which would meet mandatory distribution requirements of the contract but avoid any IRS penalties. If the annuity was rolled into a new annuity contract new surrender periods would begin, since most annuities have them.

Unfortunately some equity indexed annuities have mandatory annuitization, whether the investor wants to or not. Generally financial advisors recommend against buying these products.

**Financially Sound Insurers**

One of the first investment considerations must be the entity selected to deposit funds with. Whether the investor is buying an annuity, a Certificate of Deposit, or simply opening a Christmas club account, the sponsoring organization’s financial strength (or lack thereof) should be considered.

When selecting an annuity product, the sponsoring organization is always an insurance company. Whether the product is bought at the investor’s local bank, from an insurance agent, or just online annuities are always issued by an insurance company.

For equity indexed annuities, once the product is past the surrender period the only way to lose money is if the sponsoring insurance company becomes insolvent. Obviously no investor wants to be with an insolvent company. Guaranteed return is only as good as the
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entity sponsoring the investment; in the case of annuities that would be an insurer. Luckily most annuity insurance companies do not become insolvent, but it can happen. Historically annuity companies seldom fail. Other investments are far more likely to experience insolvency than annuities. As a result of the rareness of annuity insolvencies even critics of annuities seldom mention the possibility. Even so, it is important to utilize only financially secure insurers because even a very small chance of failure is important.

There are distinct differences between variable annuities and equity indexed annuities. EIAs are not backed by segregated reserves or specific assets, as variable annuities are. The EIA investor does not own the index, index shares, or stocks comprising the index. Equity indexed annuities are contracts. EIA investors own those contracts, which promise to pay money in the future from its general assets. Sound familiar? That is basically what life insurance policies are: contracts that promise to pay funds in the future if the insured dies during the term of the policy. Although equity indexed annuities are not life insurance they are both contracts promising future payments. EIAs are backed by the assets of the annuity company (not just specific assets or specified pools of assets), which explains why it is very important that only financially secure companies be selected. EIAs are roughly comparable in their safety to money-market funds according to Jay D. Adkisson, JD, author of Equity-Indexed Annuities: the Smart Consumer’s Guide.¹

¹ iUniverse, Inc. New York Lincoln Shanghai, Copyright 2006
The following are rating companies and their statements about themselves:

**A.M. Best Company**
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Where no rating has been assigned or where a rating has been withdrawn, it may be for reasons unrelated to the creditworthiness of the issue. No assigned rating may be for one of the following:
1. An application was not received or accepted.
2. The issue or issuer belongs to a group of securities or entities that are not rated as a matter of policy.
3. There is a lack of essential data pertaining to the issue or issuer.
4. The issue was privately placed, in which case the rating is not published in Moody's publications.

Withdrawal may occur if new and material circumstances arise, the effects of which preclude satisfactory analysis; if there is no longer available reasonable up-to-date data to permit a judgment to be formed; if a bond is called for redemption; or for other reasons.

Changes in Rating
The credit quality of most issuers and their obligations is not fixed and steady over a period of time, but tends to undergo change. For this reason changes in ratings occur so as to reflect variations in the intrinsic relative position of issuers and their obligations.

A change in rating may thus occur at any time in the case of an individual issue. Such rating change should serve notice that Moody's observes some alteration in creditworthiness, or that the previous rating did not fully reflect the quality of the bond as now seen. While because of their very nature, changes are to be expected more frequently among bonds of lower ratings than among bonds of higher ratings. Nevertheless, the user
of bond ratings should keep close and constant check on all ratings - both high and low - to be able to note promptly any signs of change in status that may occur.

**Limitations to Uses of Ratings***

Obligations carrying the same rating are not claimed to be of absolutely equal credit quality. In a broad sense, they are alike in position, but since there are a limited number of rating classes used in grading thousands of bonds, the symbols cannot reflect the same shadings of risk which actually exist.

As ratings are designed exclusively for the purpose of grading obligations according to their credit quality, they should not be used alone as a basis for investment operations. For example, they have no value in forecasting the direction of future trends of market price. Market price movements in bonds are influenced not only by the credit quality of individual issues but also by changes in money rates and general economic trends, as well as by the length of maturity, etc. During its life even the highest rated bond may have wide price movements, while its high rating status remains unchanged.

The matter of market price has no bearing whatsoever on the determination of ratings, which are not to be construed as recommendations with respect to "attractiveness". The attractiveness of a given bond may depend on its yield, its maturity date or other factors for which the investor may search, as well as on its credit quality, the only characteristic to which the rating refers.

Since ratings involve judgments about the future, on the one hand, and since they are used by investors as a means of protection, on the other, the effort is made when assigning ratings to look at "worst" possibilities in the "visible" future, rather than solely at the past record and the status of the present. Therefore, investors using the rating should not expect to find in them a reflection of statistical factors alone, since they are an appraisal of long-term risks, including the recognition of many non-statistical factors.

Though ratings may be used by the banking authorities to classify bonds in their bank examination procedure, Moody's ratings are not made with these bank regulations in mind. Moody's Investors Service's own judgement as to the desirability or non-desirability of a bond for bank investment purposes is not indicated by Moody's ratings.

Moody's ratings represent the opinion of Moody's Investors Service as to the relative creditworthiness of securities. As such, they should be used in conjunction with the descriptions and statistics appearing in Moody's publications. Reference should be made to these statements for information regarding the issuer. Moody's ratings are not commercial credit ratings. In no case is default or receivership to be imputed unless expressly stated.

*As set forth more fully on the copyright, credit ratings are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor
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in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, selling or holding.”

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In doing so, Weiss Ratings will adhere to the highest ethical standards by maintaining our independent, unbiased outlook and approach to advising our customers.”

Each rating company will have their own rating method so agents and investors must take time to understand how the ratings apply. Some professional financial planners have favorite rating companies, but generally it is recommended that agents consult more than one company. Each rating company will give their interpretation of the insurer’s strength and weakness.

Equity indexed annuities will have some elements in their contracts that can be changed periodically as the insurer deems necessary to protect itself in adverse markets. This element may cause varying financial reports by the reporting companies. More importantly, a company that seems to regularly make changes in its favor to the detriment of their clients should be avoided. Although most EIAs have this ability to change various elements of the contract, by consulting the past history of the insurer it is possible to achieve some idea of what may happen in the future. There are no guarantees but past performance may give some idea of future performance.

Is the Product Suitable?

Many states have mandated suitability standards for annuities because there have been errors made in the past. Most agents intend to do a good job for their clients but unfortunately some agents did not understand whether or not the annuity was suitable for their client’s financial situation. By mandating suitability standards (and in some cases special suitability education) the state insurance departments hope to avoid errors that may cause financial harm to its citizens. Suitability standards provide guidelines for agents who may not otherwise understand how to determine product suitability.
Insurance product suitability may be a matter of opinion, in the absence of state mandated criteria. Advocates of equity indexed annuities may feel that there are no bad EIAs while critics may feel there are no good EIAs. Aside from extreme opinions, while there are no “good” or “bad” products there are certainly situations that are suitable and unsuitable, based on a particular person’s circumstances. The goal of the agent is to determine if his or her particular client’s situation would benefit from an equity indexed annuity. If it would not, then the product may not be suitable.

The agent’s goal is to determine if his particular client’s situation would benefit from an equity indexed annuity. If it would not, then the product may not be suitable.

There are several elements that determine whether or not a product is suitable, including the individual’s risk tolerance, financial needs, cash reserves, and personal or financial goals. In some cases, it is obvious that the equity indexed annuity is not suitable. As we know (or should know by now), there is no product that is always right for every investor. It is misleading to compare one annuity product to another if the features each offer is different. We often hear this stated as “comparing apples to oranges.” Each is a fruit, but the differences are so great that they cannot be adequately compared. The same is true for some types of annuities.

Agents must stress that it is not possible to predict how the markets will perform in the future. Even looking at past performance seldom offers guidelines, as we have witnessed over the last few years. Unfortunately clients often blame their agents when investments perform poorly, so it is in the agent’s best interests to have a written statement regarding the inability to make predictions. This statement should be signed at the time an annuity is purchased and kept by the agent in the client’s file. Consider this signed statement future protection if the client or his or her family becomes dissatisfied with the investment’s performance.

Agents must ask their clients to consider several questions when considering the appropriateness or suitability of an equity indexed annuity (or any annuity for that matter). The following questions are not inclusive, but they are likely to be among the necessary questions to ask:

1. What is the soonest date the investment money will be needed? In other words, when will the money need to be withdrawn for daily living requirements?
2. Will annuitization be an option or does the investor think he or she will want to withdraw the investment as a lump sum?
3. Depending upon the date of withdrawal, could the surrender penalties be imposed if funds were withdrawn and the policy surrendered (not annuitized)?
4. Does it seem likely that withdrawals will be needed that are larger than any “free withdrawals” allowed under the annuity contract? This relates to any insurer imposed surrender penalties.
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5. How old does the investor expect to be when funds are withdrawn? This relates to the IRS penalty if funds are withdrawn prior to age 59 ½.

6. What is the intended use of the annuity investment?

7. Is the investor more interested in the highest possible gains or in preservation of principal? This relates to risk tolerance.

8. It is not possible to have both the highest rate of return and little or no investment risk. Does your client understand this?

When agents ask these and similar questions of their clients their focus should be on the most adverse possibilities. For example, if the investor thinks he or she may need large withdrawals during the surrender phase of the contract it is likely that an annuity, of any type, may not be suitable for their personal circumstances.

Investors and agents should never simply assume liquidity will be available somewhere, such as home equity or amazing investment growth. Taking the optimistic view does not comply with product suitability requirements. Any investor that does not have sufficient liquidity for the surprises in life should not invest everything in an annuity; enough cash reserves should be retained in a liquid account of some kind. This is true for all investors of all ages. We all need an emergency account that can be easily accessed.

Annuities are often used to pass wealth on to heirs, such as children and grandchildren, but many financial managers feel that goal is better served with a life insurance policy. This might be true even if the money in the annuity will not be needed at any future date. The life insurance policy should be held outside of the estate to minimize delays in distributing funds. These issues should be discussed with a qualified financial planner of course, so that the best avenues are utilized.

Equity indexed annuities are complex; if the selling agent feels the concepts are not well understood by the investor it could prove foolish to still initiate an application for the product. Perhaps a traditional fixed annuity would be better understood than an equity indexed annuity. If so, that would be a better product to place with the investor. Agents should never place a product that is not adequately understood and accepted by the investor.

Annuities are considered long-term investments, which includes equity indexed contracts. Never should excessive funds be tied up in long-term vehicles. Even when the investor does not expect to need the funds it is impossible to predict future circumstances. The investor could lose their job, experience an uncovered medical emergency or simply need a new refrigerator. All adults need an emergency cash fund that is easily accessible on short notice.

A criticism of equity indexed annuities is their complexity. In fact, even many agents avoid presenting them purely due to lack of understanding. They are right to avoid
marketing them if they are not understood since agents must understand the contracts they are selling.

Even advocates of equity indexed annuities admit that they are more complex than most other types of annuities. Since EIAs are not all the same, an understanding of one EIA product does not guarantee understanding of all EIA products. Although the basic concept may be understandable, that does not automatically mean the agent (and investor) understands the individual products being marketed. Even experienced financial planners often have to read the actual equity indexed annuity policy to gain an understanding of how the individual product performs. Certainly agents must read and fully understand any product they plan to present to consumers.

Suitability issues seem to arise for some basic reasons, including (though not limited to):

1. The agent believes he or she understands the equity indexed annuity product but does not know how to convey the terms and limitations to their clients, so they adopt a “trust me” mythology when selling them.

2. The agent realizes he or she does not understand the “details” of the product but believes the details are not important enough to worry about and markets the product anyway.

3. The agent mistakenly believes he or she understands the product they are selling. Even though it may result in an unintentional agent error, the end result can cause great financial harm to the investors. Financial harm often results in lawsuits.

4. When investors clearly misunderstand how a product works, only a fool will sell the product anyway. When agents know their clients have misunderstood an EIA under no circumstances should the product be placed until the investor’s error is corrected.

Just because an investment product, such as equity indexed annuities, are complex does not necessarily mean they should not be sold. Most agents will never understand all the small details of EIAs but if they understand the mechanics well enough to relay a full understanding to their clients that will likely be sufficient. The point is to understand the ups and downs well enough so clients do not get nasty surprises later on. Certainly a full and complete understanding is best, but an understanding that allows products to be sold safely is also generally acceptable. Many agents will gain a full understanding of just one or two equity indexed annuities and sell only those particular EIA products. This prevents any harm done to their clients as long as suitability standards are observed.

It is likely that most equity indexed annuities are marketed by annuity specialists that primarily sell only these products; they probably do not sell nursing home insurance, major medical insurance, and perhaps do not even sell life insurance products. Their focus is on annuities of various kinds. That allows these agents to become knowledgeable to a greater extent than agents that market various products. Insurance is fast becoming
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an industry of specialists. First we saw specialization in long-term health care products and now we are seeing the same thing happen in the annuity field.

It is likely that most equity indexed annuities are marketed by annuity specialists that primarily sell only these products; they probably do not sell nursing home insurance, major medical insurance, and perhaps do not even sell life insurance products.

The states have a very difficult job. They must attempt to eliminate use of the “trust me” technique to place annuity products regardless of client suitability. It is doubtful that the states will ever be able to completely eliminate unethical agents but with required suitability standards the states at least have an avenue to punish those who refuse to act ethically.

Every product has advantages in the right circumstances and disadvantages in the wrong situations. The goal is to place products where they are most likely to be advantageous for the investors.

There will always be annuity critics, although many of them disappear during difficult financial times. When the markets are performing well annuities are criticized for their low returns and lack of liquidity but when the markets are down those same critics often praise the safety of annuity products.

There is no question that annuities are long-term investments and, as such, lack liquidity. Large early withdrawals – prior to the end of the surrender penalties – will also result in loss of principal due to penalties. Therefore, large withdrawals are not suggested during the surrender penalty years. Many products allow smaller withdrawals during the surrender penalty years without any insurer fees however. All annuity investors must be aware of the Internal Revenue Service penalty of 10% on withdrawals prior to age 59 ½, called early withdrawal penalties.

It is due to these early withdrawal fees, both from the IRS and the insurer, that make it theoretically possible for equity indexed annuities to lose money. According to NASD, the guaranteed minimum return for an EIA is typically 90% of the premium paid at a 3% annual interest rate. If, however, the investor surrendered his or her EIA early, he or she could end up paying a significant surrender charge and a 10% tax penalty that would reduce or even eliminate any returns.

Since many EIA products only guarantee a return of 90% it is possible to lose money on equity indexed annuities, whereas traditional fixed rate annuities guarantee 100 percent of the amount deposited into the annuity product. Obviously one way to avoid this is to look for equity indexed annuities that guarantee 100% of the premiums paid.
Some equity indexed annuities do not pay earnings until maturity, which is usually the point at which the surrender penalties end. In other words, some contracts will not credit the annuity with the index-linked interest if it is surrendered early.

As we have repeatedly said, *equity indexed annuities are intended to be long-term investments*. They are typically not suitable for short-term use. In most cases, investors may take all or part of the money at any time but there is likely to be a cost for doing so. The cost may be stated as a dollar amount, a percentage, or as interest earnings. The greatest disadvantage of an equity indexed annuity is their significant surrender charges, especially during the first few years of the contract. It is these surrender charges that allow the insurance companies to make long term investments so they may pay investors the earnings the annuities guarantee. If too many EIA investors pulled their money early the insurers could not earn the returns they need. Surrender penalties, therefore, are used to discourage early withdrawals. Regardless why insurers do this however, the important thing for investors to fully understand is that they must be willing to leave their deposits in the annuity for the number of years stated as surrender penalties in their contracts. Investors must always be aware that the money they deposit in an equity indexed annuity is not for short term use or goals. At all times the investors must have other cash on hand for emergencies that arise. If agents learn nothing else from this course, they must learn to stress the long-term nature of equity indexed annuities with their clients.

If agents learn nothing else from this course, they must learn to stress the long-term nature of equity indexed annuities with their clients.

**It is Not a Liquidity Issue but Rather a Suitability Issue**

Annuities of all kinds are typically long-term investments so the issue is never about liquidity (there is none) but rather it is about suitability. When the topic seems to snag on liquidity it is usually a sure sign that the agent should *not* place an annuity with the investor. Equity indexed annuities are only suitable for those who will not need to withdraw significant sums during the contract term. Even small withdrawals should not be an issue when addressing product suitability. Withdrawals prior to the equity index annuity term should never be a goal – period. Therefore product liquidity requirements simply tell the agent that the EIA is not suitable for the buyer.

Although some EIAs may have provisions for withdrawals under specified conditions, such as medical need, if the investor has set aside sufficient liquid reserves (outside of any annuities purchased) even that should not be a topic. Agents and financial planners should assess liquid reserves prior to determining EIA suitability – prior to suggesting buyers consider an equity indexed annuity.

Some investors tend to be spenders and will spend funds if they are available, even if set aside for other purposes. Such people have difficulty maintaining emergency cash funds...
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because they are constantly removing the funds for other purposes. For such individuals an EIA might seem attractive because they are long-term, illiquid financial vehicles. The lack of liquidity may seem beneficial as a result. When consumers look for financial vehicles that prevent them from removing funds this is known as lockboxing, but many are skeptical of using EIAs in this way. If the investor cannot maintain an emergency fund he or she may access their equity indexed annuity anyway so the illiquidity is not ultimately a successful deterrent.

There are circumstances where lack of liquidity is an advantage. This might be true for an individual that needs money kept out of reach, and will not access the EIA on a whim. For example, an inheritance that is not needed for daily living costs or emergencies might do well in an equity indexed annuity. This might especially be true for investors who are behind on saving for retirement security.

Generally speaking, creditors cannot access funds in an equity indexed annuity so, for some people who are having credit issues, the inaccessibility of EIAs might prove to be an advantage. Creditors can usually access such things as bonds, stocks or mutual fund shares, which would have to be sold at current market value even if that means a loss. Not all states offer creditor protection for annuities so investors should seek legal council. It might even be prudent to establish residency in a state that does offer protection for funds placed in annuities. In such states creditors would never be able to get access to annuity funds (sometimes even annuity payments may receive protection from creditors). Seldom would an annuity be protected from Internal Revenue Service claims however. If this is a threat we would recommend that legal council be sought.

A Comprehensive Financial Plan

It is unlikely that any one type of financial vehicle would be sufficient to comprise a fully adequate financial plan. Equity indexed annuities must be part of a portfolio that considers all types of investment vehicles so that the investor’s goals and aspirations are fully satisfied. Assets must be logically divided among several types of financial vehicles so that the investor’s full needs are met. An agent or financial planner that merely divides the client’s assets among an array of annuities, even if diversified among several indexes and annuity types, is probably not doing an adequate job of protecting his or her clients. Generally it takes several types of investments to appropriately address possible future returns and investment risks.

Most annuities (with the exception of variable annuities) are considered safe financial investment vehicles. Equity indexed annuities could be classified with cash and equivalents such as Certificates of Deposit and money market accounts because they are made up of fixed annuities, which are traditionally safe. The risk is small that the investor will not receive at least the minimum returns. While we would all like to see huge growth, safety of principal is typically the primary concern. The biggest risk is not loose of premium (principal) but rather that the growth will be too small to match or
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exceed the rate of inflation. It is possible that loss of buying power could occur with annuities. In other words, while the principal is maintained the interest earned is too small to maintain the same level of buying power ($100 may only buy 80% or $80 of what it once could buy). This is the same risk that all conservative financial vehicles face. Lower financial risk also means lower rates of interest earnings, so lower rates of growth.

Fixed annuities promise a guarantee that a certain amount will be available at some point in time (depending on contract terms) but they do not promise that the returns will keep up with rates of inflation. Even though equity indexed annuities are not liquid financial vehicles, they do promise that at least the principal will be available at some specified date.

Many investors like to “ladder” their investments, with some coming to maturity each year during retirement or at least during the early years of retirement. Many investors stagger their investments to reach maturity in five-year increments. The goal is to provide continual income during retirement; as one investment is used to fund retirement costs, the next investment matures and takes up where the last investment ended.

For example:

Rachel Retiree has given lots of attention to her retirement planning. She has Social Security income, which is too small to live on, but no pension from her working years. Knowing that she would not receive a pension she saved regularly throughout her working years. With the help of a financial planner she knows approximately what her living costs will be in retirement. The only unknown factor was the rate of inflation so she tried to have more than she thought would be necessary available from her investments. If inflation is greater than anticipated she hopes the “extra” will cover the rising costs of living. On the other hand, if inflation is not as great as she thought it would be she will have extra funds, which of course is what Rachel is hoping for.

In year one of her retirement a Certificate of Deposit matures and is used to fund the first five years of Rachel’s retirement.

In the fifth year of Rachel’s retirement, a fixed rate traditional annuity is annuitized to provide monthly income for the next five years. Because it will pay out all funds over just a five year period Rachel will actually be able to put part of the income into a liquid savings account to cover unforeseen emergencies, such as health care needs or dental costs. This expectation of extra funds may not materialize if inflation soars but if it does not she will be over-funded. Although she could use the extra money for travel or other pursuits Rachel is wise enough to realize the future may cost more than the present.
In the tenth year, when Rachel is 72 years old (she retired at age 62 when she could begin collecting Social Security benefits) an equity indexed annuity matures. This annuity promised better returns than her traditional fixed rate annuity so she chose to have it mature when she was older. She felt it may give her more income at a time when living costs would possibly be higher due to inflation. By this time she also hopes her modest stock investments will have grown sufficiently to produce any additional funds that she might need for such things as higher insurance premiums on her health insurance or medical needs associated with growing older. Rachel knows she took on an extra risk when she chose not to buy long-term nursing home insurance. She felt she would not be able to pay the potentially rising premium rates of such insurance. Rachel hopes she will not need nursing home care even though historically she is likely to, if just from the frailty that comes with aging (especially for women who make up the majority of nursing home residents).

In the 15th year of Rachel’s retirement, when she is 77 years old, her final investment will be utilized, a bond fund. Obviously Rachel does not know how long she will live but Americans continue to live longer than those before them. It is certainly possible that Rachel could live to be 100 years old. She can only hope her money will last as long as she does. Rachel could have chosen lifetime income from her annuities to guarantee funds for as long as she lives. She chose to receive income for shorter periods of time because she felt lifetime payments would be too small to cover her expenses. Rachel can only hope she made the best choices for herself.

While equity indexed annuities might be classified with cash and cash-equals because of their high level of safety they tend to offer some advantages:

- Some EIAs offer a minimum interest rate that could be compared to that offered by CDs and money market funds.

- The interest earned on equity indexed annuities is tax-deferred. This offers a substantial gain over a period of growth years. If withdrawals are taken when the investor is in a lower tax bracket this could be a substantial advantage over other types of investments.

- EIAs offer the ability for equity-like participation in the stock market according to the index linking feature. Obviously money market accounts and certificates of deposit cannot do this. Most financial advisors feel this could offer a greater chance of beating inflation.

It is easy to see why professionals who are familiar with equity indexed annuities might choose them over CDs and money market funds. Still most people tend to keep more money in certificates and money markets than they do in EIAs, probably because so few people really understand and appreciate the features of equity indexed annuities.
Agents may sometimes see equity indexed annuities compared to some types of bonds. Investment returns may be similar, although most bonds do not enjoy the tax deferral that annuities enjoy. Even so, if withdrawals may be needed before the EIA would mature bonds are a better choice for the investor. However, if liquidity is not a concern, it is typically better to invest in the equity indexed annuity because:

- The annuity will be tax deferred; some types of bonds may also enjoy this feature (municipal bonds for example) but they usually have very low returns.
- Bond values can go down if interest rates go up. This would mean holding the bonds to maturity to get the full values from them.
- Bonds are subject to market risks, such as inflation and speculation.
- Equity indexed annuities may do better than minimum rates if the index they are linked to perform well. That would mean better performance than bonds are capable of.

This does not mean that bonds have no place in the investor’s financial portfolio since they do offer liquidity that is not available in annuity products. Bonds are used for liquidity and EIAs are used for long-term performance. Bonds might also be the investment choice if funds will be needed prior to age 59½ since annuities would be subject to IRS early distribution penalties for withdrawal prior to that age. As we previously noted, it is always an issue of product suitability.

There is another difference between bonds and equity indexed annuities: investors cannot wait for EIAs to decline in price and then buy them. Since bonds can go up and down and price, investors might wait for bond prices to go down before they buy them. Equity indexed annuities can only go up in value and have only positive correlations to the asset classes that overlap the index the product is linked to.

Agents and financial planners may sometimes want to compare equity indexed annuities to mutual funds or index shares. Mutual funds are vehicles made up of various stocks. Index shares are stocks that track the index. EIA critics often do not like that the annuities limit participation in returns if the index rises. It is true that the investor would do better with mutual funds and index shares if the index goes up, but what if it goes down? Investors that want to enjoy guarantees typically realize there is give-and-take when it comes to lowered market risk.

EIAs are subject to participation rates, caps and other limitations. Utilizing equity indexed annuities should not mean anticipating higher gains than those stated; instead the investor should only consider the minimum guarantees. Higher gains are merely a plus to the diversified portfolio.

Mutual funds typically have fees and expenses that affect the final performance. That does not mean they should not be part of a diversified portfolio but product costs should
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be considered. Mutual funds carry risks besides fees; managers are not always the best or a good manager may not remain. Managers may take excessive risks, putting the funds in a position to take a loss. Mutual funds are not necessarily tax efficient. Most equity indexed annuities do not have fees or expenses and do not experience annual taxation.

For some investors who track the index mutual funds may be their investment of choice but generally a well rounded portfolio is best. That means having some of many different investments, including annuities.

**Tax Deferred Status**

As every agent knows, annuities enjoy tax deferred status on interest earnings. Taxes are eventually paid, but not during the accumulation phase. When funds are withdrawn, taxes will be due in the year the funds are withdrawn. Basically, taxation will occur when gains are withdrawn, payments begin (annuitization), or the annuitant dies, with the annuity then being distributed to heirs.

Equity indexed annuities are taxed the same way other fixed annuities are. In other words, like other fixed annuities, equity indexed annuities are tax deferred so during the accumulation phase no taxes are due on the interest earnings. When partial withdrawals are taken, interest is considered to be withdrawn first and principal (premiums) withdrawn last. Therefore, taxable gains are the first to be withdrawn and gains would be taxable upon withdrawal. This is called the “last-in-first-out” withdrawal method, often stated as LIFO.

When taxation is delayed, such as happens during the accumulation phase, it allows the financial vehicle to gain more growth because interest is earning additional interest (compound interest in other words). Tax deferral also allows the annuity owner to choose when taxes are paid by waiting until the right moment to make withdrawals. It would make sense to time those withdrawals with a year having lower income. In most cases it also makes sense to obtain tax advice from a tax specialist. He or she can help the annuitant time their withdrawals for the best taxing out come, whether that happens to be a year with less income earnings or when significant deductions exist.

There is also an unfortunate side to the annuity’s tax deferral status: when funds are finally withdrawn they will be taxed as ordinary income (that’s why Roth IRAs are so popular – no taxation upon withdrawal). If annuity growth was taxed as capital gains, taxation rates would be much lower. Of course anything taken out prior to age 59½ will also feel the pinch of the IRS 10% early withdrawal penalty.

When EIA funds are withdrawn they will be taxed as ordinary income.
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Those who simply must find fault with annuities often bring up the fact that gains are taxed as capital gains, which tend to have the highest taxing rates. It really is simply one of the prices investors pay for a secure, low-risk investment. It is important to note that investors should first make maximum payments to such things as Roth IRAs (if they qualify for one) and 401(k) Plans. These give tax deferral on gains, like annuities do, but the contributions also reduce the investor’s current taxable income. Certainly it makes sense to first contribute to investment vehicles that do that before investing in annuities.

As we have said, there is no perfect investment vehicle, but by utilizing several in proper order (first investing in IRAs and 401(k) plans, and then investing in such things as annuities) individuals have the opportunity to develop a well rounded plan that will provide well during retirement. For tax purposes, equity indexed annuities can only be compared in terms of safety. That means comparing them to such things as government bonds or highly rated corporate bonds, which are also taxed at ordinary income tax rates – if held to maturity. If not held to maturity they could be devaluated.

There is no point in comparing them to 401(k) Plans or other vehicles that are designed differently. Once again, it would be comparing apples to oranges: both are fruit, but they are very different types of fruit. Equity indexed annuities are taxed no worse than other similar types of investment vehicles.

Lump sum withdrawals are taxed for the year in which they were withdrawn. When an annuity is annuitized, income is spread over a longer period of time, anywhere from five years to the annuitant’s lifetime. Payments for lifetime options are based on anticipated life expectancy. The original premium payments, referred to as the “basis” for tax purposes, are calculated to last until the date of the investor’s life expectancy. When annuity payments are received each month, part of it is a tax-free return of the original basis and part is the growth that is taxed to the investor as ordinary income. When the date of the investor’s life expectancy is reached (as used for the basis) all of the premiums have been exhausted. Therefore, from that point on, the entire systematic payment is taxable as ordinary income. That sounds like bad news but what it really means is that the investor is now receiving the insurance company’s money rather than his own. In other words, he or she has lived beyond the amount they paid to the annuity company; from that point on, the investor has beat the odds and is collecting money that the investor did not personally save. Even though it is taxed as ordinary income, it could be viewed as “free” income. In that perspective, taxation does not seem so bad.

**Tax-Deferral Exception**

Not all annuities are tax-deferred. They must be held for a natural person or in trust for the benefit of a natural person. An annuity that is held in a corporation, limited partnership, LLC, or other business entity might not be able to grow tax deferred. Even placing an annuity into a family-limited-partnership might cost the investors their tax deferral status. In such cases it really makes sense to hire a tax specialist.
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Exchanges

It is often possible to exchange one annuity product for another, although there may be some limitations. When exchanges are properly executed there are no immediate tax consequences since the investor’s hands do not touch the funds, so to speak. In some cases, it may even be possible to exchange a life insurance policy for an equity indexed annuity or some other annuity type. In the case of a life insurance policy, it only works one way: life insurance policy exchanged for an annuity. It is not typically possible to exchange an annuity for a life insurance policy without causing a taxable event. These tax free exchanges are known as 1035 exchanges, for the tax code they come under. In some cases, the exchange may be partially tax free and partially taxable; this often happens when there is an outstanding loan against the policy.

Annuity Gifts

Investors must be very careful when a gift is made of an annuity product. Most professionals strongly advise the investor involve a tax specialist in the transaction. The person who receives the gift may have to pay taxes on the gain on top of any gift taxes required. Even when annuities are gifted to trusts there could be taxable issues.

Investors often gift their annuities to charitable organizations. It is likely the investor will then have to pay taxes on the annuity gains, even though they were given to the charity. The charitable deduction may offset the taxes, but again a tax expert should be consulted.

Other Tax Issues

There may be other tax issues that relate to annuities. For example, estate taxes may apply in some cases. Since taxation, especially estate taxation, can be so complicated we will not try to address them in this continuing education course. However, a wise investor will certainly consider all aspects of their investment portfolio. This applies not only to annuities but to all investment vehicles.

The purpose of most annuities, including equity indexed annuities, is to fund the investor’s retirement. While taxation and estate issues are certainly important they should not cloud the real purpose of saving for retirement. EIAs are one aspect of saving for retirement; they should be considered primarily for that purpose. When investors get so side-tracked by other issues that they lose sight of their primary purpose it is difficult to stay focused on saving adequately. While annuities may end up growing an estate that is not their designated purpose; their designated purpose is to provide income during life.
Annuities Are (Sometimes) Protected Assets

Generally speaking, annuities are protected assets, which mean that others may not gain access to the accumulations in them. There are exceptions. An individual that owes child support, for example, may find him or herself having to give up the annuity values to pay the back child support. The Internal Revenue Service may also have access to annuity values when back taxes are owed. Also an investor that pledges his or her annuity as security for a loan has willingly and legally given access to their annuity values if they default on their loan.

Annuities only have protection from creditors if they were purchased under normal circumstances. For example, Tom Tardy knows he owes money all over town and those he owes the money to want to be paid. He receives a large sum of money from a relative and quickly buys an annuity to avoid paying his debts. This might be considered purchase under fraudulent conditions. If Tom Tardy gives false information on his annuity application, it could also be considered a purchase under fraudulent conditions. If Tom Tardy transfers money from an account that does not totally and completely belong to him into an annuity that might be considered a fraudulent transfer.

However, aside from situations that are used to either obtain funds fraudulently or transfer funds fraudulently, annuities are typically safe from creditors.

Most annuities are not purchased with asset protection in mind; they are purchased as a means of retiring in comfort. However many people are involved in occupations that have a high liability, such as physicians, financial planners, and insurance agents. These occupations are regularly and successfully sued by their clients. For those in such high-risk occupations annuities should have special appeal: safety from creditors. It is not possible to transfer funds into an annuity after the lawsuit has been filed, because that would then become a fraudulent transfer. Annuity investments must be made prior to legal issues.

It is always important to consider the laws of the domicile state, since annuities are not equally protected in all states. Some states completely protect a lawfully purchased annuity from all creditors, even during bankruptcy. The 2005 bankruptcy reform legislation left annuities with that protection, even though many other types of investments suffered changes.

For those who do not live in a state that protects annuities adequately from creditors it is possible to move to a state that does offer protection. However, that would have to be done prior to a filing by the creditor. Once a creditor files on an annuity, moving would not protect the funds within it.

A better option might be use of a trust that lends legal protection to the annuity values and other assets. Such trusts are not simple documents and may be expensive to have
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prepared. Even so, for the physician that knows even good doctors are sued it is worthwhile to do so. Even good financial planners and insurance agents face lawsuits in this very lawsuit prone society. Agents should be aware of their state laws and if their domicile state does not provide annuity protection from creditors and lawsuits it might be wise to move to a state that does or create a trust that will protect their assets. Although career agents purchase errors and omissions policies to protect them from lawsuits, it is a smart agent or planner that goes a step further.

For investors who do not have large values in their annuities it may not be necessary to take expensive legal steps to protect those values from creditors, including lawsuits. For those who have large values, however, it may simply be prudent to pay the cost of having legal protections in place. It will require a skilled attorney who specializes in such matters; any attorney will write the necessary papers of course, but it pays to hire one who does this on a regular basis. There is something to be said for professionals who are specialists in specific fields of service. The attorney who is a specialist in trusts is more likely to cover all necessary aspects than one who only drafts such trusts occasionally.

For those who have large annuity values it may be prudent to pay the costs of having legal protections put in place.

We must also realize that state laws change. A state that provides wide protection today for annuity values may not do so next year. Laws change and those with much to protect must be prepared. Even in states that offer annuity value protection an investor may benefit from the extra protection afforded by a well-drafted trust. If the amount owed a creditor is large enough, the creditor may find ways around state laws (such as filing in the state of the insurer’s domicile rather than the domicile of the policyholder).

Sometimes annuities are placed in trusts for other reasons. For example, perhaps the investor’s children have a poor financial history. He may place his annuities in trust purely for distribution reasons. The annuity could be directed, upon his death, to pay its proceeds to the trust rather than the beneficiaries. The trust would then pay out to the beneficiaries as directed by the testator. There are certain types of trusts that perform very well in specific situations (a spendthrift trust for instance). Trusts can be drafted by anyone and there are companies knocking on consumer’s doors offering to provide them. In fact, insurance agents may be in the business of offering revocable living trusts to their clients (attorneys are usually also involved in drafting the documents) but it is seldom wise to accept services of this kind. Expert, specialized attorneys do not send agents and other salesmen out to knock on consumer’s doors. Their experience and knowledge brings in sufficient clientele.

Probate
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Annuities bypass probate procedures (although annuity values must still be listed during probate). Most people are not wealthy enough for probate to be a severe issue, but if the investor believes probate may become slow or cumbersome, annuities may be a good investment choice. Since they have a beneficiary designation, they go directly to the person or people named in the policy. The same is true for life insurance policies. Any type of vehicle that has beneficiary designations may be able to pass the assets on to the named individuals outside of probate.

Since individuals have individual circumstances, it is very important that an attorney be consulted. In many cases, both an attorney and a tax specialist should be part of the decision making process. There are many mistakes that can be made in the attempt to protect assets; whatever it costs to involve these individuals may be well worth the cost.

Sometimes an Annuity is a Bad Idea

Far too many investments are purchased for the wrong reasons. Maybe Uncle Joe had an annuity that paid well for him so he advocates everyone have them. Maybe the age restrictions for withdrawal are misunderstood by the young couple wanting to save for a house. Maybe the agent knew too little and misunderstood too much about the product he sold. Whatever the reason, annuities are not always the right choice for consumers.

Age

Yes, we have said this multiple times, but it is important: withdrawals made prior to age 59½ will incur a 10% Internal Revenue Penalty for early withdrawal. Annuities were created with retirement in mind, so regardless off whether it happens to be an equity indexed annuity or a traditional fixed annuity, early withdrawal penalties apply. Most annuity contracts allow for free withdrawals even during surrender periods, but that does not apply to age and the IRS penalties. Anyone who might need any portion of their money prior to age 59½ should not buy equity indexed annuities (or any other annuity for that matter).

Surrender Penalties

Surrender periods are in annuity contracts to discourage contract surrender for the first seven to ten years; the exact length of the surrender periods will vary among contracts. Anyone selling or buying an annuity must be well aware of the length of the surrender penalty period. An investor who anticipates needing the premium paid for the annuity during the surrender period should consider an alternative investment. Even in the last year when the penalty amount may be only one percent caution is still advised. If the amount they anticipate needing is small the contracts that allow for surrender-free withdrawals might still work but even then the agent should be cautious in selling the product. Of course agents must always disclose all possible penalties; agents must ask the investor if he or she anticipates needing any substantial amount during the early
withdrawal surrender penalty period. This comes down to suitability. Investors who think they might need the money during the surrender years are not suitable for an annuity product in most cases. This is true of an equity indexed annuity and it is true for a traditional fixed annuity product.

Some equity indexed annuities may waive early surrender charges under specified conditions. This should never be assumed however. Consult the policy to see if the contract you are considering has this feature. If it does, there will be specific conditions that must first be met. Look for a heading similar to “Extended Care Waiver” or wording that is substantially the same. While there may be variations it is likely to say something similar to the following:

“Upon your written request, we will waive the early withdrawal charges that may otherwise apply under your contract to a withdrawal, surrender, or annuitization if at the time of such withdrawal, surrender, or annuitization or within the immediately preceding ninety days of all the following conditions are met:

1. The insured is confined to an extended care facility or hospital;
2. The confinement is prescribed by a physician as being medically necessary;
3. The first day of the confinement was at least one year or more after the effective date of the contract; and
4. The confinement has continued for a period of time that is at least ninety consecutive days.”

Proof will be required of the confinement and of course that proof must substantiate what the insured has stated. Proof must be provided prior to withdrawal of funds, never after the fact.

**Grasping Fundamental Aspects of the Product**

In all cases with all investments the investor (buyer) must understand what he or she is purchasing. If the selling agent is a good communicator he or she is probably able to educate the buyer sufficiently. However, sometimes even good communicators are not able to explain a product in a manner the buyer understands.

Any time an agent suspects the buyer does not understand the product caution should be used. A buyer who does not understand what they have purchased is likely to experience “buyer’s remorse.” Although annuities come with what is called a “free look” period when he or she can return it for a full refund it is still dangerous for the agent to place any product the buyer does not fully comprehend. Sometimes it can even result in lawsuits. Lawsuits are most likely to happen when the product does not perform as the buyer expected it to. Sometimes lawsuits are filed not by the buyer, but by his or her family.
members so it is important that the buyer fully appreciate their investment and relay why it was purchased if necessary.

Consumers buy things every day but most purchases can be touched, felt, and shown off. When a new car is purchased the family members might not agree with the purchase but at least they understand the reasoning behind it. An equity indexed annuity is not likely to be shown off as a new car would be. The buyer may have every confidence in their decision but if the children become involved it could change into a “the agent took advantage of my aging father” situation. We are not suggesting that older investors not be allowed to purchase an equity indexed annuity; all ages have a right to invest in any fashion they wish. We are advocating that agents take extra time going over the aspects (both good and bad) of the annuity if there is any doubt whatsoever that the product may be misunderstood or if there appear to be lingering doubts about how the product functions.

Equity indexed annuities can be complex, especially to an individual without past annuity experience. Even agents can misunderstand some of the EIAs characteristics so it stands to reason that many investors will be learning about the product for the first time. Clear communication is vital to an investor being happy and confident about the purchase they have made. Obviously it is necessary to disclose all pertinent information about the product prior to the sale. This is true of all annuities, not just equity indexed annuities.

Agents must be aware that there always seems to be so-called experts that do not agree with the annuity concept. Many of these individuals are more interested in selling their books than actually educating the public, but if it causes your clients to doubt their purchase it won’t matter if the author actually knows anything about EIAs. The only way to prevent your clients from doubting their purchase is to cover the product well enough for the buyer to remain satisfied with their decision. Remain satisfied even if their children question their buying decision, satisfied enough to ignore the so-called experts hoping to sway them to their personal investing views.

There are elements of EIAs that agents must completely communicate prior to placing the product. Some basic information is always important:

1. The name and contact information of the issuing insurance company;
2. The name and contact information of the selling agent;
3. The financial rating of the issuing insurance company;
4. The length and amount of the surrender penalties (policy term);
5. The point at which the insured will reach age 59½ and no longer have to be concerned with IRS early distribution penalties.

In addition to the basic information listed above, equity index annuity investors need to know:
1. The minimum guaranteed rate of interest gain;
2. The participation rate for interest crediting;
3. How the annuity is linked to the index;
4. The participation rate for index crediting;
5. Any caps that exist in the contract;
6. How the insurer will treat the annuity if the insured dies (are surrender charges waived for example);
7. Are there exchange options? If so, what are they?
8. Can the insurer change some terms in the contract (often called the “moving parts”)? If terms can be changed, specifically what may be changed? Insurers can typically change guaranteed interest rates at specified points, but there may be other terms that are changeable as well.
9. Tax consequences that may apply to the annuity, such as taxation as ordinary income when funds are withdrawn. There may be tax matters that are specific to an individual so agents are wise to suggest buyers consult their personal tax accountant.

There may be additional points the agent feels is important to discuss with their clients, but the list we have supplied is typically always addressed for equity indexed annuities.

Equity indexed annuities are primarily regulated by the individual state insurance departments with some differences in regulation existing among the states. Even so, the states primarily have similar requirements. Equity indexed annuities are not subject to SEC regulation since they are not securities. Therefore, EIAs are not subject to customer suitability, disclosure and sales practices requirements that registered securities must meet. Several states have passed “suitability” requirements for annuities however and EIAs would fall under any such suitability standards the state may have.

**Terminology for a Complex Product**

Most agents are accustomed to specific product terminology buy equity indexed annuities are not like the traditional fixed rate annuities so there may be terms the agent is not already familiar with, but that are very important to know.

**Adjusted Change:** The change in the Index Value for a segment, with adjustments as described in the indexed interest rate provision.

**Annual Reset Indexing Method:** Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the year. Interest is added to the annuity each year during the term.
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**Annuity Benefit:** The payments that may be made under the “benefit on annuity commencement date” of the contract.

**Averaging:** Some annuities use an average of an index’s value rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire annuity term.

**Beneficiary/Beneficiaries:** The person or people entitled to receive death benefits if the annuitant should die prior to withdrawing all annuity funds, unless annuitized for a lifetime benefit, in which case beneficiaries receive nothing even if the annuitant did not use all premiums deposited.

**Cap or Cap Rate:** Some contracts will state an upper limit, called a cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. It is the highest Adjusted Change for each segment of the indexed strategy.

**Code:** The Internal Revenue Code of 1986, as amended, and the rules and regulations that are issued under it.

**Commencement Date:** The annuity commencement date if an annuity benefit is payable; the death benefit commencement date will be shown on the contract specifications page.

**Contract Anniversary Date:** the date each year that is the annual anniversary of the contract effective date, shown on the contract specifications page.

**Contract Year:** A contract year is each twelve (12) month period that begins on the contract effective date or on the contract anniversary.

**Death Benefit Commencement Date:** the first day of the first payment interval for a death benefit that is paid as periodic payments or the date of payment that is paid as a lump sum if periodic payments will not be made.

**Death Benefit Valuation Date:** Although contracts may vary, typically it is the earlier of:

1. The date that the insurer has received both Due Proof of Death and a written request with instructions as to the form of death benefit (lump sum or systematic payment); or
2. One year from the actual date of death.

**Due Proof of Death:** Due proof of death is typically one of the following:

1. A certified copy of a death certificate, or
2. A certified copy of a decree that is made by a court of competent jurisdiction as to the findings of death (this is generally only used when the person or person’s
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Companies may accept other types of proof in some circumstances.

**Floor:** The lowest Adjusted Change for each segment of an index strategy is called the “floor.” It is the lowest point on equity index-linked interest. It is the minimum index-linked interest rate the investor will earn. The most common floor is 0% (zero). While that looks like a bad thing, it actually assures that even if the index decreases in value, the index-linked interest will not go negative, losing money. Yes, no interest would be earned but neither would any principal be lost. Not all contracts have a stated floor on index-linked interest rates but fixed annuities will have a minimum guaranteed value.

**High-Water Mark Indexing Method:** The index-linked interest, if any, is decided by looking at the index value at various points during the term, typically the yearly anniversary date of purchase. The interest is based on the differences between the highest index value and the index value at the start of the term. Interest is added to the annuity at the end of the term.

**Index:** An index is the specified index that will apply to an Indexed Strategy for the term shown in the equity indexed annuity contract, usually on the specifications page. If the index is no longer published or its calculation is changed, the insurer may substitute a suitable index at their discretion. Insurers should notify their policyholders if a substitution is made. Sometimes the insurers are required to first get approval of the substitution from the state insurance department.

**Index Value:** The index value is the standard industry value of the index. The index value for a particular date is the value of the index as of the close of business on that date. For any date that the New York stock Exchange is not open for business, the index value will be determined by the insurer and stated in the policy, but often it is the index as of the close of business on the most recent day on which the Exchange was open prior to that date.

**Indexing Method:** The indexing method is the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods include annual reset, or ratcheting method, high-water mark method and the point-to-point method.

**Index Spread:** An amount by which the Index Change is reduced when computing the Adjusted Change.

**Index Term:** The index term is the period over which index-linked interest is calculated. In most product designs, interest is credited to the annuity at the end of the term, which may be ten years although the average term is more likely around seven years. Products may offer a single term or multiple consecutive terms. Those with multiple terms usually have a window at the end of each (generally 30 days) during which the policyowner can withdraw his or her funds without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.
**Index Value:** The standard industry value of the index is the index value. The index value for a particular date is the value of the index as of the close of business on that date or the most recent date the Exchange was open.

**Interest Compounding:** Some annuities pay simple interest during an index term. That means index-linked interest is added to the original premium amount but it does not compound during the term. Others pay compound interest during a term so that the index-linked interest hat has already been credited earns additional interest. In either case the interest earned in one term is usually compounded in the next however.

**Participation Rate:** The participation rate is the portion of the index change that is used to compute the adjusted change. It decides how much of the increase in the index will be used to calculate index-linked interest. It is the portion of the index change that is used to compute the Adjusted Change. Note the definition of “adjusted change” above. Participation rates are typically guaranteed for stated amount of time, but the company will change the rates after that time.

**Point-to-Point Indexing Method:** The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to the annuity at the end of the term.

**Segment:** Segment is the period of time over which the change in the index is measured for an indexed strategy. A segment may never be longer than the term of that strategy. The initial segment begins on the first day of the term. Subsequent segments begin upon the expiration of the preceding segment. Daily segments that end on a day that the New York Stock Exchange is closed are often disregarded.

**Term:** For a declared rate strategy, the period of time during which the interest rate is declared; for an indexed strategy, the period over which an indexed interest rate is calculated. The initial term begins on the first interest strategy application date. Subsequent terms begin upon the expiration of the preceding term.

**Valuation Date:** A date on which the index value is measured to compute the Index Change. If an indexed strategy uses valuation dates that are daily, then dates on which the New York Stock Exchange is closed are disregarded. If an indexed strategy uses valuations dates that are other than daily, the valuation dates are the dates within a month that correspond with the first day of the term.

**Vesting:** Some annuities do not credit any of the index-linked interest, or only part of it, if the investor withdraws their money before the end of the term. The percentage that is bested, or credited, general increases as the term comes closer to its end and is always 100% vested by the end of the term.
General Contract Provisions

All contracts have general provisions. In life and annuity insurance policies the general provisions establish what might be called the “ground rules.” The following is a sampling of what might be seen in an equity indexed annuity policy.

Entire Contract

The contract must be identified. It might state something similar to: “This Contract is an individual deferred annuity contract. It provides for both declared and indexed interest rates. It is restricted as required to obtain favorable tax treatment under the Code. This contract, any riders or endorsements to it, and the application for it, if any, form the entire contract between the owner and the issuing insurer.”

Changes and/or Waivers

The contract is always the final word on the terms and conditions of the annuity. Agents do not have any authority to make changes or waive any part of the contract. The policy will state this in wording similar to the following:

“No changes or waivers of the terms of this contract are valid unless made in writing and are signed by the insurer’s President, Vice President, or Secretary. No other person or producer, including the writing agent, has any authority to change or waive any provision of this contract. The insurer reserves the right both to administer and to change the terms of this contract to conform to pertinent laws and government regulations and rulings.”

Misstatements

We usually think of misstatements in terms of age but it can relate to any misstatement. Some errors affect the performance of the policy while others have little effect. Often misstatements change the premium cost of the policy but annuities typically do not have this concern since they are based on the amount earning interest, usually not the age of the insured. In some cases, age does have a bearing however since many annuities will not issue coverage to anyone above a specified age. Misstated age can also affect the amount of systematic payments upon annuitization since age is a major factor in determining projected length and amount of those payments.

Most policies address the issue of misstatements. In an equity indexed annuity it might read similar to the following:

“If the age of a person is misstated, payments shall be adjusted to the amount that would have been payable based on the correct age. If payments based on the correct age would have been higher, we (the insurer) will immediately pay the underpaid amount in one sum, with interest, at the rate of ___% per year. If payments based on the correct age would have been lower, we (the insurer) may deduct the overpaid amount, with interest at a rate of ___% per year, from succeeding payments and pursue other remedies at law or in equity.”
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Of course the interest rate will be filled in, but for our example we felt it best to leave it blank.

**Required Reporting**
The state insurance departments probably have some requirement for notifying clients of changes in policy status or earnings. Policies will state how often such reports will be issued to their policyholders. Generally companies notify at least yearly of changes that will affect their policyowners. The policy will state how reporting may be expected. It might read similar to the following:

“At least once each contract year, we (the insurer) will send you a report of your current values. We (the insurer) will also provide any other information required by law. These reports will stop on the earliest of the following dates:

1. The date that this contract is fully surrendered;
2. The annuity commencement date; or
3. The death benefit valuation date.

The reports will be mailed to the policyowner’s last known address. If permitted by law, in lieu of that we may deliver these and other required documents in electronic form. The reported values will be based on the information in our possession at the time that we prepare the report. We may adjust the reported values at a later date if that information proves to be incorrect or has changed.”

**State Law**
Certainly states may have laws in place that affects how the annuity contract may be written and laws change from time to time. It stands to reason that insurance companies must follow what ever laws are in place and any laws that come after the contract was written, if they affect the contract. There is likely to be some statement in the equity indexed annuity regarding state laws; it may read similar to the following:

“All factors, values, benefits, and reserves under this contract will not be less than those required by the laws of the state in which this contract was delivered.”

**Claims of Creditors**
Some states will better protect against creditors than others. Your annuity will follow what ever the state dictates by law. It may be stated as the following: “To the extent allowed by law, this contract and all values and benefits under it are not subject to the claims of creditors or to legal process.”

The important part of that statement is “to the extent allowed by law.” At any point creditors become an issue the insured should obtain legal advice from a competent attorney that specializes in contracts or consumer law. Since laws do sometimes change the policyowner should not rely on information obtained at an earlier date.
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Other Contract Items
There will be other items covered in most contracts, such as Exclusive Benefit (who may benefit from the contract), liability issues, tax issues, incontestability and transfer by the company. In all cases, agents must be fully aware of the products they are representing and selling. Of course applicants have a responsibility to fully read the contracts but as every agent knows, they seldom do. Instead they rely upon their agent to fully disclose all facts and figures.

Even when an insurance producer believes he or she has fully disclosed all relevant facts and features of the product, there is no way to keep the information fresh in the buyer’s mind. Since agents do not want lawsuits simply because the consumer forgot what he or she was told it is the wise agent who delivers the policy personally and goes over the features a second time. It is an even wiser agent who obtains the buyer’s initials on all key points within the policy. This can be done on a separate paper or form that the agent keeps in the client’s file at the producer’s office. Having the policy initialed is fine as long as the agent has access to it in case of a lawsuit, but that is unlikely.

Additional Payments

Some equity indexed annuities will allow only one initial payment; others will allow additional payments. Too often insurance producers do not think to inquire whether or not buyers might wish to make additional payments in the future. It is an important question to ask since the buyer might simply assume he or she can do so.

When a contract allows additional premiums (deposits) it will specifically state so. The heading might vary, but should say something similar to “Purchase Payments” or “Additional Premium Payments.” If additional premium payments are allowed it will state something similar to the following:

“One or more purchase payments may be paid to us (the insurer) at any time before the annuity commencement date, so long as you (the buyer) are still living and the contract has not been full surrendered or annuitized.”

Since annuitization locks in payments it would not be possible to make additional payments once annuitization was initiated.

Most equity indexed annuities have minimum premium deposit requirements. Many have a $10,000 initial deposit requirement, but that can vary even among policies of the same company.

Some contracts may offer a purchase payment bonus. If so, it will be specifically stated in the contract.
Surrender Values and Penalties

Equity indexed annuities have surrender penalties just as traditional fixed annuities do. The policy will state the terms of the surrender periods. This is an important part of the contract and should not be minimized.

In Conclusion

This completes your course. Only agents who completely understand this type of annuity product should consider marketing them. This is not an annuity that the inexperienced agent should represent. We recommend that agents first become familiar with traditional fixed rate annuities. Only after he or she is well versed in that type of insurance product should he or she then move into the equity indexed annuity field.