



Fixed Index-Linked Annuities – Fact vs Fiction

There are many powerful reasons to include equity-indexed annuities in an investor's financial plan, and many arguments that have been advanced by a variety of media outlets against such an allocation. Let's take a factual look at these instruments, dissect the flaws in the arguments against them, and explore the undisclosed conflicts of interest many of the anti-annuity writers and analysts are dealing with.

Before I begin, you should rightly wonder who I am. First, I'll tell you what I'm not – an annuity advisor. I have never made a dime from selling an equity-indexed annuity, or any other type of annuity for that matter. I think I'm pretty unbiased in the opinions I present below.

Currently, I serve on a three-person investment team responsible for managing a pool of assets valued at over \$1 billion. Previously, I served as an analyst and Investment Committee Chairman of an investment advisory firm catering to high-net worth individuals with anywhere from \$500,000 to \$20 million to invest. Additionally, I hold the Chartered Financial Analyst (CFA) designation and serve on the board of directors of the CFA Society of Indianapolis. For those unfamiliar with the CFA charter, the following is taken from the CFA Institute's website:

“First awarded in 1963, the Chartered Financial Analyst (CFA) charter has become known as the gold standard of professional credentials within the global investment community. Investors recognize the CFA designation as the definitive standard for measuring competence and integrity in the fields of portfolio management and investment analysis.”

I give you my background not to imply superior results or qualifications, but rather to prove that I have no vested interests in writing this piece and to let you judge for yourself how much weight to give to my opinions. Brian Singer is my father-in-law, we talk regularly about business, and I happen to believe that his services can be extraordinarily beneficial to many individuals. To help those individuals weigh the merits of equity-indexed annuities in the face of a concerted industry campaign to steer investors away from them, I offered to put my thoughts on paper. This is not intended to be a comprehensive recommendation to *all* investors, but rather a thought-provoking paper.

Ask yourself – who is making negative arguments... and more importantly... why?

Never ask a barber if you need a haircut, never ask a chef if his food is good, and never accept a financial writer or analyst's *negative* opinions without critically analyzing his motives. Consider the following:

- Next time you read a negative article about annuities in a financial magazine, conduct the following exercise: go back to the front cover, flip through the entire issue, and keep a running total of the number of ads placed by mutual fund companies, brokerages, and other folks who *don't* profit from annuities. At the same time, on the same sheet of paper, keep a running total of ads placed by advisors who use annuities or insurers who offer equity-indexed annuities [ask Brian for a list of preferred providers if you need one]. No contest – the brokers and mutual fund firms practically own those magazines. Advertisers pay the bills – most magazines couldn't stay in business on subscription revenues alone. So, ask yourself, is there some possible reason why a given magazine *might* have a conflict of interest?
- Of course, while advertisers pay the bills at magazines, the editors still want to maintain subscription numbers to bring in money and to charge a higher rate for advertising. There is one very insidious underlying conflict of interest buried in the arguments *against* indexed annuities that, ironically, highlights one of their greatest strengths. When indexed annuities are purchased by investors who understand how they work and whose circumstances are ideally suited to the positive features of them, they can essentially be a one-time decision. Talk with any of Brian's clients, and ask them how much ongoing work they need to do in order to maintain a comfort level and to generate the desired results. You'll probably hear, "very little." But most financial magazines publish twelve times a year, and thus have little appetite to steer investors into a one-decision product like indexed annuities. Instead, these magazines would like you to run to your mailbox every month, and anxiously read advice on what to do next – which hot stock, mutual fund, or strategy should be pursued next. One-time decisions are anathema to monthly publications for obvious reasons.
- Dateline NBC ran a few specials several years ago about deceptive sales practices used by a very small sample of insurance salespeople. It's true, there are deceptive salespeople in *all* industries, including financial services. That shouldn't turn investors off to an entire category of investment options, but rather ought to highlight the importance of finding a trusted advisor with years of experience and extensive positive references. Personally, I hate car shopping. I'd estimate that over half of all the car salesmen I've come across in my life used deceptive tactics. Do I still buy cars? Yes! I just make sure to use one of several trusted salesmen I know.

Would it shock you to hear that NBC's parent company, General Electric, has a finance division that offers mutual funds used by financial advisors and that are widely used in variable annuities [which are much different from equity-indexed annuities]? You're also unlikely to see equity-indexed annuity providers advertising on *The Office* or *Sunday Night Football*, but you might notice a few other finance companies that would rather see your money with them than in an indexed annuity.

Incidentally, I joked with Brian last fall that Dateline should run an expose about how many millions or billions of dollars that this Dateline series wound up costing investors and retirees who were scared into inaction *before the market crash*. Somehow, I'm not holding my breath.

- Some financial advisors will write articles in newspapers or magazines that are critical of indexed annuities under the guise of helping supposedly gullible readers steer clear of these products. Usually, these articles are thinly veiled advertisements for the advisor's own services. When the market is going up, the argument focuses on the return caps that prevent the investor from fully participating in the upside during very strong years for the market. When the market is crashing, the argument turns to supposedly high fees, long lock-in periods, and even, astonishingly, the fact that with the market down so much already, it's silly to switch into a principal-protected strategy. The latter is akin to an arsonist watching his work in progress while holding the empty gas can in one hand and a phone in the other telling the fire department not to bother coming because the house is already on fire. Please. How stupid do they think we are?
- The Securities and Exchange Commission (SEC) went on a crusade several years ago to increase regulation of indexed annuities, in part because of the publicity generated by the Dateline series. A full discussion of the recent failures of the SEC is beyond the scope of this paper, but suffice to say, it has lost an enormous amount of credibility in the eyes of the investment profession and the public due to its actions, or lack thereof, during the years leading up to the global financial meltdown we are all suffering through today. I am personally mortified, as are many of my fellow professionals, that this organization dedicated so much focus on indexed annuities and so little time on initiatives that could have softened the damage suffered over the past year.

As an example, on March 11, 2008, SEC Chairman Christopher Cox said, "We have a good deal of comfort about the capital cushions at these firms at the moment," in reference to major investment banks, specifically directed at the rumors that Bear Stearns was teetering on bankruptcy. Three days later, Bear effectively went under. That's what we call a credibility killer – if the SEC's opinion on indexed annuities ever mattered to you before, it shouldn't any longer.

Look, the point is that when you read or hear a criticism of annuities, you shouldn't assume it's an unbiased view being offered by an omniscient expert who simply wants to help investors. Often, they just want your money, and the only way to do it is to attack the competition. Don't fall for it. If you have doubts, talk to Brian. Or his hundreds of satisfied clients. Or me.

Point by point, let's tear apart the arguments against indexed annuities

They have excessive penalties for surrender / withdrawal

This argument demonstrates a stunning and dangerous misunderstanding of the proper role of annuities in an investor's overall plan. If you hear an analyst or writer make this argument, he clearly doesn't understand the purpose of an annuity, and the rest of his criticisms should be summarily dismissed. Here's why.

An annuity is, essentially, like Social Security or a company pension. The primary role of the annuity is to provide a predictable [and hopefully growing] stream of income for a retiree or soon-to-be-retiree that eliminates longevity risk [the risk you outlive your money]. It's not a checking account. It's wise to have other money outside of the annuity to pay for unexpected bills, cars, trips, gifts, or anything else above & beyond what your monthly income could support.

Have you ever heard a criticism of Social Security that it does not allow retirees to withdraw extra money? Of course not! That argument would be absurd – it's an income account, a salary for retirees, if you will. It's not a checking account, nor is it an investment account. The same holds true for most pension plans.

An annuity is, at its essence, the purchase of a permanent, predictable income stream for the remainder of the annuitant's life. To purchase the annuity, investors generally sell assets – IRA's, 401(k)'s, CD's, savings accounts, government bonds, etc – that have uncertain future returns and offer no certainty that they will provide lifetime income. The investor shifts his "longevity risk" [the risk he lives longer than expected] to the insurance company. It's a long-term investment, and a pretty wise one at that. It's like Social Security or a pension plan and should be viewed accordingly. Seen this way, it's insane to criticize them for not allowing rapid and large withdrawals.

Having said that, though, most annuities *do* allow partial withdrawals each year. The insurance companies want to offer their valued clients the opportunity to access funds without penalty each year. And in the event that the client has an unexpected need to redeem a larger percentage of the value, that *can* also be accomplished by paying a surrender charge. With many insurers, this charge is generally not overly punitive, contrary to popular belief. Many back-end loaded mutual fund redemption charges are just as high.

Annuities have high fees

This is more true for variable annuities than it is for fixed or equity-indexed annuities. But again, analysts and writers who want to tar the entire annuity industry with a broad brush in order to discredit them and route you to other investment options care less about this distinction.

A variable annuity offers the owner the chance to invest in mutual fund sub-accounts, many of which have extremely high expense ratios. Additionally, the insurance company will charge a fee for ongoing administration, accounting, producing statements, and a variety of other business expenses. It's this double-fee structure that has [perhaps rightly] given variable annuities the reputation for being excessively expensive.

But equity-indexed annuities are *far* different from variable annuities, and any comparison by critics is lazy, deceptive, or both. The insurer generally does not outsource the investment management within an equity-indexed annuity, so there is not a

second constituency that takes the extra layer of fees that has been a wide source of criticism.

Are equity-indexed annuities free or as cheap as some index funds run by Vanguard and other firms? No. These insurers have employees, corporate offices, and other standard business expenses. They are entitled to charge fees and earn profits. The larger question to ask is whether the value received by the equity-indexed annuity investor exceeds the fees being charged. To me, the value undoubtedly *does* exceed the cost. I would venture to guess that if you were to ask *every* one of Brian's clients, they would agree.

Legendary investor Warren Buffett's first rule of investing is, "Don't lose money." His second rule? "Never forget rule number one." Equity-indexed annuity investors mostly received a 0% return in 2008 when global markets were down anywhere from 35-50%. The fees charged by the insurance companies offering these annuities are actually in-line with the total expenses charged by financial advisory firms that take a 1% annual fee and invest client assets in mutual funds that also charge fees. Equity-indexed annuities provided far superior returns, but also gave immeasurably valuable peace of mind to their owners. Their fees could have been doubled or tripled, and they still would have offered remarkable value.

Equity-indexed annuities cut off the investor's upside

It has been said that markets and investors swing between fear and greed. During great times, investors get greedy and worry about "only" making 10% in a year when some others are up 20% or more. During poor times, investors are fearful.

During bull markets, when investors are most tempted to be greedy, analysts and writers like to point out that many equity-indexed annuities can "only" earn 10% even if the market is up much more. Again, this argument missed two critical points. If you hear it in the future, dismiss it for the following reasons:

- 1) Investor suitability. Equity-indexed annuities are generally best suited for people approaching retirement, currently in retirement, or risk-averse investors of any age. 10% is a great return for these folks, and it is dangerous for them to invest in a way that could generate 30%+ returns during boom years. For 25 year olds who have 40-year time horizons and a willingness to accept the risk of large losses, it's true that participating during boom times is a primary way to build wealth. But as you age, your time horizon shrinks, your desire to take risk decreases, and maximizing returns ceases to be a primary goal. Capital preservation is far more important. Since maximizing returns isn't terribly important for equity-indexed annuity owners, anyone who makes this argument clearly doesn't understand investor suitability, a basic tenet of financial planning.
- 2) The amount beyond the cap does not go to the insurer – I've read a number of criticisms that equity-indexed annuities cap the investor's annual return at 10% [or so]. They generally seem to imply that the insurer is pocketing the difference and

thus making a killing at the expense of their clients. Not true! Anyone who criticizes equity-indexed annuities without actually understanding how the no downside / capped upside return pattern is created is someone whose advice/criticism should be completely ignored.

While it can be a bit complicated to explain, I'm going to try my best. If you don't follow it completely, it's okay. The key is just to get a basic understanding.

Equity-indexed annuities are comprised of three main elements: a "call option" purchased by the insurer, a "call option" sold by the insurer, and "general account" investments.

Call options give an investor the right, but not the obligation, to buy something at a predetermined price at a specific date in the future. Let's say you think the S&P 500 is going to do well over the next year, but don't want to take the risk of owning it and seeing its value decline significantly if you're wrong. Instead of buying the S&P 500 Index near its current value of 900, you can buy a call option for \$100 that gives you the right [but not the obligation] to buy the S&P 500 in June 2010 at the value of 900. So if the S&P 500 is at 1200 a year from now, you'd exercise your right to buy it for 900. You would receive \$300 next June, or \$200 net after paying the \$100 cost of the option.

If the S&P 500 crashes further and goes down to 600, you wouldn't exercise your right to buy it for 900. You'd be out your \$100, but would avoid the \$300 loss that would have occurred if you had instead owned it outright. This is where the downside protection comes in.

For investors seeking to avoid losses, call options are great tools. The problem, though, is that the cost of the option is pretty high. A \$100 cost when the S&P 500 is at a value of 900 is 11%. So if the market is flat over the next year, the investor would lose 11%. One way to reduce that loss is to sell a call option at a higher price, and effectively sell the biggest part of the upside to someone else.

For example, you could sell a call option that gives someone else the right to buy the S&P 500 at a value of 1000 in June 2010. The buyer of that option would pay you \$55. That reduces your overall cost to \$45, or around 5%.

If you have a \$90,000 equity-indexed annuity, that means the insurance company would pay roughly \$10,000 to buy the call option, and receive \$5,500 for selling the call option. The net cost is \$4,500. The insurer then invests the remaining \$85,500 as part of its "general account" with the intention of growing it to be worth at least \$90,000 a year from now.

Let's assume the insurer succeeds, and the \$85,500 grows to be worth exactly \$90,000 in a year. The return to the investor then depends wholly on what level the S&P 500 closes at in June 2010.

- If the S&P 500 is worth 950 a year from now, the first call option [the one the insurer bought] will result in a \$5,000 gain. The second call option [the one the insurer sold] expires worthless, since the S&P isn't above 1000. So the annuity owner's account is now worth \$95,000 [\$90,000 plus \$5,000].
- If the S&P 500 crashes to 600, neither option is exercised, and the annuity is still worth \$90,000.
- If the S&P 500 soars to 1200, the insurer receives \$30,000 for the purchased call option, but has to pay \$20,000 to the owner of the second. Net, the insurer receives \$10,000 and the annuity owner's account is worth \$100,000. If the S&P 500 doubles to 1800, the insurer receives \$90,000 for the purchased option but has to pay \$80,000 to the owner of the second. Again, the net is \$10,000 received. *Any level for the S&P that is above 1000 results in a \$10,000 gain. No more, no less.*

As you can see, when the market soars, the insurer doesn't make out like a bandit. The upside goes to someone else. Why doesn't the insurer hold onto all of the upside? Because retirees don't want to lose money from year to year. By selling off some of the upside during those [fairly rare] years of massive gains, the insurer insulates retirees from losses during down years and even years of mild gains. If it didn't, the investor's maximum loss in a given year might be closer to -5%, rather than 0%.

The return calculation used by annuity companies omits dividends, which can be a significant portion of stock returns over time

Again, the implication is that the insurance company is somehow stealing money from its clients by not passing along dividend income. Now that you understand how these equity-indexed annuities are created, hopefully you can see through this argument too.

The call options that are used are based on the price of the index, and do not include dividends. The insurance company isn't choosing to omit dividends – that's just how call options have always worked. Even so, if call options with dividends were available, it wouldn't make a difference. Call options would cost more if they included dividends, because the expected return would be higher. Critically, though, the cost of the call option *purchased* and the call option *sold* would both be higher.

Since it's the spread between these two that matters, it wouldn't affect the return earned by annuity holders if dividends were included. To suggest otherwise indicates an ignorance of how these annuities work. Ignorant critics should, well, be ignored.

Annuities are complex

Equity-indexed annuities have a host of features that can be tailored to an individual's needs and concerns. They're very flexible. That flexibility can be misinterpreted as

complexity. If you work with a trusted advisor who has years of experience, he'll be able to pick the right product and features, and succinctly explain the rationale to you. I've sat in meetings with Brian, and can definitively tell you that he fits this description in spades.

Is it complex that you can link your annuity returns each year to any one of a dozen different indexes, including foreign stocks, small cap U.S. stocks, and bonds? Is it complex that you can add an inflation rider to your policy to protect against the risk that today's profligate government spending leads to significant inflation in a few years that threatens to erode the purchasing power of retiree income? Is it complex that dozens of annuity providers can appear to offer similar products, but are differentiated in critical ways not immediately obvious to non-professionals?

Sure, equity-indexed annuities are very flexible, and can appear to be complex and overwhelming to prospective owners. But that merely highlights the importance of working with a fantastic advisor who *understands* those features inside & out. Again, if you're on the fence about whether a particular annuity advisor is able to make a complex product very understandable and comfortable to own, ask for references of existing clients, or set up an introductory meeting or two with the advisor.

Equity-indexed annuities trail the overall market over long periods of time

Forbes Magazine recently published an article about equity-indexed annuities that encouraged investors to instead invest according to traditional theory [in the market with no explicit downside protection – funny, Forbes sells a lot of ads to companies that would profit if this advice is followed!]. Here's a direct excerpt from that article:

“Since 1995, these [equity-indexed] annuities have easily outpaced the S&P 500 and bond indexes alike. ‘There is no asset category that outperformed them. We were extremely surprised, really just amazed,’ says David Babbel, professor emeritus of insurance and risk management, who conducted a study of equity-index annuity returns beginning in 1995.

The audacity of Forbes to then proceed to criticize equity-indexed annuities is remarkable, though sadly not surprising.

So to an extent, recent results have neutered the argument that annuities underperform the market over long stretches of time. But in the event that this point resurfaces at some point in the future, remember:

- Past performance really doesn't predict future returns. In fact, it's just lazy for any analyst to recommend investing in anything and steering clear of other vehicles merely because of historical returns.
- The “lower returns” argument ignores risk taken. Risk-adjusted returns are the most important measure to look at. Given the explicit downside protection provided by equity-indexed annuities and lack thereof provided by direct investment in the market, it's no contest when looking at risk-adjusted returns.

- The world has changed. Our “Today’s Economy” presentation from March walked through the origins of this crisis and long-term implications, and the belief that the stock market always rises over long periods of time is far from airtight. Please call Brian’s office if you’d like a copy of the presentation or would like to schedule an appointment to walk through it.

Annuities are often sold using deceptive sales practices

First, you have to substitute “sometimes” for “often.” This issue is not as widespread as some have made it out to be. But, sadly, there are some advisors who use unscrupulous tactics and are more interested in making money than helping people. Again, that should *not* discredit annuities, but rather *accentuate* the importance of finding a trusted advisor with scores of references available and deep ties to the community he works in.

Equity-indexed annuities are valuable components of an overall financial plan for many retirees and those close to retirement. The product is very sound, even if a small [yet visible] percentage of those who sell them are not. To avoid deceptive salespeople, here’s what I would suggest:

- 1) Make sure your advisor knows your personal situation, including financial goals and time horizon. Many of the deceptive practices center around advisors who sell annuities to investors who have a short-term time horizon and are nearly certain to trigger the surrender penalty.
- 2) Talk to the advisor’s clients! If the advisor has a client advisory board or hosts client appreciation events, ask to attend. While there, ask whether the annuity has performed as expected, whether the client would make the same decision again if he had the opportunity to go back in time, how accessible the advisor is to meet or talk over the phone, and anything else on your mind.
- 3) If the advisor does not understand how an equity-indexed annuity return is generated [as discussed in this paper], or how the various riders [such as inflation] work, it’s best to keep looking for someone with more expertise. The deceptive salespeople are only in it for the money, haven’t immersed themselves in details, and don’t have a passion for helping their clients. Passion and in-depth knowledge of the industry and available products are impossible to fake.
- 4) I’d avoid salespeople who only represent one company, since their objectivity is limited and different insurers offer unique features that appeal to different client situations. There truly is no one-size-fits-all solution with equity-indexed annuities, or other financial advice for that matter.

My closing comments

Thanks for taking the time to read this entire paper. I know that choosing an advisor and strategy to follow is difficult, particularly in the turbulent market and economy we find

ourselves in today. Don't be paralyzed into inaction. You can grab control of your financial future, and knowledge is the first [and most important] step in doing so. I hope that this paper has, in some way, helped you along that path.

I am available to answer any questions about the contents of this paper, or other financial matters on your mind. Simply call Brian's office, and you can set something up with him, me, or both of us.

Finally, I would be remiss if I did not offer my candid thoughts about Brian. Hopefully my financial background detailed at the beginning of this paper lends credibility to this statement: Brian is an exceptionally trustworthy, passionate, knowledgeable, and dedicated advisor. I've sat in meetings with him and spoken with many of his clients, and believe that anyone seeking a financial advisor would be well served to meet with Brian and give strong consideration to his services.

Respectfully,
Jim Bergstrom, CFA