Market Spotlight | By Jason Beckley

Fundamentals of Equity-Indexed Annuities

February 1, 2014

In recent years Equity-Indexed annuity sales have hit record levels. That's a result of investors purchasing these annuities without fully understanding the complexities of their contract. Given the scars of past market volatility, the promise of principal protection with potential for growth is appealing to many people. Insurance companies which issue these Equity-Index annuities spend millions of dollars on high end marketing materials in an effort to promote the upside potential with little to no explanation of risks and complexities of the contract. Nor do they mention the high level of compensation paid to the insurance agents who sell these products.

Despite the potential pitfalls, Equity-Index annuities have potential advantages that many investors find appealing. The first and possibly most attractive provision of an equity-indexed annuity is the guarantee that your account value will not lose value due to market declines. Another advantage is the ability to participate in some portion of a specified indexes return in positive years. Other advantages include tax deferral, upfront bonuses, stable life income stream, estate planning, and multiple rider options to fit the client's needs. While these reasons may be compelling, buying a product based only on its features may not be consistent with your planning goals and objectives.

Understanding how these contracts provide potential gains is not always as easy as the selling agent might have you believe. The index-linked gains depend on a combination of indexing options and limits set by the issuing company. Complex differences between Equity-Index annuities offered by various insurance companies can make comparisons nearly impossible. However, the methodology used by the insurers who sell the annuities is universal: use derivatives to put collars around the annuities, which limit both their upside and downside for investors.

These differences between each insurance company's offerings may include:

- **Participation Rates**- A participation rate determines the percentage of the gain in the selected index will be credited to the annuity.
- **Interest Rate Caps-** An upper limit is placed on returns above a certain level.
- **Spread/Margin/Asset Fee**-The amount the insurance company retains above the upper limit interest rate cap.

A special note of caution from FINRA in regards to the first three differences listed above. Per FINRA, "Some Equity-Index annuities allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features."

OmniStar financial group™

©OmniStar Financial Group Market Spotlight

Additional differences include:

- **Indexing Method**-Annual Reset, High Water Mark, or Point-to-Point are methods which determines the change in the index over the period of the annuity. The selected method will impact the calculation of interest to be credited to the annuity.
- **Index Averaging**-Index value averaged versus actual index value on specified date.
- **Interest Calculation**-Simple interest versus compound interest
- **Exclusion of Dividends**-Most Equity-Index annuities will exclude gains from dividends from interest calculations.

All of the potential differences are inherent to Equity-Index annuities and, consequently, affect the investor's return. From there, it gets even more complicated. There are variations between Equity-Index annuity products as to how much contract fees are charged, length of the contract, upfront bonus retention clauses, and surrender fees.

Fundamentally, investing dictates that whoever bears financial risk will assume some costs and will demand a return. This happens to you when you buy and investment; you expect a return when you buy a risk asset such as a stock. In the case of Equity-index annuities, the issuing insurance company provides a guarantee and in return they expect to make a profit. Simple, right?

If you consider an Equity-Indexed annuity, first decide what you are trying to achieve. Once you have performed your due diligence on available solutions that will accomplish your needs, you can then decide if the costs are worth the protection. Sometimes this is difficult because the future is unknown and the risk may not be clear for a long time. Like many other decisions in life, we are forced to make our best choice without having all the information. Take your time, find a trusted source, and completely understand what you are buying. Remember, it is your money and you deserve to be well informed. As the old saying goes, if it sounds too good to be true, it probably is.

No matter what investment vehicle you chose, keep two rules in mind: If you want a reward, you must accept the potential for risk. All investments, no matter how safe or secure they seem, have inherent risks.

©OmniStar Financial Group Market Spotlight