

EQUITY INDEXED ANNUITIES – TOO GOOD TO PASS UP, OR TOO GOOD TO BE TRUE?

Executive Summary

Equity indexed annuities (EIA) are frequently touted as providing the best of both investment worlds: a guaranteed minimum return and participation in stock market appreciation. On the surface they seem like a “can’t lose” proposition. After all, who wouldn’t want to lock in a minimum return and still participate in the stock market when it goes up?

Before jumping in, however, investors should consider the old adage, “if something appears too good to be true, it probably is.” Since the investor is essentially purchasing insurance to protect from a risk, it is important to ask two questions: (1) how bad is the risk, and (2) how expensive is the insurance?

Based on our analysis, the risk that these products protect against is very low. In fact, our analysis suggests that investors would have been better off avoiding EIAs in over 78% of the time periods considered.

While the risk that this insurance protects against is low, the cost has been extremely high. Using what we believe to be conservative assumptions, the average historical cost for a \$100,000 investment in an EIA with a 13-year holding period has been over \$180,000.

The SEC and The Financial Industry Regulatory Authority (FINRA) have issued an investor alert on these products to warn potential investors that they are not necessarily the financial panaceas that they are often marketed to be.

What are equity indexed annuities?

On the surface, EIAs are insurance products that combine the guaranteed interest rates of a fixed annuity with the investment component of a variable annuity. As a result of this combination, EIAs guarantee a minimum rate of return and simultaneously allow the investors to participate in market gains. While this sounds great, these products are extremely complex and the manner in which they actually credit gains and returns to investors can be illusory.

While lack of standardization makes it virtually impossible to analyze EIAs in a vacuum, I was able to obtain specifics on a few “best equity indexed products of the month” web sites, as well as those that were previously sold to current clients by former advisors. Here is a summary of common features:

- Most products offer downside protection (minimum return of 0-4%) along with some level of participation in the stock market.
- The market participation is generally 70-100% of the stock market price move depending on the product, and the most commonly linked index is the S&P 500.
- The participation is generally linked to the movement in index price rather than total return, *which means that it excludes dividends*. In addition, positive market moves are typically capped at a certain maximum rate per month, quarter, or year.
- These two features – exclusion of dividends and maximum return caps –have a significant drag on long-term market returns (as we’ll see later).
- Most products require that your money is locked up for a period of 7-13 years, and significant penalties apply to withdrawals prior to this time period (frequently in excess of 15%).
- Most products provide a guaranteed fixed rate, but only guarantee this rate for a short period. A lower rate applies in future years.

- Actual returns that are credited to the account may be reduced by expenses incurred by the insurance company (administration, marketing, operations, etc...).

In essence, you are purchasing insurance and paying the insurance company a premium in order to protect your portfolio against losses while enjoying at least some level of upside potential. The cost of the premium that you pay may be in the form of foregone upside potential, foregone dividends, administrative expenses, or all of the above.

Since you are paying a premium to protect yourself from the risk of loss, it is very important to consider two factors prior to purchasing:

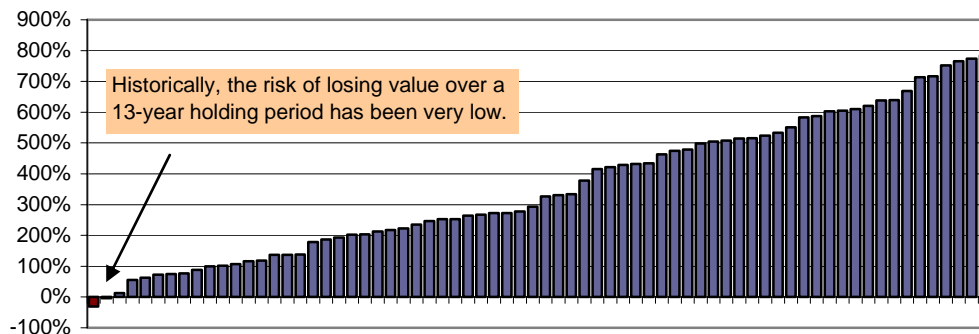
- How risky is the event that you are trying to avoid?
- How costly is the insurance that you are purchasing?

What is the risk?

When purchasing an EIN, the risk that you are trying to avoid is that of negative investment returns over a particular holding period. Since the products that I found had surrender periods of 13+ years, I am going to consider that time period in this analysis. Here are my findings:

- The frequency of losses over a 13-year holding period for a portfolio that is naively balanced 60% S&P 500 and 40% bonds has been 0%. Since 1926, there has never been a loss over 13 calendar years for this simple mix.
- A more reasonable comparison, however, may be to the S&P 500 since that is the investment to which these products are linked and you could presumably balance your portfolio around it.
- The frequency of losses over a 13-year holding period for a 100% S&P 500 investment is less than 3% (two losses over 70, 13-year rolling periods).
- Both of the holding periods that experienced losses occurred during the Great Depression (1930-1942 and 1931-1943), and the total losses over these two holding periods were -30% and -4%.

13-year returns for S&P 500 (sorted from worst to best)



- Based on this, the risk that an investor is trying to avoid by purchasing an EIN, namely avoiding a loss over a 13-year holding period, is not very significant; there has only been one meaningful 13-year loss since 1926, and there have been none since 1932.

What is the cost of this insurance?

The next step is to determine how expensive this insurance is for investors to purchase. For the purposes of this analysis, we consider an investor's cost as being the difference between the value obtained with an EIN and the value that would have been attained by simply buying an S&P 500 Index fund and holding it for the 13-year period.

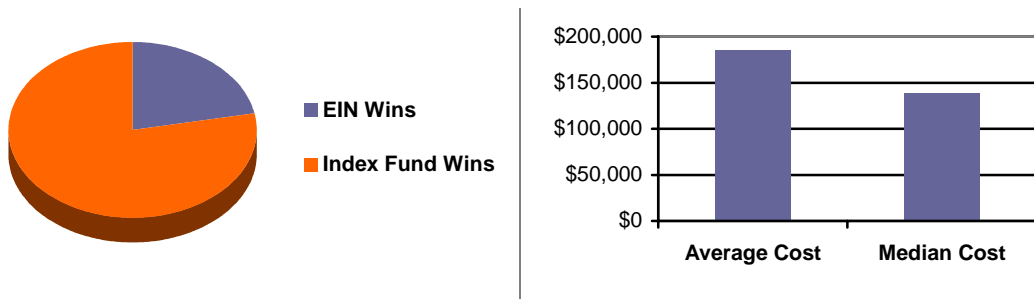
The actual cost incurred by the investor will depend on each product's details, so in order to estimate the cost of holding an equity linked annuity we have made the following assumptions regarding the purchased product.

- A \$100,000 initial investment.
- 0% administration costs.
- 0% sales costs.
- An average dividend yield of 2%.
- A 100% participation rate in price increases.
- Upside potential capped at 12% per year with no high water mark requirements.
- Minimum annual return of 3% with no participation reduction.

Using these assumptions, we compared the ending value of the EIA to the value that an investor would have achieved by simply investing in an S&P 500 Index fund. Rolling 13-year periods from 1926 to 2007 were considered (1926-1938, 1927-1939...1995-2007).

The results are summarized as follows:

- The investor would have been better off in 55 of the 70 time periods by simply investing in an S&P 500 Index fund. In other words, there was a 78% chance that purchasing the EIA would result in a lower investment value.
- The average cost of the EIA, measured by the difference in ending values, was \$185,000.
- The median cost (the one that had as many results above it as below it) for the EIA was \$138,000.



A real life comparison

The marketing materials for EIAs are very effective, and the “real life” illustrations that they present appear to make a compelling argument for the products wealth creation/protection benefits.

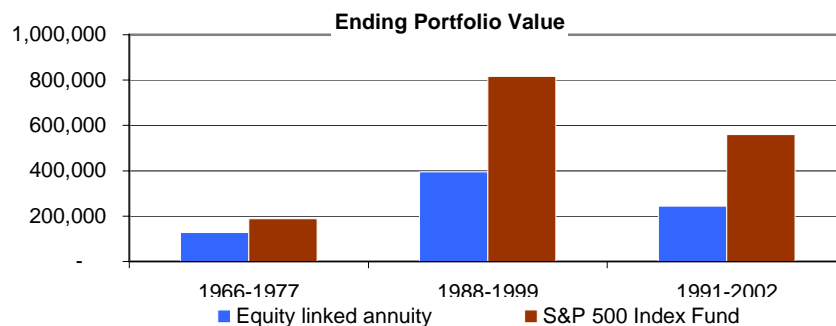
One advertisement made a particularly compelling argument for the “benefits” of these products, by comparing the value of an EIA to an investment that “received the *price movement* of the S&P 500” over three separate 12-year periods. The results were very impressive, and I initially

assumed that they had cherry picked three time periods that worked to their advantage...after all, they got to choose any time periods they wanted to illustrate the benefits.

Since real investors calculate total return as *price movement plus dividends*, I compared the results to what a real investor would have received if they simply invested in an S&P 500 Index fund during the same time period.

As the following table and chart illustrate, an investor would have significantly outperformed the EIA in each of the three handpicked time periods!

	Time Period		
	1966-1977	1988-1999	1991-2002
Equity linked annuity	128,318	395,182	245,096
S&P 500 Index Fund	187,850	817,522	559,607
Added "value" of EIN	(59,532)	(422,340)	(314,511)



Conclusion

- Market gyrations and short-term volatility can create anxiety, but the S&P 500 has experienced only two negative returns over 13-year periods since 1926, and more moderate allocations have never experienced a 13-year holding period loss.
- These products take advantage of investor fear and anxiety during difficult investment times, but they provide illusory benefits.
- As currently structured, EIAs provide extremely expensive insurance to cover a risk that has historically been almost nonexistent.
- This is not the way to buy insurance, nor is it an effective way to invest.
- An important lesson from all of this might simply be the importance of a long-term focus for investors.
- Be skeptical of offers that sound too good to be true. Companies do not give things away without anticipating something in return. There is no free lunch, and a healthy dose of skepticism is warranted.
- Under most circumstances, investors seeking to minimize return volatility would be much better served with other strategies.