Safety Cushion

An equity-indexed annuity can offer clients a share of the market's gains while protecting against a loss. By Roccy DeFrancesco

AFTER THE BEAR MARKET OF 2000-2002, when many stocks plunged sharply (and the benchmark S&P 500 fell 43.9%), clients began realizing the stock market doesn't return 10% every year in lockstep. Millions of people lost billions of dollars over that interminable three-year stretch. Since then, many clients have been looking for alternative investments that won't turn into more losses.

Some turned to old-fashioned certificates of deposit (CDs). Why? CDs are a simple product; they offer a guaranteed return on investment, and they can be cashed in or renewed at the end of a specific term of months or years.

Yet as most clients have figured out, CD rates remain extremely low, as do rates on any fixed-return investment vehicle today. Clients balk at the low rates of return, especially when they know that they have to pay income tax on those skimpy returns.

So what is better than fixed-return vehicles? The quick and easy answer is anything that starts with the word "variable." The problem is most variable investments, such as stocks and mutual funds, have no principal guarantees.

An alternative is the equity-indexed annuity, or EIA. This is a nice, although potentially confusing, option for clients who want to protect investment dollars while participating in market growth.

EIAs are a bit of a hybrid between a variable investment tool with no guarantee and a fixed-investment vehicle with a principal guarantee. They don't subject your client's money to the downside risks of the market, but they still give the client the potential to benefit from the market's advances.

In return for that guarantee, any market gains are capped at a certain percentage (such as 9% a year), and the EIAs match their growth to that of an index, most often the S&P 500. As will be discussed later, the real question is how to determine which EIA to use.

To give an example, consider a client who put $100,000 into an EIA with a 9% annual cap and pegged to the S&P 500 from 1993-2002. After those 10 years, the after-tax balance would have grown to $143,200, versus a balance of $123,750 for the same amount invested in a taxable brokerage account with a 1% annual fee and prevailing capital gains and dividend taxes paid. (See "Sleeping at Night" on page 100.) In this case, the client not only received principal protection, he or she actually outperformed the brokerage account, despite the EIA's 9% annual cap on earnings.

If you say this example is misleading because every 10 years the stock market isn't going to have a crash like the one from 2000-2002, I would have to agree. Investing in stocks and mutual funds over an extended bull market is always better than investing in an EIA with a cap. For many clients, though, trying to get the best of one world (a rising market) while protecting against the worst (a crash) is an appealing—and secure—scenario. As advisers know, no one can predict future market behavior.

Despite their appeal, wading through the different types of EIAs can be hard. Almost every major insurance company has an EIA, and each one of their products seems to be different. A summary of various ways that EIAs can be offered follows. In most cases, I'll be only discussing point-to-point annuities with growth pegged to the S&P 500.

A traditional EIA has a hard annual cap (ranging from 7%-12% or more depending on the year purchased) and a guaranteed minimum investment return of zero—in other words, no loss can be credited. If the S&P 500 goes up 10% with a 10% cap, the client receives that 10% return for that year. If the market goes up 20%, the client still gets 10%. If

the S&P 500 falls 10%, then the client's account balance stays the same. The traditional EIA also has a 100% participation rate (see below). Following is an explanation of some of the most common EIA features and options.

Valuation methods. EIAs and their caps vary depending on what type of valuation method is used. Most caps are available with the option of point-to-point or month-to-month valuation.

Point-to-point valuation means the annual crediting value will be locked in every 12 months after the annuity is funded. For example, if an annuity was funded with $10,000 and on the 365th day the S&P 500 was up 7%, the client then would be credited with 7% growth. If the day before or the day after the anniversary date the S&P was down to 5% growth, that number is immaterial when determining the amount credited for that particular year.

Month-to-month valuation takes the monthly return of the market and then averages that return for the year to calculate the final crediting number. Monthly valuation almost always returns less to the annuity holder than point-to-point valuation, and therefore most insurance companies offer higher annual caps with a month-to-month valued EIA (because their exposure is less).

Participation rates. This refers to how much of the annual growth of a measuring index (most often the S&P 500) will be credited toward the amount of money in the EIA. In a traditional EIA, the participation rate is 100%, which means that all of the return will be credited to the money in the EIA, subject to the cap.

Some EIAs, however, have less than 100% participation. Most of those policies, in turn, have higher caps or no caps at all on the measuring index. So for example, if a client had $100,000 in an EIA with a 75% participation rate, and the S&P returned 24% for the year, then the client would be credited with 75% of that growth, which is 18%.

This type of EIA sounds much better for clients at first blush, if you think the S&P 500 will have returns similar to past years, when it often spiked above 20%. (This reflects the old adage that although the S&P 500 might *average* 8% a year, it never *returns* 8% a year). If the S&P 500 doesn't have those high spikes, however, then the lower participation rate annuities won't perform better than their EIA cousins with hard caps and 100% participation rates.

EIAs with fees. The EIAs described above are usually sold as "no load" products with no annual administration fee, service charge, certificate charge (CC) or management fee. But be warned that many EIAs do have such charges.

CCs are usually charged only when the measuring index has a positive year. For example, assume that an EIA offers a 100% participation rate, with no cap on returns and principal protection. That sounds wonderful. But unfortunately, that same annuity would typically have a CC of 2% annually. When you run the numbers, EIAs with hard caps and no fees will outperform EIAs with better cap terms if the market doesn't have years with 20%-plus returns.

EIAs with bonuses. Many EIAs today offer annuity owners a bonus for buying the product. Looking though a sample of the EIAs currently on the market, one company is offering a 10% first-year bonus, which means that if a client put $100,000 into the annuity, the account balance would be $110,000 at the start. Another company is offering a 1% bonus each year for the first 12 years (based on the first year's premium). In the $100,000 example above, the annuity company would contribute $1,000 a year into the EIA, regardless of what is happening with the measuring index.

Since the insurance companies never lose money, there is always a catch when they give something for "free." Whenever a company offers bonuses, it usually imposes higher surrender charges on the annuity and extends them for a longer period of time. As a side note for agents, many companies will reduce the agent's compensation when the annuity holder receives large buying bonuses or has shorter surrender periods.

EIA contract changes. One of the reasons EIAs are difficult to evaluate is because the terms that comprise them can change. What can be changed?

The annual caps. Most of the companies that offer hard annual caps reserve the right to change those caps on an annual basis. The companies always

Continued on page 132

Sleeping at Night

Even in an extended bull market, an EIA can do well for a client

The following examples show what would have happened to $100,000 in a traditional EIA versus what the client would have gained in a typical brokerage account with the same returns. From 1993 to 2002, the client did much better with the principal protection of an EIA. In a market period with no major setbacks (the extended bull market of the 1990s), the EIA will not do as well, but it will still produce a respectable return. The EIA examples, which are pegged to the S&P 500, assume a 9% annual cap (point to point), principal protection, and no certificate charges.—*RD*

	Investment Period	Balance at End of Period	Balance after Tax in Lump Sum
Brokerage Account $100,000	1993-2002	$123,750	$123,750*
EIA with 9% Cap $100,000	1993-2002	$172,000	$143,200
Brokerage Account $100,000	1990-1999	$240,000	$240,000*
EIA with 9% Cap $100,000	1990-1999	$204,500	$162,700

*Assumes 1% annual management fee, capital gains and dividend taxes paid each year, and 40% tax bracket.

EQUITY-INDEXED ANNUITIES

Continued from 100

have a bottom cap threshold that they cannot fall below, but advisers need to understand and explain this to clients so they don't get upset when the 9% cap drops to 6% in a down market.

Some insurance companies will have multi-year caps that stretch out for two or more years. For example, if an EIA product has a two-year cap of 15%, then the client will not be credited more than an effective 7.5% each year for the two-year window. (The total return is always applied to the annuity account at the end of the second year.)

Participation rate. Many insurance companies reserve the right to change the EIA participation rate annually. An EIA might start with a 100% participation rate in an up market, but when and if the market starts heading in the opposite direction, that rate can be adjusted down to whatever minimum threshold the EIA contract language states.

One of the limited participation rate "no cap" EIAs on the market right now has a 10-year window where the 75% participation is calculated with a principal guarantee at the end of the tenth year. This is an important product feature, because without the annual guarantee of zero, the 10-year window will include down years that will be factored into the amount credited.

CCs (fees). Many companies have changeable CCs. If you look at some of the marketing materials for EIAs, the chances are high that the CC indicated on the product brochure is not the same as the CC that the company is currently charging its policy holders.

In one instance, an insurance company's cap was 8%, and the highest possible CC that the company could use was 15% (the current CC rate was 1.5%). With that scenario, if the measuring index returned 8% and the CC was at 15%, the client would receive a zero return when the market was up 8%.

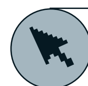
Surrender charges. All EIAs have surrender charges that annuity holders must pay if they want to give up the product and withdraw all the money. The charges vary depending on the company, but they typically start out high the first few years (10%-15%) and then scale down to zero. Surrender charges usually are in effect for at least seven years, and they can last as long as 14 years. The shorter the surrender period on the product, the less an agent will make on the sale.

Commissions. If you are a commission adviser selling an EIA, you can expect to make approximately 5%-6% of the premium as a commission if the EIA has a short surrender period and 7%-9% on longer surrender period EIAs. General agents typically call what they choose to pass through to agents "street" commissions. If you work with the right general agent, you can create a relationship where 10% or more on some products can be passed through.

Non-security product. Finally, don't forget that EIAs are treated like non-security products. This means agents with a life insurance license can sell a product that can act and look like a variable product without having to have a variable security license. Many advisers who have a security license don't have to watch their broker-dealer take the usual haircut off the top before they collect the commission. And unlike variable annuities, moreover, EIAs don't take the commission from the investor's account balance; it comes from the pocket of the insurance company instead.

In conclusion, EIAs are one investment product that can benefit more cautious clients who want to maintain their investment principal while still participating in the upside of the stock market (with a cap, of course). EIAs do a good job of meeting those two goals, as long as the client clearly understands that in a steadily rising or big bull market, his or her EIA account balance will lag behind traditional investments. **FP**

Roccy DeFrancesco, J.D., is a partner in TriArc Advisers, which provides education on wealth management and advanced planning to financial and legal professionals. He can be reached at www.triarcadvisors.com or 269-469-0537.



To take the CE Quiz online, go to www.Financial-Planning.com

SPENDING BINGE

Continued from page 104

they are going to eat 1,200 calories a day, they will be off that diet in two or three weeks." Reining in spendthrifts calls for long-term behavior modification, not short-term spending budgets.

Jason Weybrecht, a vice president with Spero-Smith Investment Advisors in Cleveland, starts all new client interviews with a close look at debt levels and spending habits. In every conversation, he stresses how each decision they make will impact their long-term goals.

He says it's a fine line between leading them toward those goals and getting overly involved in micromanaging their day-to-day spending. "We are not big believers in setting up budgets," he says. "Our philosophy is we don't mind if you spend the money, but you have to understand how that spending affects the goals that we have set."

The rest is up to the clients, he says, pointing to one family he worked with for years. When the parents died, each child received $750,000, and they all had similar goals for their inheritance. He sat down with each one and came up with a financial plan to achieve their personal goals. Despite their well-laid plans, one daughter just couldn't stop spending. She ran through all of her money in three years, with nothing to show for it today.

"Our job is to help them see things with their eyes wide open," he says. "We want to help them understand that based on their current debt, spending, and assets, they aren't going to be able to do what they want to do. When they get motivated enough, they find a way."

When they don't, Weybrecht must make another hard call—when to cut them loose. "We have fired clients who haven't been able to come to grips with those terms. We're not being judgmental, but if they are spending beyond their means or accumulating unplanned debt, their goals can't be achieved," he says. "We're not miracle workers." **FP**

Rebecca McReynolds, a freelance business writer in Tucson, Ariz., wrote about advising high-income clients who lose their jobs in the March issue.