THE STRAIGHT SCOOP ON INDEXED ANNUITIES.

By Tim Morton

Plain and simple they are fixed annuities – thus the updated name **Fixed Indexed Annuity**.

When you buy an index annuity, the principal is backed by the insurance company that issued the annuity. As with all fixed rate insurance products, index annuities provide a minimum guaranteed return. Excess interest beyond this minimum guarantee is calculated based on movements on an external index, but the customer is on no way directly involved in buying the investments. In short, this product is a fixed annuity with a guaranteed minimum interest rate and gives owners an opportunity for a higher yield if the index used to calculate interest crediting generally moves positive.

Again, with an indexed annuity, at the end of the surrender period chosen, a customer is guaranteed to have more value in their account than they deposited, just like any fixed rate investment. No such guarantees can be made for customers in a well diversified securities based portfolio.

Index annuities are designed for folks that are averse to risk. Thus they can be considered for the fixed safe portion of a portfolio. Also the type of person who navigates toward lower risk and lower guaranteed returns is the person for a fixed indexed annuity. Certificate of deposit buyers and traditional fixed annuity buyers fit this profile. Fixed index annuities offer customers a potential for higher returns than traditional savings vehicles without market risk to principal.

Indexed annuities approved for sale by most Broker Dealers require that they have surrender periods of 10 years or less, can not require annuitization to get out (known as two tier annuities) and can not have surrender charges above 10% in any year. Keep these criteria in mind when purchasing this product, but there may be situations where you can deviate from this criteria and the product will still be suitable.

Surrender charge schedules in Indexed annuities are similar to Variable Annuities. Liquidity is almost always 100% available at the end of the surrender period, 10% of the account value is free for distribution (no surrender charges) during surrender periods and surrender charges are typically waived in the event of death, long term care or terminal illness.

Most Indexed Annuities have different interest crediting strategies that can be mixed and matched – like sub accounts in a variable annuity where you can allocate funds among the various strategies including a fixed guaranteed interest option. The worst case in any indexed strategy is zero – ***never any erosion of premium or prior interest earned***. You can re-allocate on the strategy anniversary dates. Strategies are just different ways of calculating how interest will be credited and normally based on the S&P 500 index, but you will see other indexes used as well (Dow Jones, Russell 2000, etc.).

I like to keep things very simple and typically only use one primary strategy, the annual "point to point with cap" strategy or ones that have slight variations to this (trigger rates and 2 yr point to point with cap for example).

ANNUAL POINT TO POINT WITH CAP EXPLAINED: Let's say the annual point to point cap is set at 7.5%. You purchase the annuity and the insurance company takes a snapshot of the S&P 500 – let's say the S&P 500 is at 1000 at purchase. Nothing happens until the anniversary date. On the anniversary date, if the S&P 500 index closes higher than the start point of a year earlier, then positive interest is credited to the annuity.

For example:

- If at purchase the S&P was 1000 and closed 1 year later at 1100, the gain in the index would be 10%. If the cap on the product was set at 7.5%, then 7.5% interest is credited to the account even though the index was up 10%. $100,000 invested originally would now show an account balance of $107,500.

- If the S&P closed at 1050, a 5% gain, then a full 5% would be credited since it was under the cap of 7.5%. $100,000 invested would show an account value of $105,000.

- If the S&P closed at 900, a 10% loss in the index, then no interest would be credited. $100,000 invested would still show an account value of $100,000. The good news however, is that the starting point for the next year is now set at 900 – known as the **ANNUAL RESET**. No need to recover from losses, like in security based investment, because there are never any loses in a fixed indexed annuity.

  WHY THE ANNUAL RESET FEATURE IS SO IMPORTANT - Let's say the S&P 500 index comes back 10% to 990 in year 2 and the cap remained at 7.5%, then 7.5% would be credited in year 2. In this example the index dropped 10% in year 1 and came back 10% in yr 2. A $100,000 original investment would now have an account value of $107,500. In a security based investment, like a mutual fund portfolio or Variable Annuity, your account value would most likely still be less than your original investment because you have to recover from prior drops in value before you can see positive gains.

Lifetime Income Riders Available

Most indexed annuities also have optional riders available to guarantee lifetime income, without annuitization, in the same fashion as those riders available with

Variable Annuities. These riders have a cost and I don't like to use them without creating a real income plan for the client, but they can be very useful in many situations. In addition, the income riders available with indexed annuities, often provide higher income benefits and for less cost than those offered by variable annuities. Income Riders create a separate income only account, just like with a Variable Annuity. Sometimes I refer to this as a shadow account. It is mainly used to just determine the maximum amount of income the client can draw from the annuity without annuitization and still be guaranteed for life. This shadow account grows separately of the annuity value. Remember, the annuity value grows as described above and is the death benefit and cash or walk away value. The income rider account value is just a virtual value use to determine the future income that can be withdrawn without annuitization.

Income riders come in various flavors and for various costs. Some will step up the income account at guaranteed rates of 7%, 7.2%, 7.5% or 8% for 10 year periods or for a lifetime. Some can be used immediately for income calculations and some you have to wait a year. The guaranteed income is typically calculated at the time of first distribution, base on the higher of the income account value or the annuity value and in conjunction with the client age at the time of first distribution. The income calculations typically generate more income than their Variable Annuity cousins and for less cost.

Great products and suitable for many clients.

Fixed Indexed Annuities are an ideal bridge for a customer that has never invested or has little invested in the stock market because of the fear of loss. However they still want the potential for a higher return than they're earning on other saving instruments. Index annuities are also attractive for stock market investors that want to take and protect their profits or sit out a portion of their portfolio for a while. They don't want to lose value and/or they want the potential for a higher return than they might get from moving funds into a money market account or other fixed rate savings vehicle.

Investors near retirement or in their early retirement years are also perfect candidates for indexed annuities as they are willing to give up a little potential on the upside to avoid any losses to a retirement nest egg. Losses, even slight, could cause devastation to a retirement plan, resulting in a change in retirement lifestyle or extending their eventual retirement date. Sequence of returns risk can easily cause a retirement portfolio to erode too quickly and not provide the lifetime guaranteed income as planned.

Call your investment advisor today for a complete evaluation of your situation to see if repositioning a portion of your portfolio into a indexed annuity is suitable for you.

Call Westland today for a personal briefing on these products and to help incorporate them into your practice. We are here to help!

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