

Understanding Index Annuities

History of index annuities: Index annuities were introduced in early 1995. The financial tools to create index annuities have been around for several years. In 1994 the stock market had a rocky year- bond funds returns were poor, the S&P 500 ended the year on a down note, and many stock funds and variable annuities had minimal or negative returns. Due to the turn in the market and complaints from numerous customers the index annuity was created. It was designed to attract risk-averse investors that wanted protection of principal and the opportunity for higher returns than those of a traditional fixed annuity or CD-type vehicle.

Since the creation of the Index annuity the sales have vastly increased. Index annuity sales were \$400 million in 1995 and by the end of 2003 annual total sales reached a record of over \$14 billion!

How do Index annuities work: Index annuities are designed to mirror the performance of a common or well-known index, such as the S&P 500, NASDAQ, Russell 100 index, Dow Jones or the S&P 100. Because index annuities have similar guarantees as a traditional fixed annuity, they are not considered a variable product., and therefore a securities licensed is not necessary for the sale of these annuities. Index annuities provide a guaranteed interest rate combined with the ability to earn a percentage of certain market-driven indexes.

Terms of Index annuities:

Participation Rate: A percentage of the gain of the S&P 500 index credited accumulation value for a certain period. The participation rate is declared by the insurance company generally declared at 55%-100%.

Example: Suppose an index annuity has a defined participation rate of 70%. If the index it follows goes up by 8%, the annuity's accumulated value increases by 5.6%. And in many index annuities, the insurance company mitigates downside risk.

Index Spread or Margin: Percentage deducted from the index increase prior to crediting the index gain to the annuity. This is often used in products that have a 100% Participation Rate. Generally spreads can range anywhere from 1.5% to 5%

Example: When you open a savings account, you are subjected to a spread. The bank may be earning 5% on your money, but in a savings account, they're only paying you 1%. In this example the 4% difference is the spread.

Caps: An overriding maximum percentage that can be credited to the annuity for the period. Generally the cap can be no less than 3% and on the average higher than 12%. Caps are usually adjusted annually.

Example: If the market performs at 12% and the cap on the product is 8% , interest credited would be at 8%. If the market performs at 6% the client will be credited the 6% interest rate.

Minimum Guarantee: Minimum guarantee promises an accumulation value usually equal to a percentage of the original principal, less any withdrawals, accumulated at a minimum guaranteed interest rate by the end of the surrender or period to provide a portion of the initial premium, to provide this minimum guaranteed return the insurance company invests, in bonds or other conservative instruments. On the average the minimum guarantee is from 1-3%.

Index Crediting Methods:

Annual Reset: An indexing method under which index growth is measured annually. The index value starting point is reset each year, gains are locked in.

Point-to-Point: The S&P index value on the date of issue is compared to the index value at the end of the contract term. This percentage is then measured by the participation rate or cap and credited as interest.

Monthly averaging: An index method in which takes 12 monthly Index readings and averages the difference. Most monthly average EIA's have a cap on the upside but not the downside.

High Water Mark: The difference between the highest index value achieved on any of the contract anniversaries, is compared to the index value of the policy start date. At the end of the contract term, the account is credited the highest S&P index value during the term multiplied by the participation credited as interest.

Things to look for in an Index annuity:

- **Strong Ratings.** Look for insurance company ratings of “ A” (Excellent) or better. This will ensure they will be around when your client needs them most.
- **Fixed Spread.** In a down market the insurance carrier will try to increase the spread to make up for loss earnings. If the spread is fixed this can protect your client if the market has a bad year.
- **Participation Rates.** Higher participation rates the better. However, the benefits of a higher participation rate can be reduced by higher spreads and long indexing periods. Make sure to read the fine print.
- **Surrender Periods.** Index annuities typically have longer maturities than other annuities. Make sure that the surrender period is no longer than 10 years.
- **Free Withdrawals.** Most companies offer 10% of your original annuity's value to be withdrawn every year, free of penalty. You should look for a company that offers a 10% withdrawal on the accumulated value, or guaranteed value, whichever is greater.
- **Death Benefits.** Look for a company that provides full accumulation value at death or at least the minimum accumulation (whichever is greater). Remember annuity proceeds bypass probate.

As you can see, index annuities are designed to give customers a long term growth and retirement planning vehicle. They offer many benefits including tax deferral and retirement income. Most agents seem to shy away from index annuities due to the fact that they do not understand them. This overview should provide you with the basic knowledge to feel comfortable in knowing that you are doing the right thing for your client.

The NASD states this:

NASD Notice to Members 05-50 - August 2005

Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities

Executive Summary

This Notice to Members addresses the responsibility of firms to supervise the sale by their associated persons of equity-indexed annuities (EIAs) that are not registered under the federal securities laws.

Expectations of selling the correct EIA

The inevitable question every client will ask is "What will I earn?" A difficult question to answer especially with an index annuity. Not only do you have to choose between the different crediting methods such as point-to point, point-to-point with annual reset, high water marks, monthly averaging & daily crediting methods but you also have to choose between a 5,7 or 10 year period.

Equity index annuities are designed to out perform CD's and Bonds of the same duration. While they are tied to the market, do not expect market like returns. The 5-7 year index annuity should produce a 4%-5.5% rate of return; a 10 year should perform at a 6%-8% return.

Setting attainable investment return goals will not only help you manage your time with ongoing reviews and questions but will also make you a hero when expectations are exceeded which in turn results in more sales and referrals?