

OTHER VOICES

Designed to Deceive

By FREDERIC G. MARKS

Equity-indexed annuities.

AN EQUITY-INDEXED ANNUITY IS AN INSURANCE-COMPANY product that's marketed as a way to lock in stock-market gains when the market is rising, while protecting principal against losses when the market is falling. What could be better than that?

Not so surprisingly, these annuities, known as EIAs, have been selling at the rate of \$25 billion per year. But they are so complex that few individuals could, even if they tried, understand how they really work. What people can understand, however, is the sales pitch -- which can be deliberately misleading.



Stuart Goldenberg

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\$350,000 to the annuity. Nonetheless, we did a financial analysis, and it showed that if the annuity performed according to the illustration, it would provide an after-tax rate of return of only 4.1% per year. Intrigued by such poor returns in what was, after all, a sales pitch, we did a further study of EIAs. Here's what we learned.

AN EIA IS NOT AN INVESTMENT in shares of stock or in a stock-market index; rather, it is an insurance-company contract. An EIA pays the greater of two alternative benefits -- a minimum guarantee or a possibly larger benefit based on the increase in value of a stock-market index.

The guaranteed minimum benefit of an EIA is generally that the customer will receive back 90% of the premiums paid, plus 3% annual interest on that amount. Applying the guarantee to the proposal above, the \$350,000 in premiums paid would create a guaranteed benefit of only \$355,155 after the first seven years and only \$436,796 after 14 years. In this proposal, the compound rate of return for the first seven years is thus only 0.37% per year, and only 1.67% per year for 14 years.

Recently, a client of our firm asked us to review an EIA proposal. The sales agent had presented the following illustration of the proposed cost and benefits:

1. Invest \$50,000 per year for seven years.
2. Make no contributions or withdrawals for an additional seven years.
3. Thereafter, withdraw approximately \$50,000 per year for fifteen years.

This sales presentation did not say that the EIA provided a guaranteed benefit. Instead, the three-step scenario was an illustration of a possible outcome of committing

Some EIAs credit only simple interest on guaranteed benefits, rather than compound interest, further reducing the guaranteed return.

The alternative to the guaranteed minimum benefit is based on the change in the value of a stock-market index, most commonly the Standard & Poor's 500. The benefit is measured only by the change in the price level of the index, excluding dividends. Exclusion of dividends understates significantly the total return of the S&P 500. Since 1946, the S&P 500 has returned an average of 11.40% per year including dividends, but only 7.41% per year excluding dividends.

One method used in EIAs to calculate changes in the S&P 500 is the monthly-average-return method, which measures the increase in the index level from the start of each year to the average month-end level for the year. The base is then reset at the beginning of the next year and the process is repeated until the contract matures. That method systematically and enormously reduces the S&P capital return in a rising stock market. In the years 2003-'06, for example, the S&P annualized capital return was 12.6%, compared with only 4.2% per year for the monthly average-return method.

The nearby table illustrates the effect of omitting dividends and using the monthly average-return method for measuring the change in the S&P over the 30 years from 1975 through 2004. It sets forth the total return and the annualized rate of return for these alternatives.

It is not just the 30- year period starting in 1975 in which the monthly averaging and dividend-exclusion methods reduce S&P returns. For the 241 rolling 10-year periods starting in January 1975, the monthly average-return method produced an average return 62% lower than the S&P 500's.

Besides monthly averaging, there are two other commonly used measures of the increase in the S&P index. Both are versions of the point-to-point method, in which change in the index is measured over a set time interval -- and both seem, at least superficially, more favorable to the EIA customer. However, insurance companies also use several other devices to reduce the amount they would have to pay, including participation rates, spreads, caps, and fees.

A participation rate credits to a customer's account only a part of the change in the stock index -- for example, a participation rate of 80% credits the EIA account with only 80% of the change in the S&P 500.

A spread reduces the gross credit calculated by applying the participation rate to the index. For example if the gross credit is 10%, reduced to 8% by an 80% participation rate, with a 3% spread the 8% credit is further reduced to 5% for the year.

Caps limit the effect of an increase in the index. A 14% cap means that the EIA's value will increase by only 14% when the index level increases by more than 14%. The effect of annual caps is very detrimental to the

The S&P 500 Return, 1975-2004...

...calculated with dividends, without dividends, and with the monthly average return used in many EIAs.

	Total Return	Annualized Rate
S&P 500 with dividends	4,821	13.87%
S&P 500 without dividends	1,668	10.05
Monthly averaging S&P 500	444	5.81

customer, as the long-run return from stocks is heavily influenced by years with unusually high returns. For the years 1975 through 2004, a 14% cap would have reduced the annualized price increase in the S&P from 10% to only 5.5%.

An insured death benefit is one of the selling points for an EIA. However, the cost of this benefit to the insurance company is trivial, since the risk to the insurance company is only the difference between the account value and the contractual death benefit. Therefore, a large part of any death benefit is the value of the account supplied by the customer's own money. As shown near the top of this article, the insurance company's cost for the death benefit would be probably less than \$1,000 a year out of the \$350,000 paid in by the customer.

Should a customer want or need to cash out of an EIA early, there is a "surrender charge" that is generally 10% to 12% of the account value, and higher in some cases. Annuity-surrender charges gradually reduce over a number of years, typically at a rate of 1% a year. Nevertheless, the effect of surrender charges is to make an EIA's cash-surrender value less than the premiums paid for many years. In some EIA contracts, surrender charges last throughout the life of the contract.

Someone seeking stock-market gains with no risk to principal could do far better by adopting a simple strategy of allocating 60% of a portfolio to U.S. Treasury securities with the balance of 40% allocated to a low-cost S&P 500 index fund. A thorough study of this approach, by Craig McCann and Dengpan Luo of the Securities Litigation and Consulting Group concludes that, except in very rare cases, the EIA returns much less to investors than would such a portfolio. (The excellent report can be downloaded from <http://www.slcg.com>.)

Our own analysis confirms the report's findings, indicating that even during major bear markets, such as in the years 1973-'82 inclusive, this strategy would have provided a total return of 112% (7.81% a year) versus a total return of only 25% (1.67% a year) for the guaranteed benefit under an EIA.

Equity-indexed annuities are insurance contracts so complex that it's virtually impossible for customers or even brokers and agents to evaluate them. Yet salesmen can readily determine that their commission for selling an EIA will be much larger than commissions on mutual funds and even on other annuity products.

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