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Investor Bulletin: Indexed Annuities

An indexed annuity is a type of contract between you and an insurance company. During the accumulation period – when you make either a lump sum payment or a series of payments – the insurance company credits you with a return that is based on changes in a securities index, such as the S&P 500 Composite Stock Price Index. Indexed annuity contracts also provide that the contract value will be no less than a specified minimum, regardless of index performance. After the accumulation period, the insurance company will make periodic payments to you under the terms of your contract, unless you choose to receive your contract value in a lump sum.

Can you lose money buying an indexed annuity?

You can lose money buying an indexed annuity. If you need to cancel your annuity early, you may have to pay a significant surrender charge and tax penalties. A surrender charge may result in a loss of principal, so that an investor may receive less than his original purchase payments. Thus, even with a specified minimum value from the insurance company, it can take several years for an investment in an indexed annuity to “break even.”

Many indexed annuities do not apply negative changes in an index to contract value. Therefore, if the index value declines over the course of a crediting period, no deduction is taken from contract value. However,

some indexed annuities are being offered that do apply negative changes in the index to contract value, so that if the index declines during the crediting period, you could lose money, whether or not you cancel early.

Further, all amounts payable under an indexed annuity are subject to the claims-paying ability of the insurance company. Circumstances may arise where the insurance company is unable to pay its obligations.

What are some of the contract features of indexed annuities?

Indexed annuities are complicated products that may contain several features that can affect your return. You should understand how an indexed annuity computes its index-linked interest rate before you buy. First, any gains in the value of the index are generally computed without including dividends paid on the securities that make up the index. In addition, an insurance company may credit you with a lower return than the actual index's gain. Some common features used to compute an indexed annuity's interest rate include:

Participation Rates. The participation rate determines how much of the index's increase will be used to compute the index-linked interest rate. For example, if the participation rate is 80% and the index increases 9%, the return credited to your annuity would be 7.2% ($9\% \times 80\% = 7.2\%$).

Interest Rate Caps. Some indexed annuities set a maximum rate of interest that the indexed annuity can earn. If a contract has an upper limit, or cap, of 7% and the index linked to the annuity gained 12%, only 7% would be credited to the annuity.

Margin/Spread/Asset or Administrative Fee. The index-linked interest for some annuities is determined by subtracting a percentage from any gain in the index. This fee is sometimes called the “margin,” “spread,” “asset fee,” or “administrative fee.” In the case of an annuity with a “spread” of 3%, if the index gained 9%, the return credited to the annuity would be 6% ($9\% - 3\% = 6\%$).

It is important to note that indexed annuity contracts commonly allow the insurance company to change the participation rate, cap, and/or margin/spread/asset or administrative fee on a periodic – such as annual – basis. Such changes could adversely affect your return. Read your contract carefully to determine what changes the insurance company may make to these features.

Another feature that can have a dramatic impact on an indexed annuity’s return is its indexing method (or how the amount of change in the relevant index is determined). The amount of change is determined at the end of each “crediting period” within the contract’s accumulation period. In many contracts, the crediting period is one year, although the length of the crediting period may vary from one contract to another. Common indexing methods include:

Point-to-point. This method credits index-linked interest based on comparison of the index level at two discrete points in time, such as the beginning and ending dates of the crediting period.

Averaging. This method credits index-linked interest based on comparison of an average of index values at periodic – such as monthly – intervals during the crediting period to the index value at the beginning of the period.

You should note that insurance companies may not credit you with index-linked interest for a crediting period if you do not hold your contract to the end of the period.

These and other features may be included in an indexed annuity you are considering. Before you decide to buy an indexed annuity, you should understand how each feature works and what impact, together with other features, it may have on the annuity’s potential return.

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