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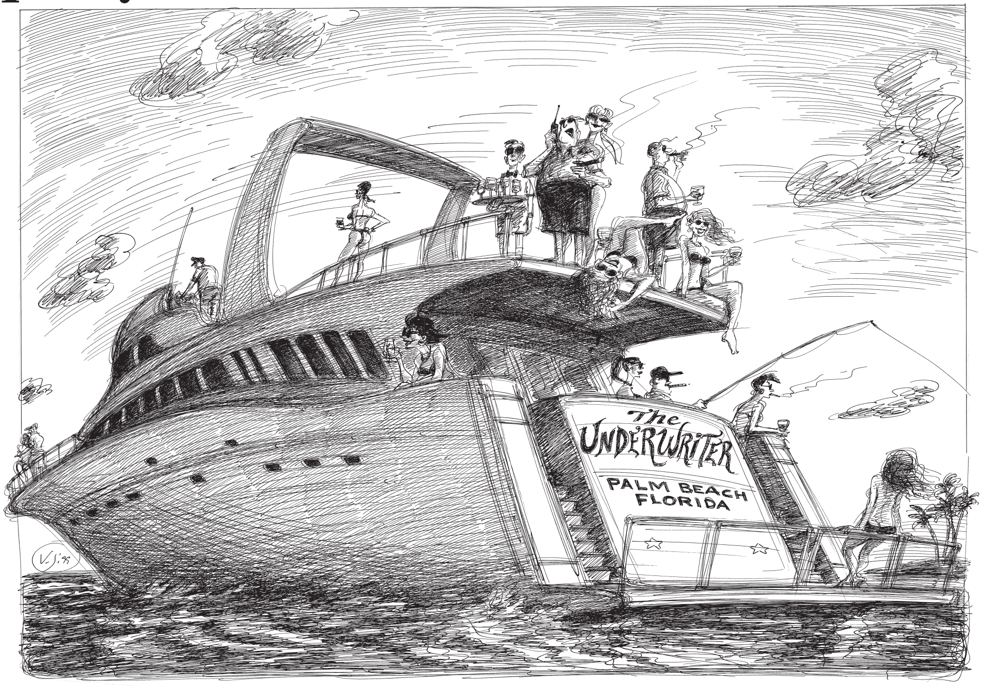
Don't Buy Equity-Indexed Annuities

Big Commissions



"Be real, Jenkins! If I hadn't ripped off my clients, someone else would have."

"Life insurance isn't bought; it's sold." So goes the old maxim that supposedly explains the life-insurance industry's high commissions and sales-driven culture. Although life insurance is a necessity for many people, industry apologists claim that it's a hard sale because people don't like to face their own mortality. The argument for the high commissions is that that's what it takes to sell people something that's so good for them. But that leads to the question: why do life insurance companies pay such high commissions to sell people something that *isn't* so good for them?

Over the years, the life-insurance business has become the investment business. Life insurance companies are "asset gatherers," and a majority of their assets are now derived from the sale of annuities. (1982 marked the first year in which annuity reserves exceeded life-insurance reserves.) Today, the industry's annuity reserves are about twice as large as its life-insurance reserves.

Annuities are essentially a fixed-income or equity product with a life-insurance wrapper that enables the tax-deferred build-up of assets. In recent years, a type of fixed annuity—the equity-indexed annuity—has become a hot product. Last year, close to $30 billion worth were sold. The sales pitch is simple: if the stock market goes up, you'll get some of that appreciation without the risk of losing money. But the cost of avoiding risk can be high enough to make a product unattractive. There are several problems with equity-indexed annuities: (1) they aren't good investments, (2) you don't know what you're going to get, and (3) the fees and commissions are exorbitant. (The high commissions are what entice brokers to sell these products.)

Equity-indexed annuities can have a lot of sizzle. An ad run by Safe Harbor Financial in the *National Underwriter* touted a 16% commission for Conseco Life Insurance Company's Eagle Classic 500. Although equity-indexed annuities are regulated as insurance products rather than as securities, the ad plays up the stock-market angle. Under the headline "The sky's the limit!" it shows a steeply inclined chart of the increase in the accumulated value of an annuity linked to the returns on the S&P 500 from April 1982 to April 2000. (Although the chart looks great, if you study it closely and compare it with the actual results of the S&P 500, you'll discover that the return on the annuity is about one-third that of the S&P 500.)

With most investment products there's an inverse correlation between expenses and returns: the higher the expenses (fees, commissions, etc.), the lower the returns. How, we wondered, could an insurance company offer an annuity that was "indexed to 100% of the growth in the S&P 500 Index," pay a 16% commission, and still make money? In annuity parlance, a product that has 100% of the growth in an index is said to have a 100% "participation rate." It would be unprofitable, or highly risky, for an insurance company to sell a fixed annuity with a 100% participation rate. Even the largest index *fund*, the Vanguard 500 Index Trust, can't guarantee 100% of the return. Although Vanguard is extremely efficient, it still incurs 9¢ of expenses per $100 under management; thus it might be said that an investor achieves a 99.91% participation rate. An insurance company's equity-indexed annuity would have many more expenses than an index fund. First, the annuity provides some sort of guaranteed return, for which there must be a cost. Second, the insurance company has commissions, overhead, and other expenses. Finally, the insurance company has investment risk, surrender risk, and capital requirements. It turns out that the 16% commission on the Eagle Classic 500 was real, but the 100% participation rate was illusory. It was a "teaser rate" guaranteed for one year, after which it could be reset as low as 50%.

Equity-indexed annuities are fixed annuities that have some of the characteristics of fixed annuities *and* variable annuities. The product is designed so that a purchaser of the annuity will get some of the growth of the stock market without the risk of losing money. The annuities generally contain a guaranteed return, which might be 1% or 2%. They also have a variable component, which might be a 35% to 100% "participation" in the growth of the S&P 500 index. But even when an annuity offers a 100% participation rate, an investor won't necessarily get as high a return as would be achieved in an index fund. That's because the participation rate is based on the growth of the *index* and doesn't include dividends, which, historically, have been responsible for a significant percentage of returns. (The current dividend yield on the S&P 500 is about 1.75%.) Further limiting the annuity owner's results is the fact that the returns from the participation rate are often capped at between 3% and 10% in any one year. Another key feature of equity-indexed annuities is their surrender charge, which can be as high as 25%. The surrender charges gradually disappear over time, but can be in effect for more than fifteen years.

Another problem with equity-indexed annuities is that there's no way of knowing what you're going to get under the contract, because there are numerous moving parts that can be changed at the discretion of the insurance company. For example, the insurer may initially offer a 100% participation rate, but the contract terms generally allow it to lower that rate significantly, perhaps to 50%. Or the annuity may start out with an 8% annual cap that can be lowered to 4% at the company's discretion.

When you add it all up—the large commissions (10% to 15%), the lack of certainty in the contract, the surrender fees, the hedging costs—you come up with a high price for a product that doesn't fill a logical investment objective. In sum, an equity-indexed annuity provides a very modest fixed-rate return with a small equity kicker.

"I have no use for equity-indexed annuities," says Glenn Daily, a fee-only insurance consultant in New York who specializes in life insurance and annuities. "It's a sad commentary on the life-insurance industry. They know that people respond to guarantees, so they're exploiting human foibles to make a buck off of people's tendency to experience more pain from their losses than pleasure from their gains. (In behavioral finance that's called 'myopic loss aversion.') They're getting people to focus on the risk in a piece of their portfolio rather than the risk in their entire portfolio. To understand this product you'd need to understand the value of the underlying components: the fixed income, the stocks, and the derivatives used to hedge. Because the designs are so complex, that's difficult or impossible to do."

There are scores of equity-indexed annuities sold by many different insurance companies. In general, the annuities are similar: they provide some guaranteed return plus some sort of return based on the stock market. Because there are countless permutations in the participation rate, cap rate, guarantee rate, surrender charge, and commission, it is extremely difficult to compare one annuity with another, and to understand what one is paying for. American Equity Investment Life Insurance Company's Premier Gold Annuity appears to be fairly typical. It has a 50% participation rate that can decline to 35%. It guarantees that 88.7% of the premium will grow at 2.25% per year for the first ten years and 3% thereafter. The surrender charge is 17.5%, declining to zero over sixteen years, and the commission is 8.5%. But try comparing that to Great American Life's American Icon annuity, which has a 100% participation rate and a 7% annual cap that the company can lower to 3%. The American Icon guarantees that 90% of the premium will grow at 2.75% per year. The surrender charge is 10% declining to zero over ten years, and the commission is 9%.

Equity-indexed annuities are very long-term products, and anyone investing for the long term should be concerned with total returns over time rather than with short-term fluctuations. But let's say that someone wants to to invest in annuities and have some exposure to the stock market without the risk of losing money. A better way to accomplish that would be by buying two low-cost annuities: one from Berkshire Hathaway and one from Vanguard.

Berkshire's single premium deferred annuity (brkdirect.com) is easy to understand, and you know exactly what you're getting, which is the U.S. Treasury strip rate for the term you want. Right now, the rate for fifteen years is 4.61%. Vanguard's Equity Index Portfolio variable annuity tracks the S&P 500 and has no commissions or surrender fees; its total annual expenses are 0.44%.

continued

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Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Editorial Associate . . . Yonathan Dessalegn
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (434) 244-4615
E-mail: David@InsuranceObserver.com
Website: InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
One SNL Plaza, P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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Equity-indexed annuities: Try to compare.

Because there are countless permutations in the participation rate, cap rate, guarantee rate, surrender charge, and commission, it is extremely difficult to compare one annuity with another, and to understand what one is paying for.

Company	Contract	Participation Rate	Cap Rate	Guaranty	Surrender Charges	Commission
American Equity Investment Life	Premier Gold Annuity (Index-26)	50%. Can be lowered to 35%.	None	2.25% on 88.7% of premium for first 10 years. 3% thereafter.	16 years: 17.5%, 17, 16.5, 16, 15.5, 15, 14, 13, 12, 11, 10, 9, 8, 6, 4, 2, 0	8.50%
Great American Life	American Icon	100%	7% per year. Can be lowered to 3%.	2.75% on 90% of premium.	10 years: 10%, 9, 8, 7, 6, 5, 4, 3, 2, 1, 0	9%

If you buy these annuities instead of an equity-indexed annuity, you can actually figure out what you're going to earn over time. After fifteen years, for example, the Berkshire annuity will have almost doubled in value and the Vanguard annuity will have tracked the returns of the S&P 500, minus 0.44% per year for expenses. There's nothing thrilling about this investment strategy, but it makes more sense than buying an equity-indexed annuity.

The brokers that made billions of dollars in commissions from the sale of equity-indexed annuities last year will undoubtedly disagree.