Popular indexed annuities called 'terrible ideas' for seniors

High hidden fees, long surrender periods just some of the pitfalls

By Bloomberg News & InvestmentNews

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When Helen Siswein, a retired teacher, heard about an investment that might earn 8% a year and never lose money, she was sold.

“I thought, "Boy, if the market surges, I could make a lot,'” said Ms. Siswein, 82.

In July 2003, on the advice of an insurance agent who came to her former home in Bucks County, Pa., after her husband died, she put about $1 million into four different annuities linked to stock market indexes.

Ms. Siswein said that the agent didn't tell her that she was locking up most of her money until her 87th birthday or that there were caps on how much she could earn.

Five years later, it cost Ms. Siswein fees of as much as 15% of her account balances to get out of the investments, the contracts show. One annuity earned an average of about 3% a year after the penalty was subtracted, while the index it tracked, the S&P 500, returned 6.3%, including dividends.

Investors such as Ms. Siswein are buying more equity-indexed annuities — contracts that earn money based on the performance of stock indexes and don't decline in value if held to maturity. Although that protection may be attractive to investors who saw the S&P 500 plunge 38% in 2008, the contracts' complex terms and embedded fees make it unlikely they will perform as well as expected, said Kent Smetters, a professor of insurance at The Wharton School of the University of Pennsylvania.

“These contracts have really high hidden fees,” said Mr. Smetters, a former economic policy official at the Treasury Department. “That's why they're terrible ideas for older people, even though they're peddled to them.”

Insurers led by Allianz SE and Aviva PLC sold a record $8.7 billion of indexed annuities in the third quarter of 2010, up 16% from the year-earlier period, according to AnnuitySpecs.com, a market research company. The contracts generally earn nothing when stocks fall, and include caps on returns which insurers can change at will.

Sales representatives are paid commissions of as much as 12%, and some are rewarded with incentives. Unlike the fees on mutual funds, those costs aren't disclosed.

Indexed annuities are part of a boom in structured products, which are opaque investments pitched as a way for conservative investors to earn higher yields.

While more of the complex annuities are being marketed by insurance agents, stockbrokers are pushing structured certificates of deposit and notes, which are similar derivatives-based investments created by Wall

Street banks. Sales of structured notes rose to a record $49.5 billion last year, according to data compiled by Bloomberg.

“The pure psychology of downside protection with upside potential sells really well,” Mr. Smetters said.

“These products are all very complicated,” he said. “The problem is, they're not transparent.”

Sales reps typically downplay the complexity of indexed annuities and their long lockup periods, said Barbara Roper, director of investor protection for the Consumer Federation of America. The contracts are “one of the most abusively sold products on the market today,” she said.

Insurers create the annuities using derivatives, which are financial contracts whose value is derived from stocks, bonds and commodities. Although the policies guarantee principal if held to term, they have withdrawal penalties that may be enforced for more than 10 years.

The dividends paid by stocks in the index generally aren't counted toward the annuities' returns. Buyers can convert the contracts into a lifetime stream of income at maturity.

Most don't, Mr. Smetters said. “You will never get all of the upside” of the stock market, because returns are capped, said Eric Thomes, senior vice president of sales at Allianz Life Insurance Company of North America, the largest seller in the United States. “You also don't need to worry about the downside, and with what happened in 2008, this type of benefit will no doubt interest a lot of people.”

Low yields on federally insured bank CDs are helping sales of indexed annuities, said Wendy Waugaman, chief executive of American Equity Investment Life Holding Co. American Equity is the third-largest seller of indexed annuities, according to AnnuitySpecs.

“It's really easy to see why they're so popular in today's environment,” Ms. Waugaman said.

Investors also are buying because they are “afraid of market risk,” she said.

The company is offering agents that sell at least $2.5 million of its products in the 12-month period through June 30 of this year a trip to Walt Disney World. Agents must sell an additional $600,000 of annuities to bring a child.

The trip is to the firm's annual convention, a standard industry practice, Ms. Waugaman said.

Insurers who sell indexed annuities buy derivatives from banks to cover the contracts' guarantees, making the business less risky than selling other investments with a guaranteed minimum return.

In 2008, insurers lost money on variable annuities with similar guarantees when the stock market plummeted. The Hartford Financial Services Group Inc. wrote down the value of a VA business by $274 million and Prudential Financial Inc. also recorded a loss.

Indexed annuities tend to underperform a lower-risk strategy of rolling over CDs “because of the high cost embedded in these things,” said William Reichenstein, professor of investments at Baylor University.

For example, an insurer may take $100 from a customer and invest $94.33 of that in bonds and keep $2, said Mr. Reichenstein, who has analyzed several indexed-annuity contracts. With that remaining $3.67, the company buys a portfolio of derivatives linked to the S&P 500 that will give investors some, though not all, of the index's returns.

Even with interest rates near record lows, CDs may still do better than the annuities because insurers will have to reduce caps on returns to maintain profitability, Mr. Reichenstein said.

“They're not playing Santa Claus,” he said.

Insurers must earn enough over time to recoup what they pay upfront to agents or brokers who sell the annuities, cutting into returns to investors, Mr. Reichenstein said.

Commissions range from 1.5% to 12%, according to AnnuitySpecs.

The opacity of the products' fees and complexity of the return calculations make it impossible for investors to figure out if they are getting a good deal, said Glenn Daily, a fee-only insurance consultant.

“You're paying the insurance company to set up and manage a portfolio of fixed-income securities and derivatives,” he said. “You don't have transparency.”

Contracts prevent canceling or surrendering for a refund of the account balance without a penalty for a set period that ranges from three to 16 years, AnnuitySpecs data show.

However, most contracts do permit 10% penalty-free withdrawals annually, according to AnnuitySpecs. Owners may incur a 10% charge from the Internal Revenue Service if distributions are made before age 59 1/2 because the earnings are tax-deferred.

Ms. Siswein, the retired teacher, bought her indexed annuities from Robert Calamunci of Marlboro, N.J. Mr. Calamunci, now an accountant, said that he no longer sells the products and declined to comment further.

Ms. Siswein said that she needed financial advice after her husband's death left her with more assets to manage, and Mr. Calamunci convinced her to put about $250,000 into each of four indexed annuities.

One of the indexed annuities that Ms. Siswein bought, called FlexDex Bonus, was issued by Allianz Life accompanied by a 23-page packet explaining the terms. The contract required Ms. Siswein, who was 75 at the time, to tie up most of her money until she turned 87 or pay withdrawal penalties of as much as 15%.

She canceled her policy because of lower returns than she expected and the limited access to her funds, which she said she didn't understand at the time of purchase.

Earnings were based on a portion of the average monthly performance of the S&P 500, without dividends, as calculated from her contract's anniversary July 14 to the same date the following year. The S&P 500, with dividends reinvested, returned 35% between July 14, 2003, and July 13, 2008, compared with about 15% that Ms. Siswein made over the same time period, including the surrender charge, according to her current adviser, Carolyn Walder, president of Lifetime Wealth Planning and Management.

“Up until 2008, the market had gone up dramatically,” Ms. Walder said. “She should have made a lot more money during that time.”

Without the surrender charge, an investor such as Ms. Siswein could have had a total return of nearly 30% for five years, or almost 6% a year, Laurie Bauer, a spokeswoman for Allianz Life, wrote in an e-mail.

Ms. Bauer said that she couldn't comment on Ms. Siswein's contract because the latter wouldn't sign a release. Holders of indexed-annuity contracts were protected against market declines such as the one in 2008 and lost no principal or previously credited interest, Ms. Bauer said.

Ms. Siswein said that she has joined a class action filed in 2005 against Allianz, alleging misleading sales of indexed annuities. Allianz Life denies the allegations of the case, Ms. Bauer said.

Indexed annuities have caps on returns and other terms that insurers may change annually at their discretion.

Ms. Siswein's contract with Allianz Life, for example, had a cap of 8% on how much she could receive from the S&P 500's performance in 2003. That was lowered to 6% for the policy year beginning in July 2008, according to her statements.

Altering the caps allows insurers to change how much they spend on the derivatives that fund the payouts, FBL Financial Group Inc., another company that sells indexed annuities, said in a Sept. 30 regulatory filing.

“Quite frankly, each and every quarter, we've started taking additional spreads,” which has helped increase the company's profits, chief financial officer James Brannen said in an Aug. 6 conference call with analysts.

Vincent Chiodo, a 68-year-old retired firefighter, said that he invested $113,000 in an indexed annuity issued by an FBL unit called EquiTrust Life Insurance Co. after meeting an agent at a free dinner seminar near his home in Palmetto, Fla. Dissatisfied with his returns, he said that it cost him about 20% in fees last July to get out of the contract after four years. FBL declined to comment on Mr. Chiodo's policy.

Rick Stgeorge, the agent who sold Mr. Chiodo the annuity, said that he explained the withdrawal fees and that Mr. Chiodo made a mistake by terminating the contract when he did. Most of his clients are happy with their returns and tax benefits, he said. Indexed annuities allow investors to defer taxes, though earnings are taxed as ordinary income when withdrawn. Capital gains from stock sales are generally taxed at a lower rate.

“There should be parades for indexed annuities,” said Mr. Stgeorge, who spells his last name as one word. Annuities earn between 3% and 8% with “no risk,” he said.

Ron Smythe, former chief executive of Meineke Car Care Centers Inc. said that he started moving money into indexed annuities about a year ago. He bought a contract issued by Allianz Life from Mr. Stgeorge because of the principal protection and potential for higher yields than other annuities.

Mr. Smythe, 76, who is retired and living in Longboat Key, Fla., said that he is unconcerned about the surrender charges for early withdrawal because he is holding them “for the long range.”

Unlike the stocks they track, fixed indexed annuities generally aren't subject to U.S. securities laws and are regulated by state insurance departments. A provision of the Dodd-Frank financial-overhaul law blocks the Securities and Exchange Commission from overseeing the market.

State insurance regulations aren't strict enough to prevent sales reps from taking advantage of the elderly with indexed annuities, said Ms. Roper, who lobbied for the products to be regulated by the SEC.

In Iowa, companies and individuals licensed to sell annuities have to gather information from buyers, such as their finances and age, to ensure that the contract is suitable, said Jim Mumford, first deputy commissioner and securities administrator for the state's insurance division. Agents who offer indexed annuities also must take at least an additional four hours of training on the products, he said.

Annuities aren't guaranteed by the Federal Deposit Insurance Corp. Insurers agree to cover losses if a company fails, up to a limit that varies by state.

An investor in Florida, for example, is covered up to $250,000 or $300,000 per company, said William Falck, executive director of the state's Life & Health Insurance Guaranty Association, a statutory body that protects clients' assets if an insurer is liquidated. Although the principal on an indexed-annuity contract may be reimbursed by the state guaranty fund, the interest may not, he said.

MetLife Inc. and Prudential, the two largest U.S. insurers, don't offer indexed annuities. MetLife allows its agents to sell indexed annuities from third parties, said company spokesman Patrick Connor.

TIAA-CREF, the retirement company that manages more than $400 billion, also doesn't offer indexed annuities.

“Very few people understand what the product is,” said Dan Keady, director of financial planning for the company.