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4 Logical Questions on the Value to Clients of Indexed Annuities

"If it doesn't make sense, it's usually not true." — Judge Judy Sheindlin

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I hear all the time from diehard investors and salesmen of annuity products that "the stock market is nothing more than rolling the dice at Vegas!" To which I always respond, "Really? I didn't realize we had that many compulsive gamblers in the world."

My reply tends to get a very awkward look, because I force those investors and salespeople to logically assess their arguments. For their statement to be true, logic dictates that my response is true as well. Logic is the ultimate advisor weapon in the war on fear and misperceptions. In this and my next blog for ThinkAdvisor, I'll apply logic to some issues that you and your clients face.

For example, let's apply the concept of logic to "indexed annuities." I personally believe they're a sales gimmick, and really nothing more than a structured note or hedging strategy loaded with huge fees and surrender lockups which may, or may not, have some value within a portfolio. However, they're often sold as the "Holy Grail" or "silver bullet" investment, with many salespeople recommending investors allocate far too large a portion of their assets into the investment.

So what's wrong with them? Better yet, what does logic say about index annuities?

Logical Response to Index Annuities No. 1

Most index annuities are tied to an index, such as the S&P 500. The sales idea is that if the stock market goes up, you get the upside return, but if the stock market goes down, you don't lose anything. At least that's how they're marketed and sold. However, that's not exactly true; logic and truth tells a different story.

An annuity, by definition, is a product or contract, created and sold by an insurance company, based on the agreed terms of the annuity contract. The investor is not actually investing in the S&P 500 directly or even indirectly. Logically, you can't buy the S&P 500 and buy an annuity contract with the same dollars. Furthermore, most all indexed contracts limit the downside stops of not losing anything in bear markets by

internally limiting how much upside percent of positive years the contract actually pays. Most limits range from 70% to 80% of the positive year returns.

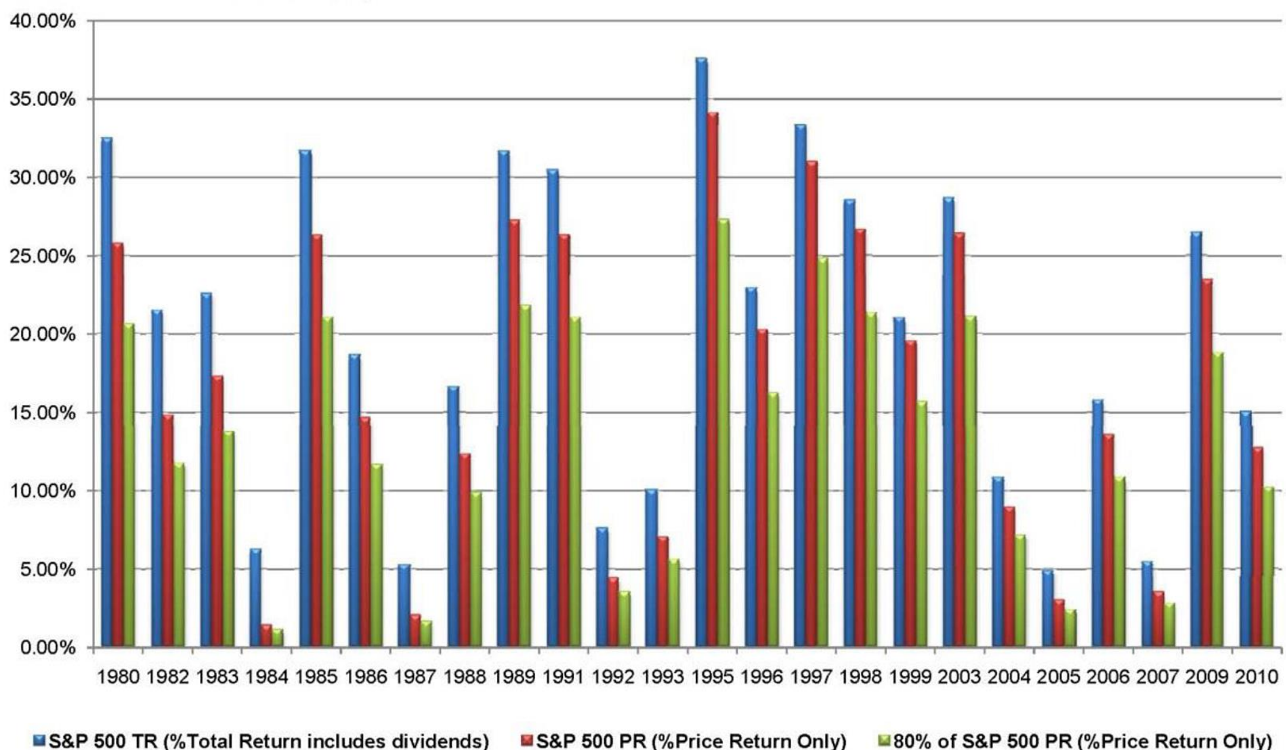
Remember, with an indexed annuity, you're not really investing. Rather you're agreeing to a contract's growth and return stipulations, which in this example is somewhat tied to the S&P 500 performance.

Logical Response to Index Annuities No. 2

An S&P 500 indexed annuity is indexed to the price-only index, which tracks the price change/ appreciation only, excluding all dividends from the 500 companies. Contrast that to the real S&P 500, which is a total return index, including all the reinvested dividends and price appreciation of all those companies.

So if you purchase an indexed annuity contract tied to the S&P 500, are you entitled to the dividends from all the companies included? The answer is no, because with an annuity contract, you don't actually own any direct shares of those companies. In truth, the only thing you own is the *right* to the contract's growth and return stipulations you agreed too.
Furthermore, when looking at an 80% benefit of the price-only index, or even 100% of the price-only index, both have significantly lower returns in positive years than the real S&P 500, which includes both reinvested dividends and price appreciation. See the chart below showing the comparison.

Indexed Annuity REALLY!! **(S&P 500 Price Index Positive Years Only from 1980-2010 compared to S&P 500 TR & 80% of S&P 500 PR)**



Disclaimer: The hypothetical example assumes an investment that tracks the returns of the S&P 500 Index total return. There is volatility in the market and a buy or sell at any point could result in a gain or loss. Your own investment experience will differ with the possibility of losing money. Past performance is no guarantee of future results. You cannot actually invest directly in an index. Money Management Services in no way guarantees the accuracy of the data received and used within this illustration. All returns are historical in nature and are not guaranteed in the future. This information is for presentation purposes only and in no way constitutes a solicitation to buy or sell securities. This historical information is provided from a third party data provider (Morningstar, Inc.) and in no way does MMS guarantee the accuracy of any data.

Logic illustrates that an investor is giving up huge return spreads including the compounded reinvested dividend return when buying an index annuity contract with only an 80% benefit. That's how the insurance company limits the downside risk from ever going negative, in addition to locking up clients with 10-year surrender charges if you need to exit the contract before the 10 years.

Logical Response to Index Annuities No. 3

What does the insurance company do with your money once you purchase the contract? I would assume they invest in the stock market and by doing that they are purchasing the real total return S&P 500, while contracting to pay you only a percentage of the price return. That means they receive the larger return which includes reinvested dividends and price appreciation over time.

Where's the logic there? Obviously, any insurance company has to make a greater ROI on monies invested in their annuity contracts sold, to generate profits for the company and pay you the stated contract terms. Otherwise, they couldn't remain in business. Logic shows it's better to actually own the S&P 500 and get both the dividends and price return, while using structured notes, bonds, hedging strategies and other asset class allocations within your portfolio to better manage the risk and volatility fears!

Logical Response to Index Annuities No. 4

Insurance companies aren't able to invest money in special markets unavailable to the rest of the world, nor do they have a silver bullet strategy for generating better returns. Therefore, logic or common sense dictates that all index annuity contracts have to be less financially beneficial for the investor, compared to purchasing an index mutual fund or ETF of the S&P 500 and riding the ups and downs. Otherwise, how would insurance companies stay in business if they aren't selling the "perception" of investing based on fear, rather than the prudence that comes with knowledge?

Logic Is an Advisor's Most Important Weapon

Logic will always be the ultimate weapon for any advisor looking to obtain or retain clients, because when emotions and feelings dictate investor's choices based on perception or fear, its logic that ultimately helps investors come to an educated decision. So for a successful practice, advisors have to be able to relate the logic of the markets' complexities with truth, because that's clients really desire.

It's the logic which portrays your honesty, integrity, knowledge, and most of all illustrates that you care for what is ultimately in the client's best interest no matter what. Stay tuned for next month's article on "logic is an advisor's most important weapon."