

# **Index Annuities**

## **A Suitable Approach**

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## **Index Annuities: A Suitable Approach**

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## Introduction

**Welcome.** This is a book about index annuities. The authors have written about them before. John Olsen’s book *The Annuity Advisor* (which he co-authored with Michael Kitces) provided an in-depth look at how annuities work, their uses and misuses, and extensive discussion of annuity taxation. Jack Marrion’s book *Index Annuities – Power & Protection* covered index annuity basics, crediting methods and sales tips. The book you hold in your hand was written for the new index annuity world – a world where one needs to understand, not only how index annuities work, but where they fit and don’t fit, and when they are suitable or unsuitable.

After you read this book you will know how to compare different crediting methods and understand when lifetime benefit riders make sense (and when they don’t). You’ll have seen the “real world” returns index annuities have generated and be able to recognize some common and dangerous “tax traps” that can cause problems in annuity planning. You’ll have a better appreciation of what “suitability” really means, and a better understanding of the kinds the advice you can, should, cannot, and must never give in your dealings with prospects and clients.

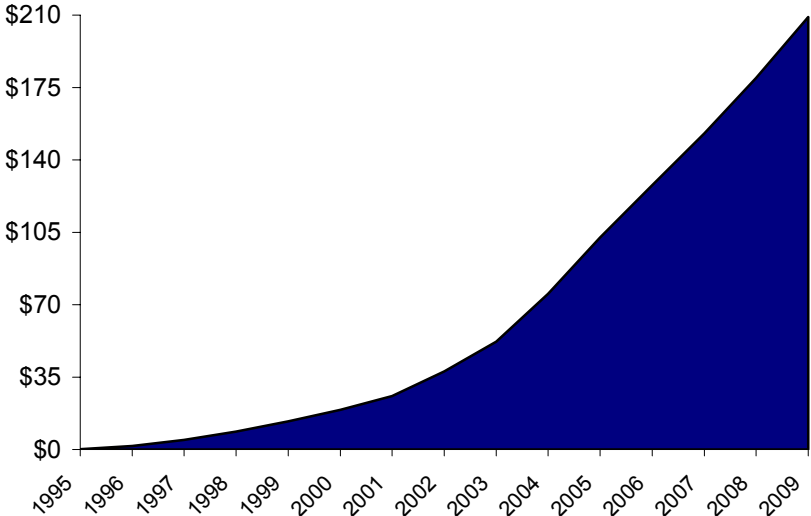
If you’d like to jump start your learning, begin with Chapter 1 – Annuity Basics, and Chapter 2 – Annuity Interest, and then use the index in the back to investigate future topics as needed. We’ve arranged it so that you don’t need to read every single word to make this book work for you. Key points of each chapter are highlighted in blue and the back of each chapter contains a cheat sheet summarizing the important ideas.

This book attempts to give you the facts about index annuities and where they fit. We once said that index annuities are a wonderfully simple concept made complicated. We hope this book makes everything clearer. We would like to thank Tonia Cronin, Yvonne de Brazil and Hugo Ernst for their suggestions on readability.

# Chapter 1 – Annuity Basics

The first index annuity was purchased 15 February 1995 by a 60 year old from Massachusetts. Over the next five years his \$21,000 premium placed in a *Keyport KeyIndex* annuity grew to \$51,779. The index annuity era had begun.

**Cumulative Index Annuity Sales (in Billions)**



**Data Source: 1995-2006 Advantage Compendium, Beacon Research, Fixed Annuity Premium Study: 2007-2009**

As the financial tools to create index annuities had been around for several years, why were index annuities introduced only in the mid '90s? One big reason for that is that the psychology of the times was right. It had been a rocky 1994 – bond fund returns were poor, the S&P 500 ended the year on a down note, and many stock funds and variable annuities had marginal or negative returns. In addition, the 8% and 9% rates consumers had realized on traditional fixed annuities in the previous decade appeared to be over. Interest rates were on a long downward slope, from a historic point of view, and insurers were looking for an annuity that had the potential to deliver

respectable returns. It was time to announce a new annuity that would provide the principal protection from market losses enjoyed by all fixed annuity owners, but given them the potential for higher interest.

Index annuity sales were barely over \$100 million that first year, but grew to \$1.5 billion in 1996, \$3.0 billion in 1997 and \$4.0 billion in 1998. Growth slowed down over the next few years, but with memories of the millennium bear market still fresh, index annuity sales exploded to over \$23 billion in 2004 and reached over \$27 billion by 2005. By the close of 2009, over \$200 billion of index annuities had been purchased.

**There was once an agent from Ames**  
That gave clients annuity gains  
It isn't his interest they said  
That put them ahead  
T'was the risk of loss that he tames

## **A Tool For Uncertain Times**

When Black Monday hit in October 1987, it was a tremendous shock to stockbrokers – because it was not supposed to be able to happen. They had been told, and believed, that a sudden drop of that magnitude was impossible.

The bear markets of the last decade have cut much deeper than the one 20 years ago. People near retirement may need to work for more years to be able to retire and current retirees may need to cut back their standard of living to try to ensure that their money does not run out. But perhaps the most long-lasting outcome is that the risk/return paradigm guiding consumer financial habits has changed.

The 1920s were a time of irrational exuberance where the “little people” invested in the stock market – many for the first time. The resultant crash soured investors of the day and their children were repeatedly told to stay away from the stock market. It wasn't until the

1960s that interest in investing began to rise and the general press again spoke positively of the stock market. The 1960s attitude then became that investing in blue chips or the “nifty 50” would make you a lot of money. However, in the crash of 1973-1974, the market dropped by half – and then it failed to recover. The stock market limped along for several years and the tone of the media changed once again – this time, to “investing in the stock market is a sucker’s game.”

1982 began the greatest bull market of the century, with fortunes being made by professional investors. There were a couple of bumps along the way – a severe one in 1987 and a minor one in 1990 – but the market quickly recovered. After 15 years or so of a rising market, the small investor once again entered the market en masse in the late 1990s. The millennium bear market tested their faith, but was followed by 5 straight up years. By 2008, it was obvious to many that the market would trend up forever.

Then came the crash of 2008-2009; it was a generation killer. The damage to investor’s psyches may well be similar to that caused by the Great Depression and the ‘70s bear markets. It may keep individual investors leery of investing for decades. However, they probably won’t be able to flee to the bank and earn high safe yields, as they could in the 1970s. Index annuities are one of the few instruments that still offer the potential for higher yields and that protect principal and credited interest from market loss.

## Real World Returns

We will explore actual index annuity returns in depth in Chapter 5, but the following chart provides an overview of index annual performance during volatile times. The average index annuity return reported beat the index for five of the eight periods since 1997. How is that possible?

Let’s look at a specific example. The annualized average index annuity return of the carriers providing policy returns for the five years ending 30 September 2008 was 6.05%. The annualized return

**Annualized 5-Year Returns**

<b>Periods</b>	<b>S&amp;P 500 Return</b>	<b>Index Annuity Average Return</b>
1997-2002	9.39%	9.19%
1998-2003	-0.42%	5.46%
1999-2004	-2.77%	4.69%
2000-2005	-3.08%	4.33%
2001-2006	5.11%	4.36%
2002-2007	13.37%	6.12%
2003-2008	3.18%	6.05%
2004-2009	-1.05%	4.19%

for an S&P 500 index fund with a 0.15% expense ratio for the same period was 5.05% (the annualized return for the index alone - that is, without considering dividends - was 3.18% and that is the return shown in the chart). Even though the index annuity returns did not include reinvested dividends and were generally tempered by caps, the average index annuity returned more than a fully participating dividend yielding index fund. Why? Because during that final year when the index went down, the index annuity owners kept their credited interest earned in previous years.

**Staying On Message**

Here is how three carriers defined their index annuities when introduced in the mid '90s:

*“You enjoy the safety and security that a traditional fixed annuity guarantees, combined with the potential of interest earnings linked to the S&P 500 Index”*

Interstate Assurance Company, Freedom 500 Index Annuity, 3158-D, 7/96

*“You will only share in the increases in the index. Your index annuity value will never decline due to decreases in the index and previous increases once earned are locked in and guaranteed”*

Community National Assurance Co., Money\$Worth Indexed Annuity, P-AN7, 8/95

Statements about “annuities” that do not make clear what kind of annuities are being described, can be confusing or misleading. A statement that is true of a deferred annuity may be false when applied to an immediate one, and vice versa. And a true statement about a fixed annuity may be false when applied to a variable annuity, and vice versa.

## Tax Treatment of Annuities

All deferred annuities generally enjoy “tax deferred” treatment. The cash value growth is not subject to tax as earned, but, instead, is taxed only when distributed. This tax-deferral applies only to annuities owned by “natural persons” (human beings). [IRC § 72(u)]. Cash value growth in deferred annuities owned by “non-natural persons” such as corporations or trusts will be taxed as earned, unless the owning entity is acting as the “agent of a natural person” [IRC §72(u)(1)]. All distributions from annuities are either (a) “amounts received as an annuity” or “amounts not received as an annuity”.

(a) “**Amounts received as an annuity**” includes both the payments from an immediate annuity and payments made under a regular “annuity payout option” from a deferred annuity (i.e.: a deferred annuity that has been “annuitized”). These income amounts are taxed as part interest and part non-taxable “return of principal”, according to an “exclusion ratio”. The ratio depends upon the length of the payout period and, for *life-contingent payouts* (where annuity payments will persist for the entire life of the annuitant), whether a *refund feature* (a guarantee of payment if the annuitant dies before all of the money placed under that life payout options has been received as annuity payments) was elected.

(b) “**Amounts not received as an annuity**” are any other distributions (actual or “deemed”) from a deferred annuity. Such amounts are taxable to the extent of “gain” (or earnings) and the tax treatment depends upon when the contract was issued.

## Some Questions To Ask About Fixed Annuities

- What is the initial interest rate or index participation rate and how long is it guaranteed?
- Does the initial rate include a bonus?
- Are there any special requirements to receive the bonus or to cash out the annuity?
- What is the guaranteed minimum return?
- What are the surrender or withdrawal penalties or charges?
- Is there a Market Value (MVA) Adjustment?
- Do the surrender costs still apply at death?
- What rate is being credited on similar annuities issued in the past?

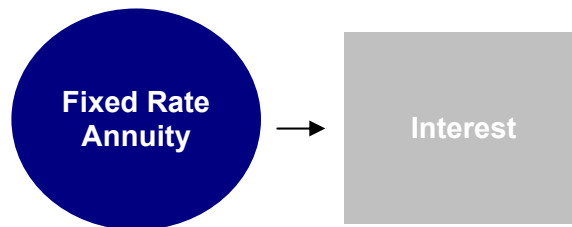
## Cheat Sheet

- Index annuities are the latest stage in the evolution of the annuity
  - Deferred annuities offer tax-deferral, lifetime income options, and may avoid probate. Money withdrawn is always taxed as ordinary income (to the extent that it is includible in income) and may be subject to IRS “Under Age 59½” Premature Distribution Rules.
  - The major difference between fixed and variable annuities is that a variable annuity owner bears the investment risk, while fixed rate and fixed index annuities protect principal and credited interest from investment risk and guarantee a minimum interest return.
  - The major difference between fixed rate and fixed index annuities is the crediting of interest earned above and beyond the minimum guarantee.
  - Fixed index annuities are insurance products; not securities.
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## Chapter 2 – Annuity Interest

### How Do Fixed Rate Annuities Pay Interest?

When you place your money with the bank they invest this money, earn a return, and after subtracting their costs pay you a stated interest rate for a stated period of time. Your principal does not fluctuate, but the interest you receive can, and usually does, fluctuate from period to period.



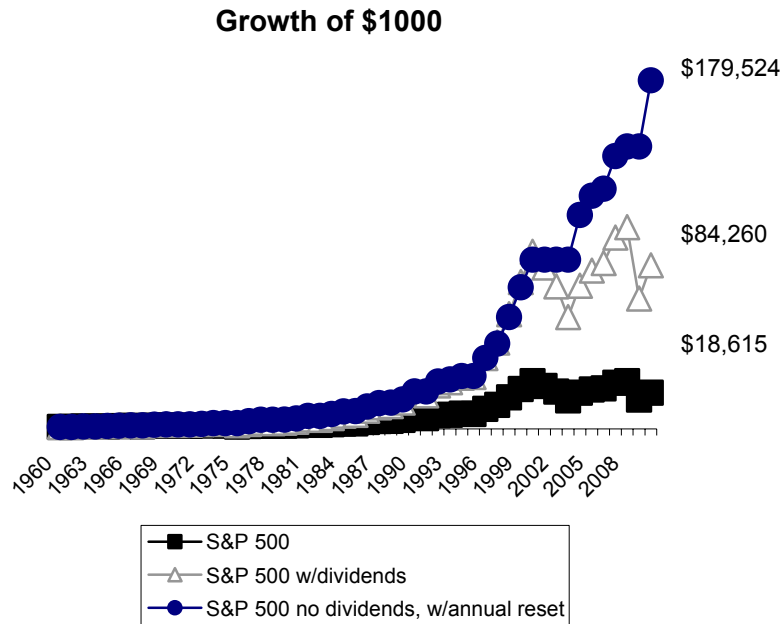
A fixed rate annuity operates in a similar way, except you place your money with an insurance company instead of a bank. When you place your money with the insurance company they invest this money, earn a return, and after subtracting their costs pay you stated interest.

#### Minimum Rate

A fixed rate annuity guarantees to credit a minimum yield and that is what makes a fixed annuity a fixed annuity instead of an investment. The minimum rate typically ranges from 1% to 3% – but it may be linked to movements of an external interest indicator – such as U.S. Treasury Notes.

#### One Year or Multiple Year Rates

All fixed annuities guarantee the interest rate for at least the coming policy year (or guarantee the rate of participation in the case of an index annuity). Typically the annuity will guarantee the rate for one year at a time and declare a new interest rate on the policy anniversary for the next year. But the new rate can never be less than the minimum guaranteed interest rate.



## How Much Interest?

The highest index annuity interest rate ever credited for a single year was over 40%, in both 1998 and 2010. On the other hand, in 2001, 2002, and 2008, the major stock market indices declined, and index annuities linked to these indices credited 0% for the year - but no previous interest was lost.

*Index annuities are designed to provide the potential for long-term yields above those of other safe money places – while always protecting principal and credited interest from market risk - and they have performed as intended.*

## Minimum Guarantee

A fixed annuity guarantees the crediting of a minimum rate of interest – which is what makes it a fixed annuity. In the case of an index annuity, the minimum guarantee is usually structured to protect

## Chapter 3 – Crediting Methods

In the last six years only ONE completely new structure has been created, the *rainbow method*. Every other crediting method on the market today had its genesis in a structure used in the past, and this includes the *balanced allocation* method (earlier called *the equity kicker* method) and *low water mark* designs. The truly new development in the index annuity world is the lifetime income withdrawal benefit and this is discussed at length in Chapter 6.

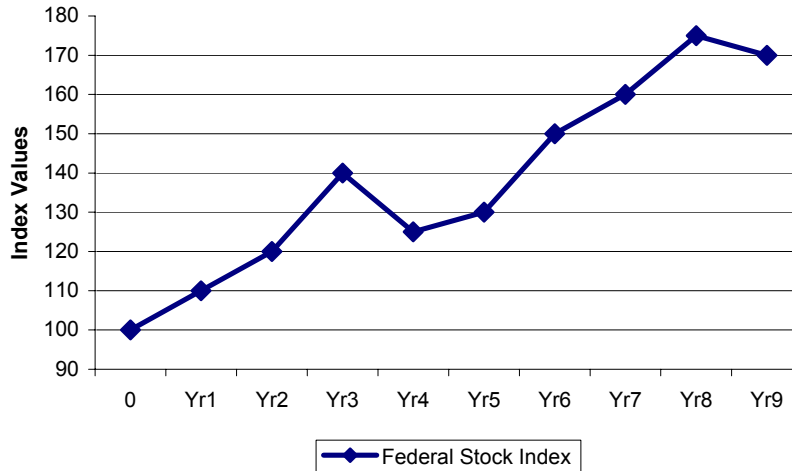
There are still really only two ways to credit index-linked interest to an annuity. One can either measure index movement over a year or two – an *annual reset* method, or one can measure index movement over a period of years – a *term end point* method. And yet, over four dozen variations on these methods have floated around since index annuities were introduced.

The first index annuity offered a term end point method variation that used the higher of the index value at the end of the surrender period or the index value on any policy anniversary. This *term high point method*, also known as a *high water mark* design, was consumer-friendly but expensive to offer, and has not been available for the last five years (although variations of this design are still available they are not the same thing). We've decided to include brief descriptions of crediting methods that are not currently offered because they may resurface.

This chapter illustrates how all of the major index crediting methods work by using the fictional Federal Stock Index. In the next chapter we will examine the good and bad points of the different methods.

### Term End Point (Term Point-to-Point)

Our definition of a *term end point* structure was one that measured index movements over a period greater than a year or two.



Example: You have decided to buy an index annuity. You will earn index-linked interest based on the performance of the fictional Federal Stock Index, which is currently at an index level of 100. The insurance company says that at the end of nine years they will credit the greater of the minimum guarantee or 100% of any index-linked interest earned calculated by dividing the ending index value by the beginning index value

### How Term End Point Interest Is Calculated

$$\begin{aligned} (170 / 100) - 1 &= 70\% \text{ Index Gain} \\ 70\% \times 100\% \text{ participation} &= 70\% \\ 70\% &= \text{Total Interest Earned} \end{aligned}$$

It is now the end of year nine and the Federal Stock Index is at a level of 170. The index annuity divides the current index level by the starting index level and multiplies the gain by our original premium. You earned a total of 70% interest for the nine years.

What if the index difference had been negative because the ending index was at a lower level than when you began? The index annuity would credit the minimum guaranteed return.

### How Annual Reset Interest Is Calculated: Monthly Cap

	<b>Beginning Value</b>	<b>100</b>	<b>2% Cap</b>
Value Period 1	102		2.00%
Value Period 2	103		0.98%
Value Period 3	105		1.94%
Value Period 4	107		1.90%
Value Period 5	104		-2.80%
Value Period 6	106		1.92%
Value Period 7	109		2.00%
Value Period 8	112		2.00%
Value Period 9	111		-0.90%
Value Period 10	108		-2.70%
Value Period 11	107		-0.92%
Value Period 12	110		2.00%

$$2.00\%+0.98\%+1.94\%+1.90\%-2.80\%+1.92\% +2.00\%+2.00\%-0.90\%-2.70\%-0.92\%+2.00\%= 7.42\% \text{ Interest Earned}$$

### Annual Fixed Rate with Equity Component (Balanced Allocation or Equity Kicker)

Crediting a fixed rate to a portion of the premium with the remainder participating in the index was first used in the last century in an annual reset design, but sales in products with this design were small. There are a couple of variations to this theme currently in use.

In both variations, the annuity credits a fixed interest rate to a portion of the contract value, crediting to the balance interest at a rate derived from index performance. A yield spread or asset fee is then deducted from the total. Net gains are credited as interest and net losses are treated as zero interest earned.

In the *balanced allocation* method the buyer typically selects a fixed rate component (the range of rates depends on the interest rate environment) and also a term end point part that participates in positive index movements over a four, five or six-year period. The higher the fixed interest rate selected, the lower the participation rate

applied to the index. At the end of the period, gains from the fixed rate and index-linked components are combined and credited. An annualized asset fee (yield spread) may be deducted from the combined return.

This “equity kicker” or “balanced” approach might look at a six year time frame and offer a couple of options. One option might allocate 50% into a fixed account paying 4% and the remaining 50% would provide a 100% participation rate on any gains in the index from start to end of the six year period. The other option might allocate 20% into a fixed account paying 4% and the remaining 80% would provide a 100% participation rate on any gains in the index from start to end of the six year period; however, a 2% yield spread would be deducted from the combined annualized gain before net interest was credited.

Let’s suppose that our Federal Stock Index has increased from 100 to 150 (50%) in six years, and that the 4% fixed rate gain, compounded over those six years is 26.5%. What is the return under these two balanced method options?

Allocation	50% Index Gain	26.5% Fixed Gain	Calculated Gain
50/50	25%	13.3%	38.3%
80/20	40%	5.3%	45.3%

Allocation	Annualized Gain	Yield Spread	Actual Yield
50/50	5.5%	0%	5.5%
80/20	6.4%	-2%	4.4%

Since a yield spread was not deducted from the 50/50 allocation the total gain remains at 38.3% for the six year period and that translates into an annualized return of 5.5%, while the 80/20 allocation produced a total gain of 29.7% (after application of the yield spread) for an annualized return of 4.4%. In this example you would have better off putting half of the premium into the fixed rate “sure thing.” When would the 80/20 allocation have won? If the index had gone up more than 87% the total net yield, even after the 2% yield spread, would have been higher than the yield on the 80/20 allocation.

Allocation	14% Index Gain	8.2% Fixed Gain	Calculated Gain
60/40	8.4%	3.3%	11.7%
40/60	5.6%	4.9%	10.5%

Allocation	Calculated Gain	Yield Spread	2 Year Yield
60/40	11.7%	-2.5%	9.2%
40/60	10.5%	-0.5%	10.0%

### Rainbow Method

Although new to the index annuity arena the rainbow concept itself is not new. It has been used for many years in the investment world. It is an option basket whose best-performing indices are weighted more heavily than those that perform less well. It is always a "look-back" because the money is allocated based on the ranking of the performance after the period is over. Not all allocation methods are rainbows. A couple of carriers credit interest based on the blended performance of multiple indices, but the specific index allocation is fixed at the beginning of each year so they are not rainbow methods. To show how the *rainbow method* works we will compare it to the *blended indices* example used earlier.

#### Blended

Federal Stock Index	60%	x	35%	=	21%
Federal Bond Index	20%	x	35%	=	7%
Foreign Index	40%	x	20%	=	8%
Medium Foreign Index	-50%	x	10%	=	-5%
					<u>31%</u>

The *rainbow method* may also use the Federal Index, Federal Bond Index movement, Foreign Index and Medium Federal Index and allocations of 35%, 35%, 20% 10%, but the allocations are ranked by performance. After the period is over the returns will be ranked highest to lowest and then the greatest allocation is given to the best performer, then the next best, and so on.

reset designs in rising markets. The tradeoff is that if the market period is flat or down, term end point designs are more likely to generate only the minimum guaranteed return.

### **The Truth Financial Writers Ignore**

Financial columnists, when writing about index annuities, often use a term end point annuity as an example of how index annuities work. They then say how much better it would be – in a perfect world – if you were to put three quarters of your money into competitive zero coupons 10 year bonds and the balance in an index fund.

If you were to follow their suggestion and put 75% of your money into zero coupon bonds, you would never get back less than 100% at the end of the period – something like an annuity's minimum guarantee. However, because only 25% of your money is in the index your effective participation rate on your total investment can only be 25%. By contrast, the participation rate of a term end point index annuity often nears 100%.

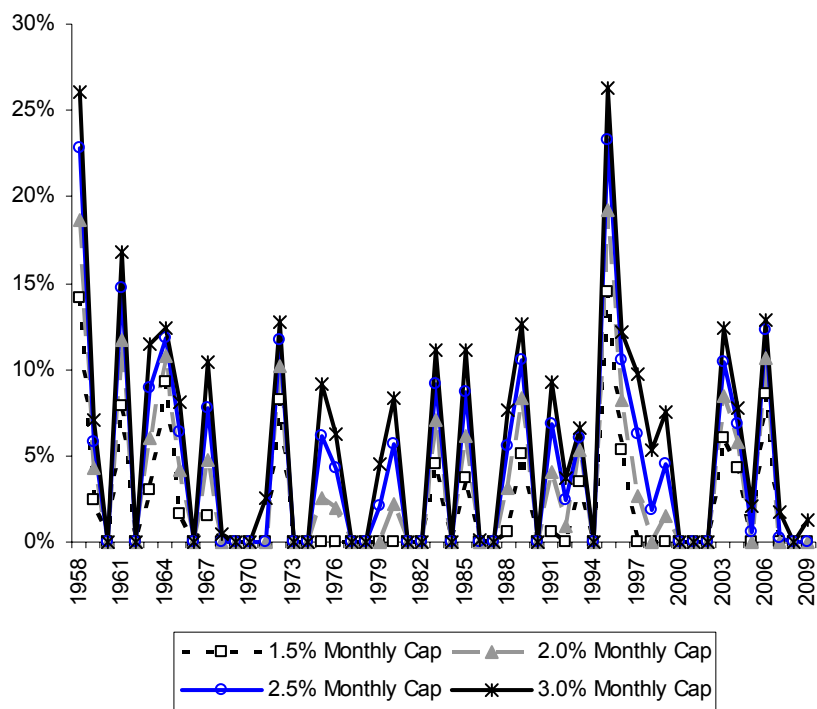
But the real problem with such articles is that their authors employ a crediting method that is used by only 2% of index annuities, while suggesting (if only by implication) that its results are representative of all index annuities. That's like focusing on the performance of health care sector stocks as an example of how the S&P 500 performs.

An advantage of almost every term end point annuity is that there are no moving parts for the entire crediting period, which is often the same length as the surrender period. The risk of getting an uncompetitive renewal rate is reduced or eliminated. A possible disadvantage is that if the climate for index participation improves in the future the rate cannot be raised.

Term end point designs follow index movements. This means potential interest can be lost if the index falls back. In addition, interest is not credited until the end of the period. If a policy is surrendered, any increases in the index from the beginning of the

3.0%. Although the highest theoretical annual returns are 18%, 24%, 30% and 36% respectively, the actual highest returns that would ever have been reached are 14%, 19%, 23% and 26%. The respective average returns over the 50 years are less exciting, being 2.0%, 3.3%, 4.5% and 5.7%.

**Monthly Cap Annual Returns**



### Key Points On Monthly Cap

- You won't earn the cap. For a 3% cap the highest annual return was 26%, but the long-term average was 5.7%.
- It is legitimate. In both actual index annuity returns and hypothetical modeling the monthly cap is very competitive with annual point-to-point methods and usually beats averaging with cap methods

while the wheel is spinning – during the surrender period – so regardless of any temporary advantage today’s pricing may produce, the “end game” result is still determined by the carrier on subsequent spins.

Ultimately, it is the carrier that decides how much money is available to fund the index-link. This is why we continue to believe that the most important factor in index annuity returns is not the crediting method, but how the carriers will treat the annuity owner when they reset that cap or rate in the future. The only way we know of to get even a hint of possible future treatment is to see how they have treated customers in the past, and that means asking for annuity renewal histories.

The real question is not whether renewal rates have gone up or down – external financial conditions affect renewal rates – but whether the carrier will furnish them at all. What if the index annuity is new and the carrier says there is no history? Fine, show the renewal histories of your other index annuities. What if the carrier will not furnish a renewal history? Well, if you were going to have an operation and the doctor refused to tell you how many patients survived, would you use that doctor?

### **Truth #4 Annual Reset Crediting Methods Are Priced To Perform The Same\***

**\*except when the available money is different**

As we’ve said, the option seller is trying to keep the probable payoffs the same for the different methods if the options are all the same price. Over the long term (fifty years, let’s say), each of these different methods can be expected to produce the same long term return even though the rates for the various “moving parts” may be different, and if the cost for the point-to-point one-year option is 6 cents the probable cost for the same one-year options associated with the other methods would be six cents too. However, even if the cost of each one is six cents that does not mean each index annuity has six cents available to pay the option.

<b>Crediting Method (option money)</b>	<b>Effective Rate</b>
Annual Pt-to-Pt (6¢) at 45% participation	74%
Monthly Averaging (8¢) at 100% participation	96%
Daily Averaging (4¢) at 53% participation	49%
Annual Pt-to-Pt (6¢) with 8.45% cap	74%
Monthly Cap (4¢) 2% cap on monthly gain	38%
Monthly Averaging (6¢) less 2.75% yield spread	74%

In the second chapter, we said the insurance company invests the premiums, earns a return, and then after paying the expenses and covering the cost of the minimum guarantee buys the option. What if the sales commission on Index Annuity A is 7% but Index Annuity B pays a 4% commission? As the expenses for Annuity B are less, that annuity issuer has more of the premium available with which to buy options. If the lower expenses gives Annuity B 8 cents left over (after buying enough bonds to secure contract guarantees) instead of the 6 cents left over in Annuity A, Annuity B can buy one-third more options, which means that the owner of Annuity B can participate in more of the index gain than can the owner of Annuity A. Costs matter!

What if Annuity B has a higher minimum guarantee, but all other factors are equal (to those in Annuity A)? If Annuity B guarantees 3% when Annuity A guarantees only 1%, Annuity A might have 4 cents with which to buy options, when Annuity B has only 2 cents. In this scenario, Annuity A can offer a higher participation rate.

Suppose the expenses for both annuities are identical, but Company A can invest its money at a higher rate (by buying bonds with longer maturities or rated less highly than the bonds bought by Company B)? Once again, Company A will have more money with which to buy options. (Of course, it will bear more risk with regard to the contract's guarantees if its bond portfolio is more at risk).

Statements from term end point styled annuities are a different matter because interest is usually not credited until the end of the term. So, even if the index gained 40% in the first year, the statement would only reflect the minimum guaranteed interest. Most insurers also provide a kind of running summary of hypothetical performance in their annual statements, as if the interest crediting period were to terminate on the statement date. It is a good idea to review a sample annual statement before purchasing such an annuity, if only to avoid future surprises.

## **Selecting An Index Annuity Carrier**

### Financial Strength

Pick a carrier with finances you feel comfortable with. If you like to use third party ratings, pick a carrier evaluated by a rating service you like and define the minimum ratings you will accept. Better yet, look at that carrier's ratings from multiple ratings services. These services use different methodologies in arriving at their ratings, and a carrier might be rated more highly (even much more highly) by one service than by another. We look at a lot of factors when we are evaluating insurance companies and, in some situations, we may feel that a "B+" carrier offers the same relative safety as one rated "A+" because rating services "scores" are merely one measure of an insurer's stability.

### Renewal Rates

We strongly believe that a carrier's treatment of renewal rates is far more important than the crediting method – or even the actual movement of the index – in estimating how much interest an annuity is likely to give us.

By renewal history, we do not mean interest credited to the policy; we mean the history of how the level of index participation in that particular annuity changes over time.

The problem is this: Some annuity issuers maintain a contract's participation in the underlying index at a fair level after the initial

reset offering 60% of annual point-to-point gain approach to ten year periods would have produced an average return that was equal to 88.2% of the average S&P 500 index return for the same ten year periods.

#### % of Annualized S&P 500 Return

	'80s	'90s
<b>Term End Point</b>		
75% of term gain, last 52 weeks averaged	78.2%	78.4%
100% of gain, 12% caps, 5 yr high pt look-back	64.0%	59.0%
annualized gain less 1.9%, last year averaged	74.5%	80.1%
<b>Annual Reset</b>		
60% of annual point-to-point gain	88.2%	65.3%
50% of annual point-to-point gain	73.7%	54.6%
100% of annual point-to-point gain, 9% cap	70.7%	47.5%
100% of annual point-to-point gain, 8% cap	63.3%	43.2%
100% of annual point-to-point gain, 7% cap	56.0%	38.9%
100% of monthly averaged gain	90.2%	69.5%
80% of monthly averaged gain	72.6%	55.9%
60% of monthly averaged gain	54.8%	42.1%
100% of monthly averaged gain, 10% cap	65.4%	48.1%
100% of monthly averaged gain, 9% cap	60.2%	44.3%
100% of monthly averaged gain, 8% cap	54.7%	40.1%
4% monthly cap	76.1%	70.4%
3% monthly cap	49.2%	51.3%
2% monthly cap	21.5%	28.9%
<b>Biennial Reset</b>		
5% monthly cap	68.3%	67.4%
4% monthly cap	48.7%	54.1%
3% monthly cap	25.6%	37.7%
100% of two year point-to-point gain, 17% cap	72.3%	56.4%
100% of two year point-to-point gain, 15% cap	67.3%	51.1%
100% of two year point-to-point gain, 13% cap	61.1%	45.3%

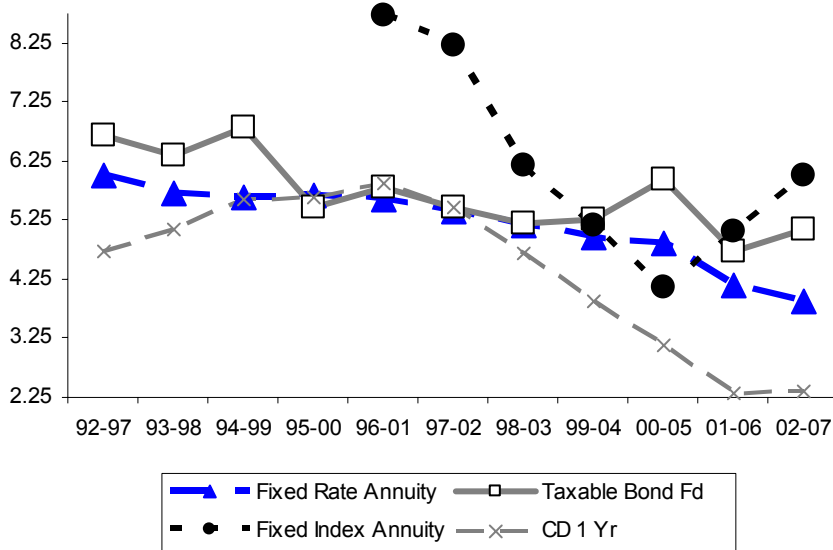
### Index Annuity Returns Are Competitive

We compared fixed rate annuity, fixed index annuity and taxable bond fund returns for five year periods beginning in 1992 and ending in 2007. Our conclusions are that both fixed rate and fixed index annuities have been competitive with U.S. taxable bond mutual funds for these periods.

*From 1997 thru 2007 the taxable bond fund averaged 5.29% a year while the index annuity averaged 5.79%*

If you look at the period from 1997 through 2007, the 5-year annualized returns for the index annuities averaged 5.79%. The average taxable bond fund return was 5.29%; the average one year certificate of deposit return was 3.64%, and the average fixed rate annualized return was 4.73%. For the periods from 1992 through 2007 the average taxable bond fund return was 5.71%; the average one year CD was 4.43%, and the average fixed rate annuity return was 5.18%.

**Annualized Returns For 5-Year Periods**



## Chapter 6 – Rider Revolution

Let's suppose you're fifty years old and plan to retire at 65. You're considering putting \$100,000 into a mutual fund this year. What amount will you be able to withdraw each year from that fund, starting at retirement, and be *guaranteed* that the income will last as long as you live? Is that too tough a question? Here is another. What will that mutual fund be worth fifteen years from now?

When we priced this example, there were deferred annuities available that would provide a 50 year old buyer with the assurance of a lifetime income of at least \$12,000, starting at age 65, based on minimum contractual guarantees. This requires *annuitization* (election of an "annuity payout option"), which amounts to a *conversion* of the annuity cash value to an *income stream*. When you annuitize an annuity contract, the decision is generally irrevocable (meaning that you cannot "undo" the conversion); you trade control of (and access to) the annuity's cash value for the right to those income payments.

### GLWB Comparison

**Start With \$100,000 @ age 50**

**Lifetime Guaranteed Income @ Age 65**

	Income	Principal
Stock Market	?	?
Fixed Annuity Annuitized	\$12,000	\$0
Index Annuity GLWB	\$15,000	\$100,000+

There is another option. As we write this there are several index annuities where, if we paid our \$100,000 premium at age 50, we could receive \$15,000 a year or more for life at age 65 based on the annuity's *guaranteed lifetime withdrawal benefit (GLWB)*. The GLWB removes uncertainty over the amount and length of the payments; it offers the same protection against living too long that annuitization does, but we also have access to the annuity's cash value. The GLWB is transforming the retirement income landscape.

Which GLWB is “best” depends upon how it is used. In Table 1 the rider with the large up front income factor (the rider crediting an initial 25% bonus) has the highest payout if withdrawals begin quickly, but the 5% payout factor makes it less attractive at older ages.

A \$100,000 deposit at age 65 to an index annuity that earned only the minimum return of 2% for 5 years – a possibility in a bad economic patch – would have an accumulated value of \$110,408. Yet a GLWB rider *on that same annuity* could guarantee a lifetime income of \$8,000 to \$9,000 a year! This represents a payout percentage of over 8% of the *account balance* and *that’s a “worst case” scenario*.

Table 2 assumes the annuity accumulated value growing at 6% a year, but deducts an annual GLWB rider fee of 0.4% meaning the account is growing at 5.6%.

**Table 2 Initial Payout Assuming Annuity Purchase Age 65**

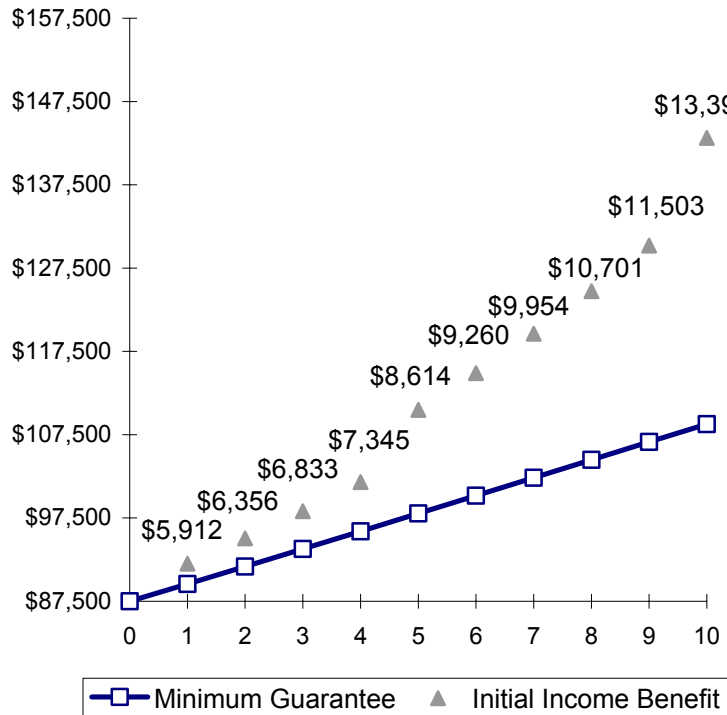
<b>6% (5.6% after rider fee) Growth Results: \$100,000 Deposit @ Age 65</b>	<b>65</b>	<b>70</b>	<b>75</b>	<b>80</b>
25% income acct bonus, then 5%/yr	6,250	7,977	10,181	12,993
10%/yr simple interest income acct growth	5,500	9,000	13,000	17,500
8%/yr income acct growth	5,500	8,816	14,033	22,205
7%/yr income acct growth	5,500	8,415	12,786	19,313
1% payout growth each 5 yr deferral	6,000	9,192	13,795	18,115

In Table 2 (which assumes a 5.6% net growth rate), the only payout method providing a higher value than it would have produced at the GLWB guaranteed growth rate (Table 1) is the payout based method (1% payout growth each 5 yr deferral), which uses the annuity accumulated account value. In all the other methods, the payout under the GLWB growth guarantee rate is higher (which is why the numbers in Table 2, for all other methods, are those from Table 1). Unless one assumes index annuities will produce significantly higher returns than they have produced historically, the payouts generated solely by the income factor growth guarantees may be what a 65 year old can expect from a GLWB.

### There Are Solutions

We have noted that it is difficult for many consumers to grasp that a 7% income account growth factor is not the same thing as a 7% cash value account yield, and, indeed, cannot even be translated into an income payout yield. One solution to this problem would be for the marketing materials for these products to show only the payout percentages and the actual payout generated. This would be less likely to confuse annuity owners as to the cash value of their contracts. Another solution would be to require annuity representatives to use sales materials that show clearly what the income payout growth results really means. For example, a sliding card matrix that specifically translates the growth rate into the payout that would be produced by that rate would make it clear that growth of the GLWB “benefit base” will produce a higher GLWB benefit payment but not a higher cash value.

#### **\$100,000 Premium @ Age 65**



## Chapter 7: “Tax Traps” In Annuity Planning

One of the greatest challenges to those who deal with annuities is the complexity (and, in some cases, uncertainty) of the tax laws governing these contracts. There are four parties to the annuity contract – *Issuer, Owner, Annuitant, and Beneficiary*. Several “tax traps” can be triggered when the owner and annuitant are not the same individual or when the owner or beneficiary is not a human being. And when the owner, annuitant, and beneficiary are all different individuals, the result is not so much a “tax trap” as a “tax disaster” – all because of how annuity contracts say death proceeds will be payable and how Federal tax law says they *must* be payable.

### IRC § 72(s) – The Rules Governing Annuity Death Proceeds

Section 72(s) of the Internal Revenue Code provides rules governing how annuity contracts must be paid out upon the death of the contract owner. This section prescribes how the contract value must be distributed *only* when an annuity *owner* dies; it does not apply if a *non-owner annuitant* dies.

#### If Owner Dies *On Or After* Annuity Starting Date

If the owner dies on or after the “annuity starting date” (that is, after regular annuity payments, under an “annuity payout option” had begun), and before owner’s entire interest in the contract has been distributed, §72(s)(1)(A) states that “the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death”. If those death proceeds (“remaining portion of such interest”) are received by the beneficiary either as a lump sum or in installments under the same annuity payout option elected by the deceased owner, those proceeds will be *excluded from income until the total amount received tax-free (by both owner and beneficiary) exceeds the owner’s “investment in the contract”*.

## Chapter 8 – Suitability

What are the suitability rules that sellers of annuities must observe? Regrettably, there is no simple answer to that question – for at least four reasons.

1. There is not one set of rules. Annuities, and those who sell them, are subject to regulation by multiple regulatory entities.
2. The existing rules, from those various regulatory authorities, are not always perfectly consistent.
3. The existing rules are not always clear.
4. The rules *keep changing!*

**Regulators** – those responsible for overseeing the activities of financial advisors – have their own tests for determining appropriateness *and advisors subject to their oversight may be held accountable for the results of those tests.*

### The Current Environment

#### Registration and Regulation Of Variable Annuities As Products

Variable annuities are *securities*, subject to regulation by the Securities & Exchange Commission (SEC) and by the securities regulatory agencies of the various states. They are also *insurance products*, and, as such, are regulated by the departments of insurance of the various states.

#### Registration And Regulation Of Sellers Of Variable Annuities & Registered Index Annuities

Sellers of securities must be properly licensed at both the Federal and State levels. A representative who wishes to sell mutual funds and/or *commissionable* variable annuities or life insurance policies, must first have passed at least the Series 6 exam, regulated by the Financial Industry Regulatory Authority (FINRA), *and* be registered to sell such

contracts with the state department regulating securities. As variable annuities are also *insurance* products, those who sell them must be properly licensed with, and be subject to the regulatory authority of, the various State Departments of Insurance.

FINRA Rule 2330 (formerly, NASD Rule 2821) imposes particular duties upon sellers of variable annuities and those who exercise compliance oversight over those sellers.

Variable annuities (and variable life insurance policies) that pay *commissions* may be sold only by a *registered representative*, affiliated with a *Broker/Dealer* that is a member of FINRA. Contrary to popular belief, this does not mean that one who is not a registered representative may never sell *any* variable annuity or variable life insurance policy. That's because there are numerous variable contracts out there that pay no commissions. These contracts are designed to appeal to (and be sold by) *Registered Investment Advisors* (who are not required to be registered representatives of a Broker/Dealer member of FINRA). These individuals are subject to a different regulatory regime and are held to a different, and higher, standard of duty.

Securities registered index annuities are typically not registered as variable annuities but as modified single premium deferred annuities. These are essentially securities versions of index annuities with reset features and protection of principal from market risk. Because they pay commissions, they also may be sold only by a registered representative, and because they are insurance products, that representative must hold the required insurance licenses.

Many advisors are “dually registered”, as *both* registered representatives of a FINRA-member Broker/Dealer and as either a Registered Investment Advisor or “Associate” of a Registered Investment Advisory firm (affiliated with that Broker/Dealer). This “hybrid” registration allows these advisors to act *either* as a registered representative (and receive commissions) or as a Registered Investment Advisor (or Advisory Associate) (and receive *fees*). Such advisors must comply with the rules applicable to “whichever hat they are wearing”. The *standard of duty* applicable to Registered Investment Advisors is a form of the *fiduciary standard*, which is

You could try to explain that the minimum interest rate is 1%, 2% or 3%, or that it floats, and then go on to say that in reality, the effective minimum rate may be 0.75% or even zero, and then say that this rate is not even credited each year, and it is not paid in addition to the index-linked interest earned. We don't recommend this.

Or, you could say “At the end of x years (or however long the surrender period is), the insurer guarantees that you will have an account value of at least \$1.10 (or \$1.07 or \$1) for each \$1 of premium, and, if, at that point, the index crediting hasn't produced that much, the insurer will go back and RETROACTIVELY credit you the additional interest required to produce that guaranteed minimum value.”

The key word here is “retroactive.” When you tell consumers that they will probably see years with zero interest credited and then add that last explanation, they will understand that they will, by the end of the term, get at least the minimum return – because retroactive means that the minimum interest isn't lost, for those years when zero interest was earned; it is merely delayed.

### **Why Surrender Charges?**

Surrender charges serve two functions. The first is to encourage the annuity owner to keep the annuity for at least a minimum number of years so that carrier can match up the maturity of the investments supporting the annuity. In other words, if the carrier issues an annuity that they expect will be cashed in after seven years, they probably do not want to back that annuity with a pool of bonds having a 15 year maturity. Why? Because, while the value of those bonds after 15 years is assured, the value at any time before that is not known (or knowable). The insurer cannot adequately back its liability to pay the surrender value of the annuity with assets that may, at the time, be worth less.

Another factor is that longer maturity bonds tend, in most situations, to pay higher yields than bonds of shorter duration, to compensate the buyer for the time element risk. If an annuity's surrender charge is longer, the carrier can invest in longer maturity bonds, typically producing higher yields, and this extra yield can be

## **Tax Treatment of Annuities Versus Alternatives**

All annuities receive tax-favored treatment, but the treatment of immediate annuities is very different from that of deferred annuities.

### **Immediate Annuities**

The income payments under an immediate annuity are taxed according to a “cost recovery” rule, in which part of each payment is deemed to be a return of principal (and, thus, not taxable).

Readers can find a detailed explanation of this treatment in chapters 2 and 3 of *The Annuity Advisor* (National Underwriter Co., 2nd ed., 2009), by John Olsen and Michael Kitces.

### **Deferred Annuities**

The earnings in deferred annuities are, generally speaking, not subject to tax as earned. Tax on those earnings is due only when earnings are distributed, which is why these contracts are sometimes called “tax deferred annuities”. All distributions from any annuity are, under current tax law, either (a) amounts received as an annuity or (b) amounts not received as an annuity. This is a source of considerable confusion for many people, so let’s clear it up now.

How can a distribution from an annuity contract consist of “amounts not received as an annuity”? This seeming contradiction stems from the fact that “annuity” has different meanings. When paired with the word “contract”, the result (“annuity contract”) refers to a specific type of legal agreement, a “contract for income”, between an issuer (usually, an insurance company) and a purchaser, guaranteeing the latter the right to convert (immediately or at a future date) the amount(s) invested to an income that is guaranteed to last for a specified period of years or for life. Those payments of income are what the Internal Revenue Code and Treasury Regulations refer to as “amounts received as an annuity”. In the latter sense, “annuity” refers, not to a contract for income, but to the special nature of the income itself (that it consists of part principal and part earnings, guaranteed for a specified duration).

2. It can charge annual expenses or reduce credited interest to accomplish the same objective. And carriers do this until expenses are recaptured.
3. It can assess surrender charges, typically reducing over time (because the potential loss to the insurer from early surrender declines with each year the annuity remains in force). The principal advantage of this is that the loss to the insurer wrought by early surrenders is offset by charges borne only by those who made those early surrenders.

Buyers of contracts that impose surrender charges are far less likely to complain about those charges when they understand that they're (a) contingent (that is, they only apply to buyers who surrender early) and (b) are in lieu of a "front end" sales charge.

Having dealt with two of the most commonly cited elements in complaints as to the "suitability" of an annuity, let's now look at some rules of thumb – "bright line tests" – that annuity representatives can use to make quick initial judgments on that subject.

### **"Bright Line" Rules for Annuity Suitability**

1. If wealth accumulation or wealth transfer to heirs is a planning goal, an immediate annuity is never appropriate (for the dollars in question).
2. If wealth transfer to heirs is a planning goal, a deferred annuity may not be appropriate, chiefly because (a) it is not eligible for the "step up in basis" that is enjoyed by many types of investments and (b) the earnings are taxed at Ordinary Income rates, either to the contract owner or the beneficiar(ies). That said, the guaranteed death benefit "riders" in some deferred annuities (both fixed and variable) may be attractive to buyers who are uninsurable (or whose insurance would be extremely expensive), notwithstanding the fact that those benefit amounts would be taxed to the beneficiaries in the same manner as other contract earnings.

## Chapter 10 – Case Studies In Annuity Planning

In this chapter, we will look at a series of case studies where we describe different financial situations and objectives of hypothetical consumers (“prospective clients”, if you will), who have asked our hypothetical annuity professional, Matt, for recommendations. We’ll assume, in each case, that Matt is acting (a) as an *insurance agent* and, alternatively, (b) as an “*investment advisor*”, “*wealth manager*”, “*financial consultant*” or in any other capacity that would subject Matt to some form of *fiduciary standard*.

We’ll do it this way for two reasons: First, to point out that the factors that Matt must consider, when acting solely as an insurance agent may (but not necessarily will) be different from those factors he must consider when he’s acting as an investment advisor. And second, to point out the potential differences in the obligations and duties he must assume in each scenario. Let’s get started.

### Case One: “I’m Tired of Paying Taxes!”

Jubal is a single 45 year old physician. He currently earns \$220,000 per year (net of expenses), and expects his income to increase each year by at least 8%. Jubal contributes the maximum amount permissible to the 401(k) plan at his practice (Tanstaaf Medical, LLC) and still manages to put away \$4,000 per month into a “moderately aggressive” portfolio of mutual funds. Jubal has very little debt (other than his home mortgage) and his health is quite good, but he doesn’t want to continue working “forever”. In fact, he’d like to retire in ten years or so. Jubal’s one main gripe is *taxes*. Not only does he pay substantial income taxes each year on his earnings, but he expects that the taxes he’ll have to pay when he sells his practice to his partners (pursuant to a buy-sell agreement) will be “downright confiscatory”. He’s asked Matt to recommend something that (a) will give him some income tax relief, (b) offers “decent growth”, but isn’t “risky” (he feels he’s already taking a lot of market risk), and (c) will give him an income in retirement. What factors should Matt consider,

when developing a recommendation and what annuity products (if any) would be most appropriate for Jubal?

**Scenario A: Matt is an insurance agent, but not a registered representative or “investment advisor”**

As an insurance agent with no securities registration, Matt is limited, not only with respect to the investment types he may sell, but also with respect to those he may even discuss. He cannot discuss *variable* annuities. Moreover, he cannot offer advice regarding Jubal’s mutual fund portfolio. He’s limited to talking about *fixed* insurance products. Let’s assume that Matt wants to recommend a fixed annuity. What factors should he take into account prior to making any such recommendation? If Matt is subject to the NAIC *Suitability in Annuity Transactions Model Regulation*, Matt must take into account the twelve factors listed in that Regulation (see Chapter 8) These are:

- (1) Age
- (2) Annual income;
- (3) Financial situation and needs, including the financial resources used for the funding of the annuity;
- (4) Financial experience;
- (5) Financial objectives;
- (6) Intended use of the annuity;
- (7) Financial time horizon;
- (8) Existing assets, including investment and life insurance holdings;
- (9) Liquidity needs;
- (10) Liquid net worth;
- (11) Risk tolerance; and
- (12) Tax status.

Let’s look at some of these: Note: The fact that we may not address every one of these 12 factors in every scenario should not be interpreted to mean that only those factors we address should be considered.

**Age.** Jubal is 45 years old. He doesn’t need more income currently, so an immediate annuity clearly isn’t called for. But what

This is especially true when one acts in multiple roles (e.g.: sometimes, as a “pure insurance agent”, sometimes, as a registered rep, and sometimes as an investment advisor”, depending upon the products being sold and/or services being performed). If this describes your practice (or what may become your practice), make very, very sure that your client understands, not only what you are recommending and why, but the *capacity in which you are acting*. It is far easier, and far less costly, to explain these things to a client, up front, before making any recommendation, than to a jury or panel of arbitrators.

### **Cheat Sheet**

- The suitability factors may change depending upon whether one is acting as an insurance agent, registered representative or financial advisor
  - Professional certifications such as CLU®, ChFC®, or CFP® may cause regulators to hold an agent to a higher standard
  - The consumer needs to fully understand the capacity in which you are acting
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