

The Pros and Cons of Equity Indexed Annuities

EIAs look attractive to conservative investors today. But product features have changed, so advisers should tread carefully.

Equity indexed annuities (EIAs), which provide a minimum guaranteed interest rate and the potential for additional interest based on a percentage of the gains in a stock market index, have become a force to reckon with in the investment marketplace. In 1995, fledgling EIA sales barely registered, amounting to \$0.2 billion. In 2002, sales were approximately \$11 billion. So if you aren't talking with your clients about EIAs, someone else probably is.

This article will explain why EIAs are an important product to understand (whether you like them or not); help you understand what is going on behind the scenes in the EIA market; and look at the opportunities that may exist for you and your clients with EIAs in today's market conditions.

When EIAs were first introduced, the market was poised to embark on one of the biggest bull runs in history. Billed as a way for conservative investors to participate in the equity run-up while limiting downside risk, interest in these products grew. So did negative publicity, with early confusion about what types of returns could be expected followed by later criticism of complex product designs and double-digit commission rates on many offerings.

Despite the controversy, many EIAs sold in 1995 and 1996 actually earned 10% or more annually for contract holders, who didn't have to worry about losing money. Those with a seven-year time frame--the bulk of the \$1.5 billion in EIAs sold in 1996--will be maturing this year. As a result, satisfied customers could be asking their financial advisers to help them decide whether to purchase another EIA. In today's market, a product that guarantees that you won't lose money but can participate in a large percentage of the gains when the stock market recovers has a sexy story to tell.

The first thing that you and your clients with maturing EIAs should understand, however, is that the EIAs of today will not produce the same results as the EIAs of seven years ago. Many of today's products are designed to capitalize on that sexy story while maximizing company sales and profits to the detriment of clients. The few high-quality products that do exist must be priced with lower participation rates and caps than seven years ago, due to the economic environment.

As interest rates declined in the later 1990s and market volatility rose, the cost of EIA options soared. Participation rates and caps went down and yield spreads went up, so some of the older, high-quality products left the market.

Many of the new products marketed during that time were designed to sell in those adverse conditions. How do companies do that? They extend the term. They use averaging to advertise a higher participation rate. They introduce rates and caps that can

change, and they add other bells and whistles like multiple buckets that de-emphasize performance. And, they increase commissions.

Seven years ago, the average EIA product term was five to seven years. There was no averaging. Participation rates and caps were guaranteed for the entire term (unless the product contained an annual reset, which required different treatment). And the average commission was 6%.

Today, 84% of products have terms of 10 years or more. Averaging of all types is commonplace. Most participation rates and caps can change on anniversaries. And the average commission is 10.4%. In fact, 80% of sales are currently in products with commissions of 9% or higher.

Don't get me wrong. I have nothing against commissions. The challenge, as with fixed annuities, is finding a product that performs for clients and pays a fair commission. This requires an understanding of the product's complexities and the patience to seek out appropriate opportunities for clients.

When doing due diligence on EIAs, I would recommend the following:

- Gather the consumer materials, agent materials, and a sample policy if possible.
- Don't sell a product that fails to publish hypothetical returns based on actual historic index values.
- Learn to define and describe the product in terms of its term length, crediting method (e.g., annual reset, point to point, or high water), whether it uses averaging and what type, current participation rate, guaranteed participation rate, current cap, and guaranteed cap.
- Use hypothetical returns from the best, worst, and recent historical periods and/or a distribution of hypothetical returns over past historical periods to get a range of potential returns. The chart on page xxx shows these calculations for one product, the Clarica Life Insurance Co. 7-Year Annual Reset EIA. If participation rates and caps are subject to change at the company's discretion on anniversaries, do that analysis twice, once at current rates and caps and again at the minimum rates and caps specified in the policy. You wouldn't put any other asset into your clients' portfolios without some reasonable expectation of performance over time, so make sure you feel comfortable with these expectations for EIAs.

If you have sold EIAs before, make sure you know when those policies will mature and meet with the clients before they do. Many EIAs are designed to renew automatically after a 30-45 day window, during which time participation rates, caps, and other variables can change.

If you haven't sold EIAs before, you should know that there are a few high-quality EIAs available, and historical analysis of their hypothetical returns makes them look attractive, as fixed rates stay low. It might make sense to use EIAs for a portion of your fixed-income allocation to increase yields on non-liquid money. You probably won't see the

double-digit returns of past EIAs, but returns ranging from 4%-7% could be common, at a time when fixed annuities are paying around 4%.

The demand for EIAs is rapidly increasing. A large number of advisors are telling the EIA story with success. Advisors with their clients' best interests at heart can seize this opportunity if they do the necessary due diligence and have reasonable expectations.

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