Help Your Clients Understand Indexed Annuities

by Farshad M. Asl, CLTC

Your clients could benefit from an indexed annuity if they want the potential of earning more than fixed guaranteed returns without risking principal and prior earnings. Indexed annuities offer all of the features of traditional fixed annuities, including tax deferral on interest gains, safety, and guarantees on earnings. They offer clients the unique opportunity to earn returns that are linked to increases in a market index while protecting their owners against downside market risk.

While indexed products have been around for almost two decades, their popularity has increased in recent years. Sales went from $3 billion in 1997 to more than $27 billion in 2005, according to LIMRA.

There is no doubt that clients are taking note of the advantages of indexed annuities. It's a great product for the client with a lower risk tolerance who wants an opportunity for higher gains as the market appreciates. It's been especially attractive to the Baby Boomer who has a large asset base and is interested in the product's tax deferral and growth benefits.

While indexed annuities offer positive benefits, they can be hard for some clients to understand. Clients sometimes have a hard time with the product's unique terms, such as "indexing," "participation rates," and "crediting methods." A client can end up misunderstanding the product when you mix the complexity with the client's enthusiasm for participating in market gains while avoiding downside market risk.

It's up to us to make sure that indexed annuities are right for our clients and that our clients have a thorough understanding of what they are about to purchase. During the sales presentation, we can touch on some of the common misunderstandings.

An Indexed Annuity Is Not the Same as an Indexed Mutual Fund

Index investing gained popularity with the growth of the index mutual fund market. So, people often assume that indexed annuities are the same as indexed mutual funds. They're not. Indexed annuities are fixed annuities, in which the rate credited is linked to the performance of a market index.

An index is simply a benchmark or a relative measure of activity performance. For example, the Consumer Price Index tracks the prices of consumer goods from year to year. Only in this case, the index tracks the performance of a specific group of stocks. It's important to emphasize to your clients, when they purchase an indexed annuity, they are purchasing an insurance contract, not stock.

Just because the index earns 9% doesn't mean that Your Client's Return Will Be 9%

Some clients mistakenly assume that they'll earn 9% on their money if the index goes up 9%. In reality, your client's potential return is affected by the product's indexing method.

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The indexing method has two parts. The first looks at how to measure the index performance. (Two popular methods are monthly averaging and point-to-point.) The second part determines what portion of that performance is credited to the account value. The portion might be calculated using a participation rate, a cap, or a deduction.

While there are different indexing methods, they work together with the method that's used to calculate the index-linked rate to determine your client's return.

It's also important to note that participation and caps are not comparable across indexing methods. An indexed annuity with a 100% participation rate will not necessarily produce a greater index benefit than another contract with an 85% participation rate. Caution your clients against comparing indexed annuities feature-by-feature. Instead, encourage them to look at each product as a whole.

Your Client Is Protected From Loss in a Market Downturn

The big advantage of indexed annuities is that they protect your client against market loss when the market experiences a downturn. Consider an investment that earns 10% a year for three consecutive years and loses 10% in the fourth year because of a market downturn. The annualized return would average just 4.6% because of that loss.

However, if that money were put into an indexed annuity with a cap of 7%, your client would earn 7% annually for the first three years and would not experience any loss due to the market downturn in the fourth year. The annualized return would average 5.21%. That's higher than if your client participated in the market at the full 10%.

With an indexed annuity, your clients will know that their account value will never decrease due to market loss. They should also understand that their account value could remain the same during periods of prolonged market downturn.

Like All Annuities, Indexed Annuity's Have Restrictions

Clients need to know about an indexed annuity's restrictions. This is especially important for older clients who may need access to their money before the end of the annuity's term or withdrawal charge period. Early withdrawals can be subject to withdrawal charges, tax penalties, and income tax. Make sure that your clients understand when they can access their money without incurring these charges. The client might want to consider something other than an annuity if they think they'll need quick access to their money to pay for unexpected expenses.

We will have more opportunities to bring the value of indexed annuities to the attention of Baby Boomers as more and more reach retirement. The sheer magnitude of the opportunity is worth taking the time to gain a thorough understanding of the indexed annuity you're selling so you can do justice to the product and your client. ❑

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