The loss of dividend income and a cap on market gains is a major drag on performance. Why invest in indexed annuities when you can go with variables?

Indexed Annuities: Too High a Price for Market 'Protection'

By Peter Katt

If the market goes up, the investor is happy. If the market goes down, the investor is happy. So goes the claim of a relatively new investment product, the equity-indexed fixed deferred annuity, referred to as an indexed annuity, that accounts for about 50% of all fixed annuity sales, and their sales are going up.

Deferred annuities are a method for long-term investors to accumulate assets on a tax-deferred basis. Investing long-term is essential for annuity purchasers because annuities all have surrender penalties for generally five to 10 years, are subject to a 10% penalty tax if withdrawals are made prior to age 59½ and withdrawals are taxed on an interest-first basis. (Please refer to "Insurance Products and the Needs of the 50-Something Individual" in the February 1996 *AAII Journal* for a more complete discussion of annuities, especially with how their investment characteristics compare with those of life insurance.)

Fixed annuities are distinct from variable annuities because policyholders have no role in selecting the investment strategy. Their premiums are held in the insurance company's general account, which primarily invests in bonds held for their yields. Therefore, fixed annuity returns will resemble bond yields less 100 to 200 basis points (1% to 2%) for annuity expenses.

Variable annuities allow the investor to select their own investments from a group of mutual funds and are therefore considered securities. Most astute variable annuity purchasers invest in equity or equity-combination funds whose results will resemble equity returns, also less 100 to 200 basis points for annuity expenses.

A 1976 investment in a fixed annuity would have produced an average annual return of about 8.0% to 9.0% for the 20-year period ending in 1995, although it should be remembered that this period includes some very high-yielding years due to raging inflation. A variable annuity invested in an S&P 500 index fund would have produced an average annual return of 12.5% to 13.5% for the same period. However, in the "what have you done for me lately?" category, bond yields have fallen dramatically since their highs in the 1980s, causing current fixed annuity returns to be in a 5.5% to 6.5% range. This drop in fixed annuity returns combined with the strong, but always volatile, stock market performance (an average of about 16.4% for the past five years) provides the backdrop for this new indexed annuity.

Table 1.
The Vanguard Index Trust Returns and Fixed Annuity Rates: 1976-1995

Year Ended	Vanguard Index Trust 500* Capital Return (%)	Income Return (%)	Total Return (%)	Fixed Annuity Rates** (%)
1976	4.1	1.2	5.3	2.1
1977	–11.7	3.7	–8.0	7.0
1978	0.8	5.0	5.8	7.3
1979	12.1	5.9	18.0	7.8
1980	25.5	6.4	31.9	8.4
1981	–9.8	4.6	–5.2	9.5
1982	14.8	6.1	20.9	11.0
1983	16.2	5.1	21.3	11.5
1984	1.5	4.7	6.2	12.0
1985	26.1	5.1	31.2	12.1
1986	14.0	4.0	18.0	11.2
1987	2.3	2.4	4.7	9.8
1988	11.6	4.6	16.2	9.5
1989	26.7	4.6	31.3	9.0
1990	–6.8	3.4	–3.4	8.4
1991	26.3	3.9	30.2	7.8
1992	4.4	3.0	7.4	7.5
1993	7.1	2.7	9.8	6.5
1994	–1.5	2.6	1.1	6.2
1995	34.4	3.0	37.4	6.1

**Vanguard Index Trust—500 portfolio data from its inception August 1, 1976, to December 1995. Includes reinvestment of income dividends and any capital gains distributions and is adjusted for account maintenance fees.*
***Representative fixed annuity rates for the period August 1, 1976, to December 1995.*

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Table 2.
Variable vs. Fixed vs. Indexed Annuities: A Theoretical Historical Comparison
(Based on a $100,000 Investment, August 1976 – December 1995)

	Variable Annuity (invested in Vanguard 500*)		Fixed Annuity		Indexed Annuity			
					Company A**		Company B**	
	Projected		Projected		Projected		Projected	
Time Period	Value ($)	Return (%)	Value ($)	Return (%)	Value ($)	Return (%)	Value ($)	Return (%)
8/76 – 12/80	152,340	10.3	136,980	7.6	125,190	5.4	131,050	6.5
8/76 – 12/85	282,310	11.8	233,073	9.5	181,310	6.6	193,930	7.4
8/76 – 12/90	491,520	11.8	368,187	9.5	278,980	7.4	273,320	7.4
8/76 – 12/95	1,005,300	12.7	512,018	8.8	480,320	8.5	396,170	7.4

**Vanguard Index Trust—500 portfolio total returns reduced by 100 basis points to simulate variable annuity expenses.*
***Company A computes the cash value every five years by taking 83% of the highest S&P 500 market value,* not including dividends*, during the five-year period. For example, if the starting investment is $100,000 and the five-year high point is $130,353, the fifth-year cash value is $125,190, or 83% of the highest capital gain for the five years. Each five years the equity-indexed annuity policy owner can decide to cash it in, convert to a traditional fixed annuity or lock into the equity-indexed annuity for another five years. Company B allows for 85% of the S&P 500 market gain (not including dividends), capped at 14% in any one year, but treats market losses as zero. For example, if the S&P 500 (*without dividends*) went up 10% in year one, Company B would recognize 8.5%; if it went up 20% in the second year Company B would recognize 14%; and if the index went down 5% in year three, Company B would recognize 0%.*

Indexed Annuities

Indexed annuities offered by such companies as Keyport Life and Lincoln Benefit have differences, but generally their annual investment returns are tied to a percentage (about 85%, subject to periodic adjustments) of the S&P 500's gains, but this *does not include dividends.* This cap on gains is offset by protection against market losses. The surge in indexed annuity sales attest to their popularity in the marketplace.

The question is: Are indexed annuities a good buy for astute individual investors?

As you will see, if the sales hype is replaced with analysis, most astute individual investors will avoid them. In this instance, "does not include dividends" is not as innocuous as "does not include batteries." *D*ividends accounted for about 29% of the total return for the Vanguard Index Trust—500, an S&P 500 index fund, over the past 20 years. Giving up dividends plus imposing a cap on market capital gains is far too severe a penalty to pay for protection against periodic market losses, as will be shown later. However, if an August 5, 1996, article in the National Underwriter (life insurance industry magazine), written to offer selling tips to insurance salesmen selling indexed annuities, is any indication, consumers may not even know that the index calculations do not include dividends, since it wasn't even mentioned in the article.

Theoretical Comparison

It isn't possible to compare historical fixed annuity, variable annuity, and indexed annuity results because indexed annuities have only been available for several years. But, it is possible to construct a theoretical comparison by using the Vanguard Index Trust—500 portfolio and fixed annuity yields from August 1, 1976, to December 31, 1995, shown in Table 1. Table 2 simulates the results for a fixed annuity, variable annuity, and indexed annuity, had they been purchased August 1, 1976, through the end of 1995, in five-year increments, using the data from Table 1. Table 3 is the same simulation, but for the period January 1991 through the end of 1995. Isolating the last five years is interesting because fixed annuity rates have been much lower, while equity returns have been robust, which are the market results that motivated insurance companies to develop this hybrid indexed annuity.

Please note that Tables 2 and 3 simulations are not an attempt to predict possible future results for fixed, variable, or indexed annuities. The only purpose of these tables is to show how the indexed annuity formulas affect re-

Table 3.
Variable vs. Fixed vs. Indexed Annuities: The Last 5 Years
(Based on a $100,000 Investment, January 1991 – December 1995)

	Variable Annuity (invested in Vanguard 500)		Fixed Annuity		Indexed Annuity			
					Company A		Company B	
	Projected		Projected		Projected		Projected	
Time Period	Value ($)	Return (%)	Value ($)	Return (%)	Value ($)	Return (%)	Value ($)	Return (%)
1/91 – 12/95	213,283	16.4	139,065	6.8	172,169	11.5	140,712	7.1

sults relative to fixed and variable annuities.

Results

As you can see in Tables 2 and 3, if the past 20 years offer any guidance, indexed annuities are a poor substitute for a variable annuity invested in the S&P 500 index because the gimmick of eliminating periodic market losses is simply overwhelmed by giving up reinvested dividend income and placing a limit on the capital gains in figuring the index. For most astute individual investors who are looking to invest in a long-term deferred annuity, the choice isn't between investing in fixed annuities or indexed annuities, as annuity salesmen would have it, but between investing in variable annuities or indexed annuities. When the proper choices are identified, most astute investors will conclude that variable annuities are the better choice.

There is one category of astute individual investors who might correctly invest in an indexed annuity, however. These are investors in their 50s and 60s making their final investment push to retirement, so their investment time horizon might be five to 10 years. Since there is little time to earn back any investment mistakes, new investments and the repositioning of equity invested assets might now be prudently invested with an eye on conservation. If fixed-income yields were low and expected to remain so, the indexed annuity might be the ideal investment product for this investor.

Conclusion

Indexed annuity sales are booming because the greed-without-fear sales hype resonates with less astute investors, not unlike having an indexed golf scoring system that eliminates all triple bogies or higher but also doesn't count birdies and eagles. A duffer with an actual score of 101 would report an indexed score of 94, but a tour pro would have his 67 adjusted up to a 75.

Similarly, astute investors seeking long-term tax-deferred accumulation are likely to have their investment returns substantially muted by investing in indexed annuities, if history is any guide.

Grading Long-Term Care Insurers

More long-term care insurers are making the list of financially strong performers, according to Weiss Ratings, Inc, an independent publisher of insurance company ratings. The 12 insurers that received strong ratings are shown below, along with the weakest long-care insurers, as rated by Weiss.

Weiss publishes a directory of life and health insurers that includes ratings and financial data on nearly all companies that write health policies. Consumers can obtain a rating over the phone for $15 per company, or a one-page Personal Safety Brief for $25. Industry-wide directories are $219. Contact Weiss Ratings Inc., at 4176 Burns Road, Palm Beach Gardens, Fla. 33410, (800) 289-9222.

Strongest Long-Term Care Insurers
(Companies with more than $1 billion in assets)

Company (State)	Total Assets ($ million)	Weiss Safety Rating
Country Life (Ill.)	2,906.0	A+
New York Life (N.Y.)	59,414.5	A
Life Insurance Co. of Georgia (Ga.)	2,809.7	A
Mutual of Omaha (Neb.)	3,116.3	A–
Teachers Ins & Annuity Assn. (N.Y.)	79,794.6	B+
Principal Mutual Life (Iowa)	51,268.2	B+
John Hancock Mutual (Mass.)	50,776.6	B+
Nationwide Life (Ohio)	35,656.6	B+
Fortis Benefit (Minn.)	4,852.2	B+
Hartford Life & Accident (Conn.)	3,170.4	B+
Time Insurance Co. (Wisc.)	1,605.2	B+
Trigon Blue Cross/Blue Shield (Va.)	1,019.5	B+

Data Date: 3/31/96

Weakest Long-Term Care Insurers
(Companies with more than $25 million in assets)

Company (State)	Total Assets ($ million)	Weiss Safety Rating
Bankers Multiple Line (Ill.)	59.5	D+
Network-America Life (Penn.)	44.0	D+
Union Bankers Life (Texas)	228.0	D
Atlantic America Life (Ga.)	36.1	D

Data Date: 12/31/95

Ratings:
A = Excellent; B = Good; D = Weak; E = Very Weak. Plus sign indicates upper third of grade range; minus sign designates lower third.

Source: Weiss Safety Ratings, Inc., Palm Beach Gardens, Fla.