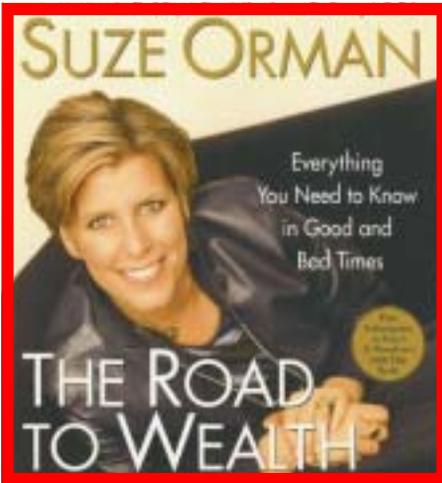


Equity Indexed Annuities



In its effort to keep up with mutual funds, the insurance industry introduced yet another kind of annuity. It was created to compete with very popular index funds; mutual funds that track a stock market index. I have to admit I like the concept—for the right investors.

How does an index annuity work?

Like all annuities, an index annuity is a contract with an insurance company for a specific period of time. An index annuity is a particular stock-market index, such as the Standard & Poor's 500. Your rate of return will usually be a set percentage of the increase in that index in the corresponding index year, up to a maximum of a given percent.

There is also a guarantee against losses. The surrender period on an index annuity is typically longer than other surrender periods of about seven to ten years.

Can you give me an example of how the set percentages work?

Yes. Let's say that your index annuity promises to give you 50 percent of what the S&P index returns, up to a maximum return of 10% per year. You invest \$20,000 on March 15. By March 15 of the following year, the S&P 500 index has increased 30%. According to the terms of your annuity, the insurance company has to give you 50% of that increase, up to a maximum of 10%. Since 50% of 30% is 15%, which is 5% higher than the preset yearly maximum of 10%, you will be credited with a 10% gain on your original deposit, in this case \$2,000. If the S&P 500 index had gone up only 15% for the year, you would be entitled only to a 7.5% gain on your investment.

You say there is a guarantee on the downside. What if the S&P 500 goes down 30%?

Yes, there is a guarantee on the downside, which is why investors in index annuities accept a ceiling of 10% a year on their gains. In fact, for those who do not want to take any downside risk, the index annuity can be a good option. Unlike regular index funds, where you claim 100% of the gains but also suffer 100% of the decreases, in an index annuity **your money can only go up; it cannot go down!** If you invest \$20,000 in an index annuity on March 15 and by the following March 15 the index has fallen by 30%, you will still end up with \$20,000 at the end of that year. The next year, when the market rises by 20%, you will be credited with 50% of that increase up to a maximum of 10% or, in this case, 10% or \$2,000. So, instead of having a total of \$18,000 after two years (you would have lost \$3,000 in the second year), as you would in a typical mutual fund account, you will have \$22,000. This kind of annuity limits your upside but effectively protects you from a downturn. Please note: This safety feature is not included in all index annuities, so be sure to ask your insurance company whether it applies to the annuity you're considering.

Are there any other safety features attached to index annuities?

Yes. Index annuities typically come with a guarantee as to your total return over the life of the annuity. No matter which available index you choose to track, in the long run you can't lose. Why? Because once your surrender period is over, the insurance company typically guarantees that you will get back at least 110% of what you originally invested or the balance of your account, whichever is greater. If you invest \$20,000, the worst-case scenario will leave you after seven years with \$22,000, or about a 1.4% minimum guaranteed annual return on your investment. Again, if you are willing to give up some upside potential, **an index annuity can help you protect yourself against downside risk, both in the short term and the long term.**

Are index annuities better in bear or bull markets?

Because of the protections they offer in exchange for the limiting upside potential, I like index annuities best in markets that are going down. In a down market, the company has to pay you something even if the indexes plummet. If the indexes go up one year, you can lock in gains for that year. Either way, you avoid taking the hits in the down years. What would you look out for with an index annuity? Be sure you know exactly what % you'll earn on any increases in the index you choose, as well as the annual and total maximum and minimum gains. Ask whether the insurance company has the right to change any of these percentages during the contract period. If so, be wary. Finally, be sure you know the length of the surrender period and the size of all fees and sales loads you'll be charged.

How do I know if an index annuity is right for me?

If you do not want to take any risks but still want to play the stock market, a good index annuity may be right for you.