

A Lost Decade: Or Was It?

By Mark R. Triplett

Vice President of Annuity Distribution
AMZ Financial Insurance Services

I recently spoke to a group of independent financial professionals at a life and annuity workshop. I had spoken to this organization on many occasions, and some of the past topics included various marketing concepts, index product designs, and the basics of indexing. This time I was asked to tackle a peculiar topic. I was asked to defend index annuities in today's interest rate environment. Well, not exactly asked to defend them, but rather provide insight as to whether they were still a good value considering today's market conditions and current interest rates. What I discovered during my investigation solidified my confidence in the products our industry markets. They have proven their worth time and again, and will continue to meet or exceed the obligations to the customer.

First of all, all index annuity products have limitations on the interest that may be credited to the client's account. As you may already know, the interest is based on "**some**" of the positive movement (and in some case the negative movement where inverse crediting methods are available) of major market indices. They do this while avoiding "**all**" of the risk associated with a negative market movement. Customers who purchase index annuities are protected from loss to principle and interest while maintaining a better than average opportunity to earn an interest rate higher than current fixed rates offered on safe money alternatives.

Often overlooked in the comparisons made between index annuities and investments directly exposed to the market is the fact that the client earns **interest** in an index annuity, not a gain or return on their investment. In fact, they earn compounded interest so their money grows faster. Even better, they earn tax deferred, compounded interest. Cold hard cash is credited to their account and cannot be stripped away when a recession hits, political unrest erupts in another part of the world, or Tsunami strikes the shores of a foreign economic powerhouse.

Secondly, the last decade has been described as a "Lost Decade." This is because many investors have had little to no gains from their investments from the year 2000 through today. Some investors have even lost value in their holdings. An annual-reset index annuity holder on the other hand, did not experience a lost decade. This is because they were not invested in anything. Rather, they held an insurance contract that promised to pay them interest based on some of the movement of a major market index and offered no change to their contract when the market conditions were destructive. Index annuity holders have experienced years in which interest credit was added to their accounts, and years when no interest was added to their accounts. There was never a year in which the market conditions resulted in a loss of any principle or interest that was previously credited to the policy.

Let's apply figures for a moment. A Baby Boomer who purchased a share of the SP 500 upon the opening of the market on Jan. 3rd of 2000 would have bought in at an index value of 1,469. As of the close of business March 16, 2011, that share was valued at 1,256. That is a **14.4%** decline in value, or negative **1.3%** on average per year. Since an annual-reset index annuity holder would have used the index as benchmark for determining index interest credit rather than an absolute value for determining gain or loss they made money. In the case of an index annuity, the index annuity holder's account value would be credited with interest in years when the value of the index was greater than it was the year before, and remained level in the years when the index decreased in value. For example, a policy issued on Jan. 3rd of 2000, applying a simple annual point-to-point calculation (*Annual Point-to-Point is calculated by comparing the value of the index on the policy issue date to the value of the index one year later*), with an index interest cap rate of 8% would have resulted in an 11 year compounded interest rate of **54.36%**. That is an average interest rate of **4.94%** during the "Lost Decade!" It may not be very sexy, but if you're a pre-retiree that cannot afford to lose retirement dollars it certainly is practical.

Lastly, the interest rate environment, although historically low, has been this way for 8 years now. Will interest rates increase in the future? It is likely, but not certain. I can remember when I would have told an advisor in 2003, "hold off on any long term annuity purchases because interest rates are bound to go up." However, I have been proven wrong. Many client's would have missed out on invaluable index interest credit while sitting on the sidelines in Money Markets and CDs.

If a client does purchase an index annuity today it would be prudent to discuss an exit strategy with them incase interest rates do rise in the future. That way they will be educated on how to minimize interest rate risk. Exercising penalty free withdrawals could be one strategy used to allow a customer to take advantage of rising interest rates. Shifting unused penalty-free money from the parent policy to a new product with an equal or lesser surrender period would make sense if interest rates have increased on new money. Another advantage to this move is that it will create new index interest crediting periods allowing for different opportunities throughout the year to earn interest. Another strategy would be introducing your customers to products with return-of-premium feature. An ROP would assure them that they can move their originally premium to a higher interest bearing account without penalty. In many cases they would forgo some or all of the interest. However, if interest rates increase dramatically this could be a desirable feature.

The bottom line is that index products are designed to be safe-money alternatives. They should be positioned as alternatives to other fixed products, CD's, etc. Reasonable expectations should be set from the beginning so that you customers are not disappointed with future results. If your customers can live with the opportunity to earn 1-3% more than they would in traditional safe-money place, please consider indexed annuity products.

By the way, it's never a bad idea to check with an independent and unbiased industry expert when evaluating products for your customers.