

The Comprehensive Annuity Investment Guide



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Indexed Annuities Pros and Cons

Indexed annuities are often referred to as "hybrid annuities." They are a relatively new type of investment product. Introduced by several insurance companies in the late 20th century, they contain parts of fixed and variable annuities. Like fixed annuities, indexed annuities will guarantee that an investor's account will not fall below his or her initial investment. Like variable annuities, indexed annuities provide for compounded growth based on an increase in the underlying investments.

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Two Phases

The return that is credited to indexed annuities is always tied to a specific market index. While it can be tied to any market index, the broader Standard and Poor's 500 is the one most commonly used. Indexed annuities are often called "equity-indexed annuities." When indexed annuities are purchased as deferred investments as part of a retirement plan, they have two phases: The accumulation phase and the distribution phase.

The Accumulation Phase

The accumulation phase of indexed annuities is the time during which money accumulates in the account. Accumulation can be one large, lump-sum payment or it can take place over many years with several smaller payments.

The Distribution Phase

The distribution phase starts once an indexed annuity is annuitized. The annuity owner can opt to take distributions as monthly, quarterly or annual distributions. The dollar amount of the distribution and for how many years they last depend on the tax status. If the annuity was bought in a retirement plan with qualified money, the payouts will be in an amount determined by the IRS based on the annuity owner's life expectancy. If it was bought with post-tax dollars, the payout amounts will be determined based on the amount the annuitant wishes to receive or by the amount of time he or she wants to receive the payments.

When indexed annuities are purchased as immediate annuities, there is no accumulation phase and distribution begins immediately. Immediate indexed annuities are purchased with a single payment, and can be funded with from any source on non-qualified, after-tax money.

What are Indexed Annuities Pros and Cons Regarding Interest?

One of the challenges of purchasing an indexed annuity is deciding on the method by which interest and

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earnings will be credited to the account. At the time the contract is annuitized, an indexed annuity owner can choose among three methods: High-water mark, point-to-point or annual reset method.

The High-Water Mark Method

Indexed annuities that calculate the return based the high-water method calculate the earnings mark several points during a 12-month period and use the highest mark to compare one year to the next.

The Point-to-Point Method

The point-to-point method uses only two points during the annual term of the indexed annuity. The most common points are the one at the start of the term and the one at the end of the term. If the index to which the annuity is tied is higher at the end of the term than it was at the beginning, the difference is then used to calculate earnings.

The Annual Reset Method

The annual reset method uses the change in the percentage of the index from the start of the first contract year to the end of that first year, and then the end of each subsequent contract year.

However, an insurance company may not pay interest on the entire amount of the principal in the account. The portion of the money on which interest and earnings are paid is called the "participation rate". The participation rate is the amount of the account that "participates" in the earnings. For example, the entire balance of the account is not used when earnings are calculated. If the participation rate is 90% and the increase in the S&P 500 is 3%, the gain credited would be 2.7%.

The amount of the return is determined by multiplying the participation rate (90%) by the increase in the index (3%). And, some companies cap the maximum percentage that can be credited to an indexed account. If, for example, the annual cap is 4%, this will be the maximum amount of interest that will be credited, even if the calculation provides for a higher percentage.

Indexed annuities, like all annuities, grow tax-deferred even if they are not included in a retirement savings account. Because money is not removed from the account to pay capital gains or ordinary income taxes, more dollars are available to compound over time before the annuity is annuitized. This means that earnings are credited to an ever-larger account each and every year. Most life insurance companies that sell indexed annuities will also guarantee that the value of the indexed annuity will never drop below the value of the total premiums paid, regardless of how the index to which the investments are tied perform.

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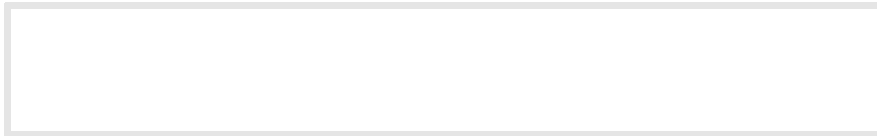
During times of extreme market volatility, especially during worldwide market downturns and significant market drops, this is an especially significant benefit of owning indexed annuities. While an investor may have to pay additional fees or purchase an additional rider to gain more protection, it may well be worth it if the markets languish for several years.

Given the Pros and Cons, What Type of Investor is Best Suited for Indexed Annuities?

Indexed annuities are usually recommended as alternatives to indexed mutual funds. Even though indexed annuities may not pay the same rate of return as an indexed mutual fund, an investor's money is typically guaranteed against loss of principal. And while the fees for administering indexed annuities can be higher than those for mutual funds, the guarantee of principal and the tax-deferred status will more than likely provide for greater gains over time.


Indexed annuities can play an important role in any individual retirement account or as part of an individual savings plan. Because growth is tax-deferred, regardless of whether or not they are bought with pre-tax dollars, indexed annuities can be very useful for younger investors who have maxed out their retirement account contributions. Indexed annuities are also well suited for older investors who wish to receive a lifetime stream of guaranteed income.

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