

A Bear-Proof Way To Ride the Market

Equity-indexed annuities remove downside risk

BY LEWIS BRAHAM

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You can insure your car for theft and your house for fire, but can you buy insurance that prevents you from losing your shirt on Wall Street? Equity-indexed annuities, or EIAs, are insurance contracts that fit the bill. They're essentially index funds that build up inside a tax-deferred account. They pay some of the returns of stock indexes such as the Standard & Poor's 500, and even guarantee a minimal rate of return. "The worst you can do is get your money back and a few extra dollars," says Jack Marrion, CEO of Advantage Group, an annuity research firm.

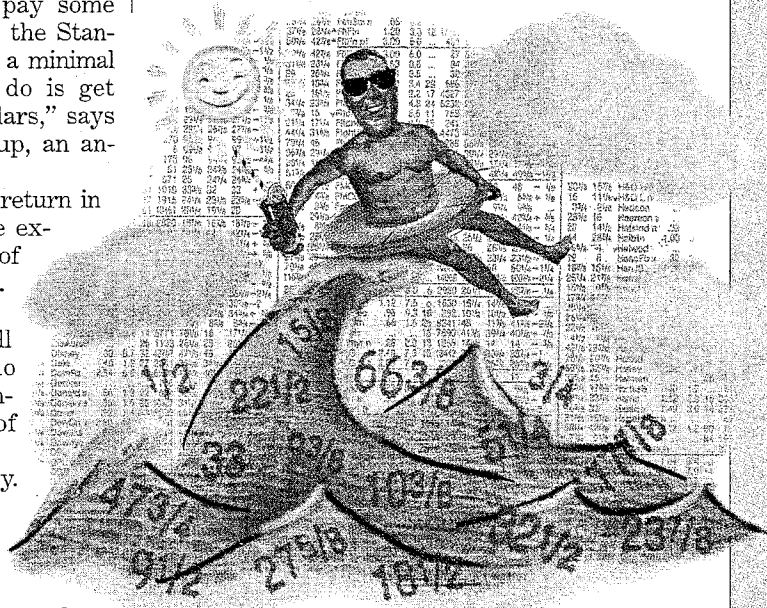
The concept is simple: a guaranteed return in exchange for a limited upside. But the execution is not. EIAs invest in a mix of zero coupon bonds and index options. Because of that intricacy, the terms—guarantees, payouts, and fees—are all over the lot. "There is absolutely no one EIA contract that's the same as another," says Joel Weiner, author of *Equity Index Annuities*.

That makes shopping for EIAs tricky. Fortunately, two free Web sites, www.annuityratewatch.com and www.annuityadvisoronline.com, do an excellent job of collecting data on contracts and their fees and features. EIAs have fixed terms from one to 10 years, and often steep "surrender charges" for cashing out early. **LAGGING BULLS.** Key to any EIA is the "participation rate," the portion of the index' gain the annuity owner receives. This ranges from 30% to 125%. Also important is the calculation of that percentage. Some EIAs use a "point-to-point" method, which gives a flat percentage for the total return achieved by the index during the

lifetime of the contract—from its starting point to its end point. ING USG Annuity & Life's Generation Pro, for instance, pays 100% of the S&P 500's return over the next nine years less a 1.7% annual fee. If the S&P 500 falls, you won't lose as you would with an index mutual fund. You'll also earn a small return on the premium.

The other approach is the "annual ratchet" in which your index value is calculated each year. Suppose you bought an EIA when the S&P 500 was 1200, and it finished the first year at 1000. You'd lose nothing that year, and in the second year your new starting point would be 1000. You then benefit when it rises above 1000. But with the point-to-point EIA, you'd have no index gains until the S&P 500 crosses 1200 again.

Ratchets usually outperform in a bear market, but underperform in a bull. Unlike point-to-point EIAs, ratchets calculate returns using an average



of an index' value. But the average can vary greatly from an index' January-to-December return. Say the S&P 500 began the year at 1000, hit 1200 on Dec. 31, and averaged 1100 for the year. With 100% participation, a ratchet contract yields a 10% return while point-to-point gains 20%.

Fees can be high, so some EIAs replace them with "performance caps." For instance, the Allianz Powerhouse contract pays 125% of the S&P 500's average value each year but caps the gains at 15%. In 1997, when the S&P 500 rose 33.4%, Powerhouse annuities gained only 15%. But in less stellar years, Powerhouse will actually outperform EIAs that charge fees.

Most EIAs track the S&P 500, but not all. Midland National's Direct 10 allows free switching between the S&P 500, the S&P MidCap 400, the Russell 2000, and the Dow Jones industrial average.

In a bull market, no EIA is going to outperform a simple index mutual fund. And as yield vehicles go, they can't compete with a fixed-rate annuity. But in a dicey market, their no-downside feature and the potential upside make for an attractive combination.

Buy a Contract on the Market

ANNUITY CONTRACT/INDEX	COMMENTS
ALLIANZ POWERHOUSE S&P 500	Annual ratchet, 125% participation rate. No fees, but 15% cap on returns. Best for bear or sideways markets.
ING USG GENERATION PRO S&P 500	Point-to-point calculation of returns, 100% participation rate minus 1.7% annual fee. Best for bull markets.
MIDLAND NATIONAL DIRECT 10 Multiple	Annual ratchet, 100% participation for four different indexes. Fees vary greatly by index—from 1.5% for S&P 500 to 6% for the Russell 2000.

Data: Advantage Group; www.annuityratewatch.com