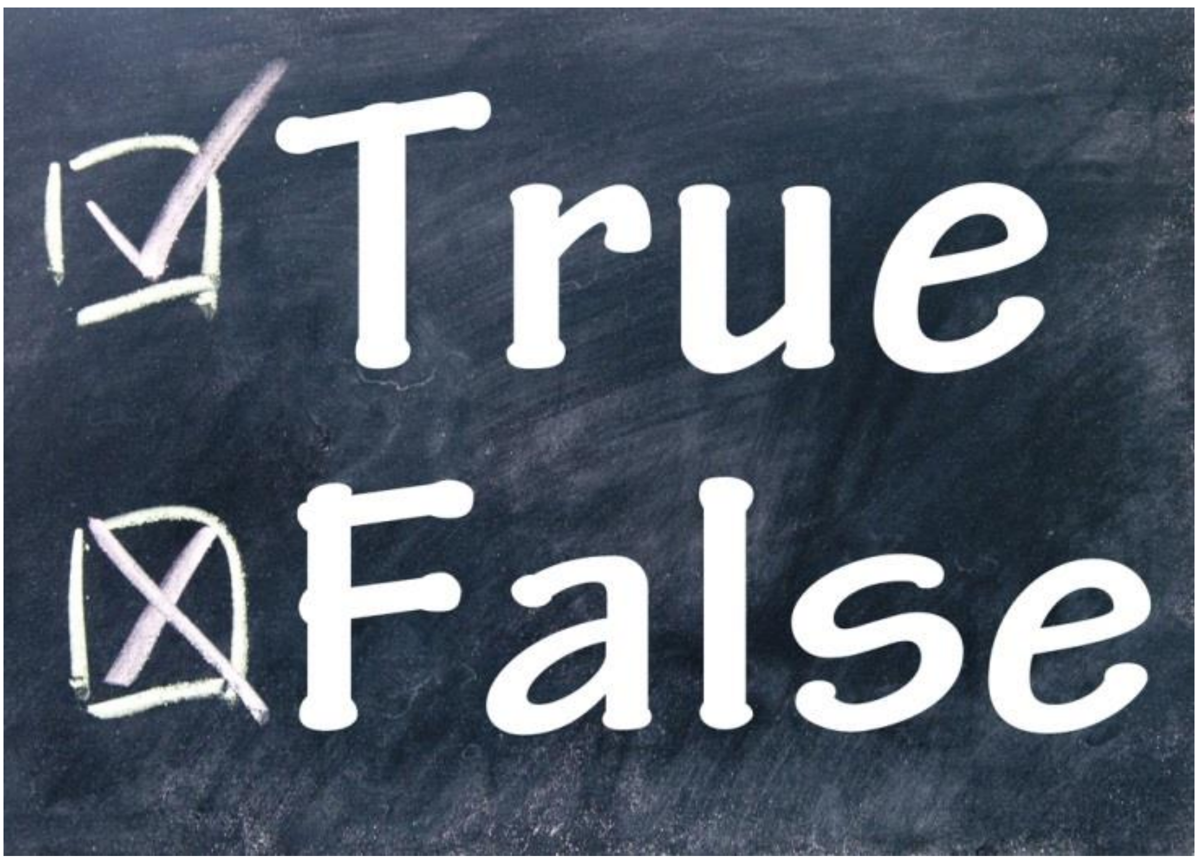
The Truth About Fixed Indexed Annuities



Index annuities were first introduced in the United States nearly two decades ago. They were initially created as an alternative to mutual funds and variable annuities, allowing their holders to participate in growth from equity indexes, while at the same time preventing the risk of loss to the annuity holder's principal in years when the underlying index produced a loss.

Today, fixed indexed annuities are looked at as an alternative to other safe money vehicles such as bank CD’s and fixed annuity rates.

Due to the recent stock market crash, investors are more concerned than ever before about the safety of their principal. Many pre-retirees lost large sums of their retirement savings - with little time to recoup such losses - during the 2007-2008 market downturn.

Fixed indexed annuities can offer a way for individuals to lock in market gains while also preventing the loss of principal. Yet, when planning for retirement, indexed annuities are too often overlooked.

One reason for this may be that these products are simply misunderstood. Yet, due to fear of indexed annuities that is based largely on misconceptions, many retirees are missing out on a steady and reliable source of income.

The truth is that index annuities have been producing sizeable returns since the first one was purchased in 1995. Some of the primary misconceptions that surround fixed indexed annuities, however, include the following:

Misconception #1: Fixed indexed annuities have high fees.

Many investors have been led to believe that fixed indexed annuities charge their owners high fees. Yet, unlike mutual funds, fixed indexed annuities do not deduct sales charges, management fees, or 12b-1 marketing fees.

Rather, the issuing insurance company takes just a small amount from the fixed indexed annuity's underlying portfolio - which lowers participation in the market index - in order to cover administrative costs and commissions to the selling brokers.

Misconception #2: Fixed indexed annuities have long surrender periods and high surrender charges.

While fixed indexed annuities do include surrender charges for the early withdrawal of funds, nearly all fixed indexed annuities will waive all such charges upon the death of either the owner or the annuitant.

Likewise, such annuities will typically waive all surrender charges if the funds in the account are used for nursing home stays, extended hospital stays, and/or other expenses due to a terminal illness. And, a number of fixed indexed annuity issuers will also waive surrender penalties if the funds are needed due to a job loss for an annuity owner who is under the age of 65.

In addition, the surrender fees that are levied by fixed indexed annuities are typically a requirement of state insurance regulators in order for these policies to qualify for sale. When such charges are levied, they will generally depend upon the minimum term of the annuity, as well as whether any bonuses were paid. In nearly all cases, the percentage amount of surrender charges will decline over time.

Misconception #3: Fixed indexed annuities are not liquid.

In a financial sense, liquidity typically refers to the ability to purchase and sell an asset with minimum disturbance of its market price, as well as the ability to purchase or sell an asset with relative ease, and/or the ability to easily concert the asset into cash.

Unlike some assets that are traded in the open market, fixed indexed annuities are private contracts that can be compared in some ways to non-negotiable certificates of deposit. In this regard, fixed indexed annuities are not traded in the open marketplace, and therefore, they technically have no market price. In this case, then, the definition of liquidity does not truly fit with these particular products.

In addition, unlike stocks and bonds - but still similar to a bank CD - a fixed indexed annuity can easily be cashed in to its issuer at any time. Yet, while both products can easily be converted to cash, both typically also possess a penalty for premature withdrawal or early surrender. In the case of a fixed index annuity, however, the early withdrawal penalty is typically always a function of how early the surrender occurs.

In most cases, 10 percent of a fixed indexed annuity's account value is allowed to be withdrawn each year penalty free. (There are some fixed indexed annuities that allow a 15 percent annual penalty free withdrawal).

The majority of fixed indexed annuities that are sold today have a maximum of 10 years of surrender charges - after which an unlimited amount of withdrawals may be made by the annuity holder without incurring any surrender charge at all.

Misconception #4: Fixed indexed annuities don't perform well.

Fixed indexed annuities will essentially perform based on the underlying index, with interest crediting options that are linked to the specific index. Therefore, while the returns on a fixed index annuity can be somewhat difficult to predict, long-term growth can still be estimated. In most cases, fixed indexed annuities will likely return between 4 and 6 percent.

It is also important to note that because a fixed indexed annuity will never lose principal, the account is always moving forward, locking in the previous year's gains. This means that even during a recession with negative market returns, a fixed indexed annuity will not lose value. With this in mind, it is possible that a fixed indexed annuity could potentially outperform CDs, bonds, and treasuries.

Annualized Five-Year Returns

Period	S&P index return	FIA avg. return	Number of FIA's	Return Range
1997-2002	9.39%	9.19%	5	7.80% to 12.16%
1998-2003	-0.42%	5.46%	13	3.00% to 7.97%
1999-2004	-2.77%	4.69%	8	3.00% to 6.63%
2000-2005	-3.08%	4.33%	28	0.85% to 8.66%
2001-2006	5.11%	4.36%	13	1.91% to 6.55%
2002-2007	13.37%	6.12%	23	3.00% to 8.39%
2003-2008	3.18%	6.05%	19	3.00% to 7.80%
2004-2009	-1.05%	4.19%	27	2.25% to 6.83%
2005-2010	-1.47%	3.89%	36	2.33% to 7.10%

Note: All returns shown above are annualized (geometric) rates of return. The S&P index returns are not meant to proxy for index mutual fund returns, which would include dividends, expense ratios (the least costly have featured approximately 20 basis points per year), trading costs (another 30 basis points per year), tracking error and taxes; rather they are to reference what happened to the most popular index to which many fixed indexed annuities are linked through some formula.

Source: Wharton Financial Institutions Center, Personal Finance, "Real World Index Annuity Returns," 2010.

Misconception #5: Fixed indexed annuities are very complex.

Technically, fixed indexed annuities are not complex at all. In its most basis sense, a fixed indexed annuity is simply a fixed annuity that also offers additional features such as a different way of crediting interest to its holder.

Fixed indexed annuities essentially work in the same manner as a regular fixed annuity, with the primary distinguishing factor being their link to the underlying index. Yet, even though interest earnings are locked in - up to a stated cap each year - these types of annuities will not incur any negative index return.

Misconception #6: Fixed indexed annuities provide no inflation protection.

Fixed indexed annuities can provide their holders with the opportunity to combat inflation as well as potentially shrinking purchasing power. Many issuing insurers provide index annuity purchasers additional options for enhanced interest rate crediting that, for instance, may use a point on a published "swap curve" as the benchmark rate. These types of strategies can not only serve the purpose of combating inflation, but they can also help annuity holders to deal with future interest rate uncertainty.

Misconception #7: Fixed indexed annuities are subject to insurance company solvency risk.

Because fixed indexed annuities are essentially fixed products, they are actually regulated by the individual state insurance departments. Most states have adopted the Suitability of Annuity Sales model regulation.

One of the key attractions of fixed indexed annuities is that they provide their holders with protection of principal. The funds that back a fixed indexed annuity are held in the issuing insurance company's general account - not a separate account as is done with securities. Should anything happen to the issuing insurance company, the holders of the company's fixed indexed annuities would be protected by the state guaranty fund.

Misconception #8: Fixed indexed annuities are expensive and they pay a large commission at the expense of their clients.

Although there are some fixed indexed annuity issuers that pay commissions as high as 13%, others pay only 1% as a sales commission to the selling agent or broker. In addition, unlike mutual funds, indexed annuity commissions are paid only one time, in exchange for the agent or broker servicing the account over the entire life of the annuity contract.

Misconception #9: Fixed indexed annuities are not as tax-advantaged as qualified retirement accounts.

All fixed indexed annuities offer tax deferral, and therefore they have no requirement of income taxation until the time that funds are withdrawn. This can essentially help the fixed indexed annuity holder's money to grow faster, due to the earning of interest on dollars that would have otherwise been paid as taxes.

Misconception #10: Fixed indexed annuities are a bad financial planning tool.

The truth is that fixed indexed annuities offer credit that is linked to the upside growth of specific markets, yet without the downside risk of loss that can occur within those same markets.

Therefore, these financial vehicles can be excellent retirement and estate planning tools due to the fact that they are safe - making them very suitable for the funds that should not be put at risk of a market loss. In addition, these annuities are both insured and protected assets, and they can be used to build a predictable and comprehensive financial plan.

The Bottom Line

In many respects, a fixed indexed annuity can offer the best of both worlds, providing guarantee of their principal amount with the potential for index-linked growth, as well as no risk of principal due to market downturns.

Other benefits of these products can include flexible income riders that can allow their holders a lifetime income as well as the ability to pass any remaining account value to heirs, low or no annual fees, availability of the income base for a death benefit, and tax-deferred growth of the funds inside of the account.

Fixed indexed annuities offer their holders something that stocks and mutual funds simply cannot - the ability to lock in the prior year's earnings. Because of this feature, the funds in a fixed indexed annuity will not fall during a downward moving market - in essence giving the funds inside of the account even more upward potential as they are able to reset at the new "low" for the following year. And, as with other types of annuities, upon annuitization, a fixed indexed annuity can also provide its holder with a retirement income that he or she literally cannot outlive.