Equity-Indexed Annuities

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Equity-indexed annuities are a type of fixed annuity, but they are different from other fixed annuities because of the way they credit an annuity's value. Rather than crediting interest based on a specified fixed rate, equity-indexed annuities offer the opportunity to receive interest credits associated with annual changes in stock and bond indices without the risk (i.e., losing money) of directly participating in stock, bond or equity investments.

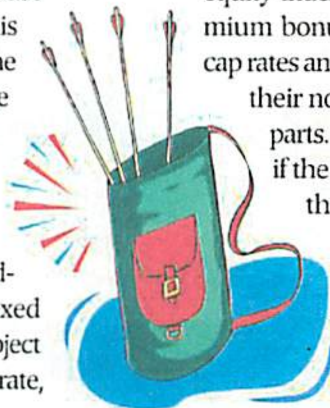
Equity-indexed annuities provide a guaranteed minimum interest rate in the event the linked index consistently performs poorly, resulting in no interest credits to the annuity. While the basic concept is simple, the variety of features and terms makes them anything but that. Let's look at some of the most common features.

For starters, there are several different approaches to measuring the amount of change, if any, in the index (which determines how much interest you receive), often called the indexing method or interest-crediting strategy. Two of the more common methods are annual point-to-point and monthly point-to-point.

Annual point-to-point credits the interest based on the entire percentage change for the year in the selected index. For example, if the index's percentage change were 10 percent, the interest credited to the equity-indexed annuity contract value would be 10 percent, subject to any applicable participation rate, cap rate or spread (discussed in greater detail later).

With the *monthly point-to-point*, the amount of interest credited is based on the sum of the 12 monthly percentage changes (positive and negative) in the index. Positive returns are subject to a monthly cap rate (1.5 to 2 percent is common), while negative returns have no downside limit. As a result, negative monthly changes may cause the index credit for this strategy to be zero for the contract year, even if the overall annual index change is positive.

As previously mentioned, the amount of interest ultimately credited to the equity-indexed annuity will likely be subject to either a participation rate, cap rate, spread or combination. A participation rate decides how much of the increase in the index will be used to calculate the index-linked interest. For example, if the calculated change in the index were 10 percent, and the participation rate were 70 percent, the interest credited would be 7 percent.



THE EQUITY-INDEXED ANUITY is another arrow in your quiver and may help you achieve your goals.

A cap rate puts an upper limit (or cap) on the index-linked interest rate. In the above example, if the equity-indexed annuity had a cap rate of 6 percent, the interest credited would have been capped at 6 percent, not 7 percent.

Besides choosing your index-crediting strategy, you'll have to choose which index you want to link to. Some insurance companies may offer only one option, such as the Standard & Poor's (S&P) 500, but other companies may offer many more.

Many companies also offer a premium bonus version, which provides a bonus on the amount you invest in the contract. For example, a company offering a 10-percent bonus would credit your contract value $10,000 with a $100,000 investment. Bear in mind that equity-indexed annuities that have premium bonuses will likely have lower cap rates and/or participation rates than their non-bonus annuity counterparts. It's possible that, over time, if the linked index performs well, the non-bonus annuity with the higher cap rate could be worth more.

Another optional benefit is a living benefit, commonly called the guaranteed minimum withdrawal benefit (GMWB). For an additional cost (ranging from 0.40 to 0.50 percent and up), you can elect a GMWB that provides guaranteed income for life based on what's referred to as the guaranteed withdrawal base and the guaranteed annual withdrawal rate. One attractive feature of the living benefit is the annual credits to the withdrawal base in the years that no withdrawals are taken. For example, for a period of time, say, for the first 10 years of the policy, a company may offer a 7-percent annual credit to the withdrawal base in the years no withdrawals are taken. Note: The withdrawal base is not the contract value, and it is only relevant when you take withdrawals at the guaranteed annual withdrawal rate. If you want to cash out, you would receive the contract value, less any applicable surrender charge.