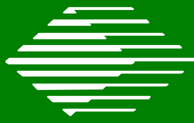


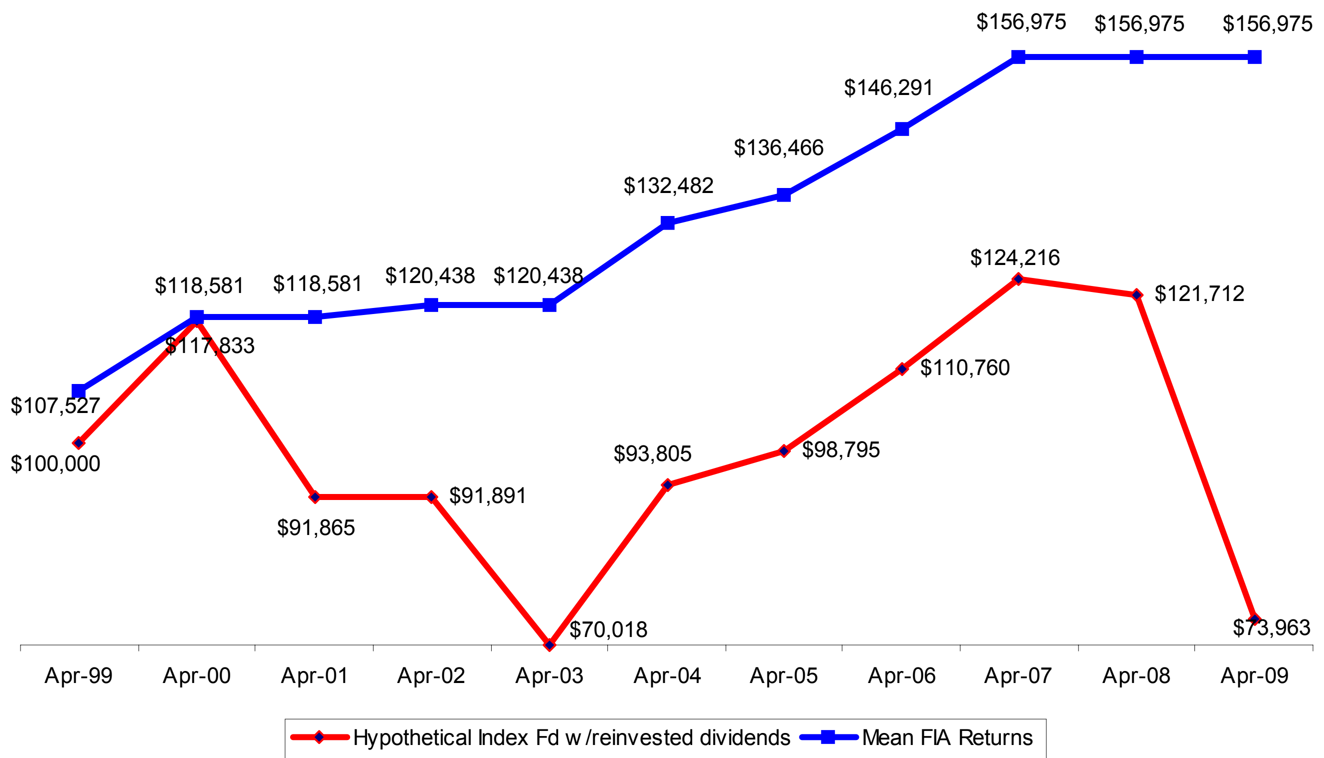
INDEX COMPENDIUM

Honesty In Annuity Reporting Series Report 1

Lankford Loses (and so did the poor consumer)

In the September 2010 issue of *Kiplinger's Personal Finance Magazine* Kimberly Lankford wrote an article titled "An annuity you really should avoid" concluding "you get a lot less than investors in the actual index would receive because of caps on returns and other limitations." However, she conveniently overlooks what happened if you had followed her advice a decade earlier.

In the April 1999 issue of *Kiplinger's* Kim Lankford wrote her first index annuity-bashing article titled "These investments are less than meets the eye" At the time she honed in on my research that said index annuity interest was 8% to 17% in 1998 whilst the S&P 500 was up 29%. She concludes the article by relating a story of a financial planner that *rescued* – her word – a couple owning an index annuity that had *only* earned 13% in 1998, and had them cash in the annuity, incur surrender penalties, and invest what was left in a "real index fund". What was not reported was how client fared later on.



The Index Fund

Say that you placed $100,000 in a hypothetical S&P 500 index fund on 1 April 1999. You would have participated in 100% of the index movements – no caps or spreads to reduce your gains, and benefited from reinvested dividends. By 1 April 2000 your S&P 500 index fund would have soared to $117,833 posting a 17.8% gain. Perhaps Lankford was right?

However, 2000 was the beginning of the millennium bear market. A year later the value of your index fund had dropped to $91,865. By 2003 the value had plummeted to $70,018. Now let's look at what might have happened if you ignored Lankford's column and kept the annuity.

The Index Annuity

I don't know which index annuity the couple was "rescued" from, but I do have the actual performance of three annuities that have published histories back to 1998. I've used their real world average returns for the following ten years as a proxy for "capped" index annuity performance.

The first point is the index annuity had already gained before the financial planner got involved. The planner cashed in the annuity and forced the couple to incur a surrender charge. According to my notes the typical second year surrender charge back then was 7%. What this means is if the planner netted out $100,000 to put in the fund after surrender charges that the annuity's accumulation value before the surrender charge was $107,527 ($107,527 x 93% = $100,000).

The average index annuity return for that first year was 10.3%, which was well below the 17.8% gained by the fund. But since the index fund started with less money due to the surrender charge – $100,000 instead of $107,527 – the index annuity account is worth a smidgeon more in April 2000, or to be specific, the index annuity account is at $118,581 and the fund is at $117,833.

4 years later the index annuity is worth $120,438 and the index fund is worth $70,018

In 2001 when the index fund had fallen to $91,865 the index annuity was still valued at $118,581. In fact, it was able to take advantage of a small bear market rally and increase to $120,438 by 2002. In April 2003 the annuity value was $120.438 and Lankford's "rescue" was worth $70,018.

Later Years

As the millennium bull market cycled into place the index fund roared back. By the summer of 2005 it was again finally back to $100,000. Indeed, from 2005 to 2007 the hypothetical index fund gained 26% to the index annuity's 15% return. However, since the index annuity had never lost ground its value in April 2007 was $156,975 versus $124,216 for the fund. Following the column's advice had cost the couple over half of the gain they might have had in the index annuity. Unfortunately for Lankford, the story gets worse because the decade's second bear market was about to begin. By April 2009, ten years after the couple had been told to dump the index annuity and buy "a real index fund", this index fund was worth $73,963 – less than half of what they might have had without a rescue.

Getting 0% of the losses more than offset not getting 100% of the gains

A recurring theme in these anti-index annuity attacks is to say they are bad because you may not get 100% of the gain. What they seldom say is that you also get 0% of the losses. But now you know the other side of the story.

The S&P 500 index fund return includes reinvested dividends and assumes annual fees of 0.18%. The index annuity returns are the average of 3 index annuities with published renewal histories using annual point-to-point with cap methods. Taxes are ignored. This article is for educational purposes and is not intended to be a solicitation to buy or sell any security or annuity, nor is it financial or investment advice. It is written as a humorous commentary on current media practices. Consumers should consult their advisor about their personal situation. And although the results shown are intended to be correct within their context they are not warranted. S&P 500" is a trademark of The McGraw-Hill Companies, Inc., which does not sponsor, promote or endorse any annuity.

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