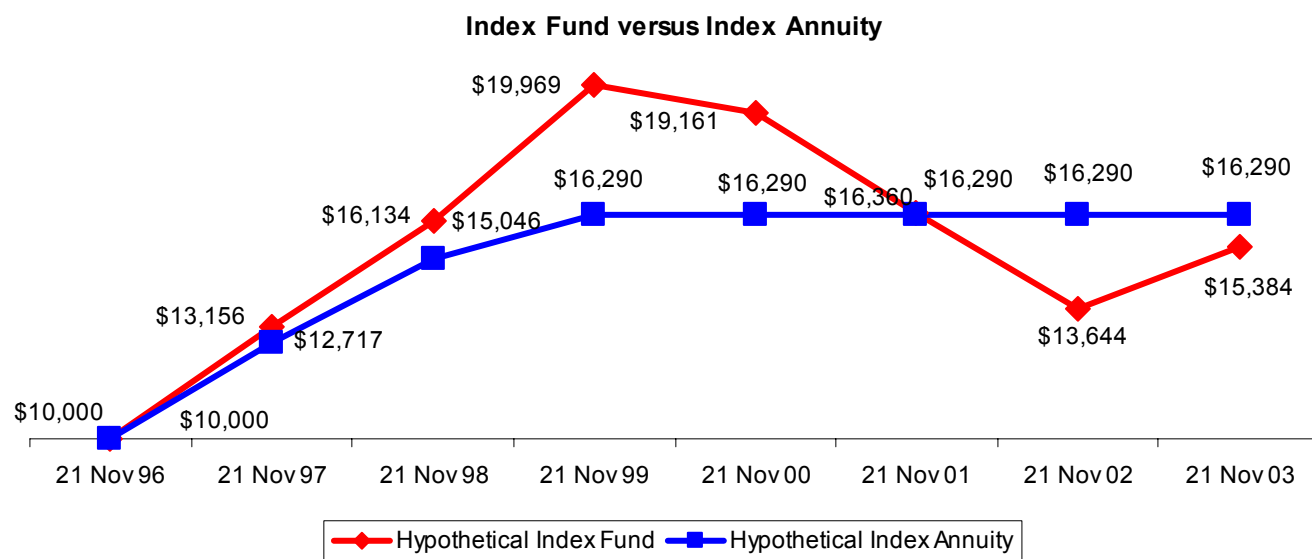




Burns Baffled? (on how index annuities really work)

Back in the fall of 1996, when index annuities were young, a reader asked financial pundit Scott Burns his opinion. The reader said the annuity he was considering had a 7 year term and a design that used the highest anniversary index value as the end point, calculated the total return over 7 years, and then deducted 2.5% from the annualized return, giving the annuityowner the rest. The reader then asked does this seem good to you?

Burns replied that obviously the reader's financial advisor was getting a 2.5% annual fee "on your money" completing missing the fact that an index annuity *yield spread* is simply a way of showing the annuity's participation in the index, and is not in any way the same as a management fee. He went on to say that while one financial planner had calculated that index annuities could return about 7% a year, that from 1926 to 1995 the return from stocks was 10.5%, and that because the index annuity does not include reinvested dividends, that you're looking at a probable return of 5%. But let's look at what really could have happened over the next 7 years.



On 21 November 1996 the S&P 500 closed at 742.75. Seven years later the index closed at 1035.28. However, the highest anniversary point was reached in November 1999 when the index closed at 1422, and this is the end value the index annuity would have used. After deducting the spread a \$10,000 premium in our hypothetical index annuity would have grown to \$16,290 by 2003 for a 7.22% annualized return – pretty much on track with what that unnamed financial planner predicted.

Because it did include reinvested dividends, and participated 100% in index gains, the same \$10,000 investment in 1996 in our hypothetical index fund would have grown to \$19,969 by 21 November 1999 – but then the millennium bear market hit, and since the fund also participated 100% in index losses its value on 21 November 2003 was \$15,384 for a 6.35% annualized return.

Burns' advice would be right if market returns of the broad past predicted the narrow future, but they don't. Burns would also be right if the stock market was one continuous bull market, but it isn't.

Burns Bested (because an index annuity doesn't lose)

An annuity producer wrote to Scott Burns relaying that he had sold an index annuity in August 1996 with a \$470,000 premium and that the annuity's value in August 2008 was \$940,000, stating that Bernie Madoff's investors would have loved to have had an index annuity instead. Burns responded by saying index annuities should not be properly compared to equity investments because of their "lower inherent risk" and then proceeded to do just that by comparing the index annuity with 6 handpicked equity funds (the type of fund is listed below; actual fund names are available in Burn's column).

Burns apparently uses an August 1996 start and an August 2008 end for his fund calculations and concluded "as you can see, the EIA was beaten by the pure equity index." However, Burns neglected to do a follow-up column.

<u>Performance Ranking</u>	<u>Aug-2008</u>	<u>Performance Ranking</u>	<u>Feb-2009</u>
Moderate Allocation	\$1,365,726	Conservative Allocation	\$1,021,736
Conservative Allocation	\$1,205,664	Moderate Allocation	\$ 999,501
Balanced	\$1,203,263	Index Annuity	\$ 940,000
Moderate Allocation	\$1,158,989	Balanced	\$ 846,204
Index Fund	\$1,140,888	Index Fund	\$ 833,428
Income Fund	\$1,107,127	Moderate Allocation	\$ 814,077
Index Annuity	\$ 940,000	Income Fund	\$ 768,537

Using end of August 2008 values I calculated what the equity funds were worth six months later (including reinvested dividends). As you can see, the index annuity value at the end of February 2009 is now ranked third in returns instead of last. In fact, the difference in annual return after twelve and a half years between the index annuity and the best performing mutual fund is only 0.7% a year, and the index annuity return is at least 1% higher than the bottom three funds, which leads to my point.

Index annuity bashers will mention how well their equity investments did in years like 2009 when the market soared, but neglect to bring up the huge losses suffered in 2008. Or they'll compare index annuities with certain asset categories at one time and with other asset categories at other times, but only when they have the advantage. However, I've yet to see a financial columnist do an update on their index annuity comparisons when the annuity would now win.

An index annuity is purchased by consumers that do not want to cope with the giant swings of the stock market. They are purchased by consumers that enjoy that they can never lose interest once it's been earned. Index annuities are purchased by consumers that don't want to read the paper each day to see whether they're winner or losers, because with index annuities they know they are never losers.

http://assetbuilder.com/blogs/scott_burns/archive/2009/12/23/an-eia-salesperson-miscalculates.aspx

The hypothetical index fund return includes reinvested dividends and assumes annual fees of 0.18%. The hypothetical index annuity return assumes a high water mark design with a 2.5 yield spread. 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, of course, 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.