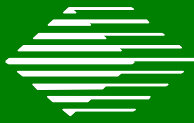

INDEX COMPENDIUM

Honesty In Annuity Reporting Series Report 3

Cruzing For A Bruising (because “stocks usually go up”)

The first index annuity was purchased in February 1995. It only took until October for Humberto Cruz to begin bashing them*.

Back in 1995 Cruz told consumers that since stock prices rise most of the time you’d make more investing the market than buying an index annuity. To highlight this he mentioned an example of one annuity where the annual return was capped to a mere 14%. In addition, there were surrender penalties of 7 years. And just in case you still weren’t convinced how bad these were, Cruz warned readers that the index annuity was not FDIC insured – although no one he named claimed they were, and that “there is no guarantee your return will beat or even match inflation” which is true about every asset out there, with the exception of inflation-indexed bonds.

His conclusion: “Would I buy any of these annuities for myself?...If I am going to leave my money untouched for five to seven years...I'm willing to leave it untouched in the stock market.”

The capped annuity was worth $154,560; the uncapped index fund value was $149,983

The column appeared in October 1995. If you had placed $100,000 in the 7-year annuity he mentioned by October 2002 your annuity cash value was $154,560 when the surrender period ended. If you had “left it untouched in the stock market,” perhaps buying a hypothetical index mutual fund that gave you both reinvested dividends and 100% participation in market movements. Your $100,000 was worth $149,983.

Even though your index annuity never gave you 100% of the annual gains, did not include reinvested dividends, and had a cap on earnings to boot, you still wound up with roughly five grand more in your pocket with the index annuity.

* Humberto Cruz. Best Of Both Worlds? October 13, 1995

Cruz Control (selecting facts that support your opinion)

In an October 2010 column** Cruz cites the *Real World Index Annuity Returns* study I was involved with, but seems to carefully select only data that makes index annuities look bad. He mentions that the report shows index annuity returns averaged 4.7% percent a year or less half of the time, but he fails to mention during these times the S&P 500 ended with losses (the worst index annuity return was 4.2%).

He closes this annuity-basher’s quote-fest by reporting people can build their own index annuity by putting enough of their money in a certificate of deposit so it will grow back to the total original principal at maturity, and putting the rest in an index fund. “Even if the fund goes to zero, they’ll get their [money] back...and they will earn stock dividends.” Okay, let’s see how that combo is working for ya.

An effective 11.6% participation rate for a CD/index fund combination when the index doubles

**Humberto Cruz. Index annuities: Trick or treat? October 21, 2010

When the article was written the average 5-year CD rate was 1.63%. That means you'd need to put $9,223 in the CD to guarantee $10,000 in 5 years leaving $777 to invest in the index fund. If the index fund doubled in value in the next 5 years – a 14.9% annual return, you'd have $1,554. Adding the hypothetical index fund value of $1,554 to the $10,000 from the matured CD gives us $11,554 – or the equivalent of an 11.6% participation rate. Using the CD/fund combo idea in a period where the index fund doubles gets the user a 2.9% annual return on their original principal. Now let's see how you would have fared with this CD-index fund combo in recent times versus actual index annuity returns:

Start	5 Yr CD	Into CD	Into Fund	End	Combo Value	FIA Value
10/03	3.00%	$8,626	$1,374	10/08	$11,711	$13,414
10/04	3.38	$8,469	$1,531	10/09	$11,497	$12,278
10/05	3.83	$8,287	$1,713	10/10	$11,772	$12,102

The rates on 5-year CDs on three consecutive 1 Octobers were 3% in 2003, 3.4% in 2004 and 3.8% in 2005. These low rates means there wasn't a lot of money leftover to put in the hypothetical index fund after buying the CD. For these periods the CD/fund combo grew by the end of the five years to: 2008 ($11,711), 2009 ($11,497), and 2010 ($11,772). By contrast, annuity values, based on actual average index annuity performance reported in the *Real World Index Annuity Returns* study, ranged from $12,102 to $13,414. These examples ignore any taxes owed on the CD interest or fund dividends.

The fatal flaw in the logic of using a CD/fund combo-pak as an index annuity alternative is that the same factors that can make the combo more attractive also make the index annuity more competitive. If rates are higher, less money is needed in the CD to protect the principal, so more money goes into the index fund. However, higher interest rates would also mean that index annuity participation rates and caps can go up. In addition, while a strong bull market helps the index fund it can also cause the index annuity to perform well.

A good example of this is the period from 1997 to 2002. Since 5-year CD rates were at 6.76% (http://www.jumbocdinvestments.com/historicalcdrates.htm) less money would have gone into the CD leaving more for the index fund, and, to help even more, the stock market soared for the next three years. But this environment also meant index annuities had high index participation in that soaring market. $10,000 in the hypothetical CD/fund grew to $12,647 in our 1997-2002 timeframe, but the average reported actual index annuity gain would have pushed the annuity value to $15,521.

The reality is when you look at all of the facts (and not just carefully selected ones) that index annuities have performed competitively in times of both high interest and low interest, and rising and falling stock markets. They aren't perfect, but they have been tested in the crucible of fiery financial markets and proved their mettle.

The hypothetical index fund return includes reinvested dividends and assumes annual fees of 0.18%. CD rates source is bankrate.com The hypothetical index annuity return calculations are based on average annual returns reported in the *Real World Index Annuity Returns* study. 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.

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