

TOO GOOD TO BE TRUE

September 2009

As with many things in life, investing is full of trade offs. Investments that do well in one area can be poor in another. For example, the stock market has an excellent record of providing after-tax and after-inflation returns over time, but does not hold its value as well in short time frames. Fixed choices such as bonds and CD's generally hold their value well, but have weak after-tax and inflation records. We have been researching diligently for over twenty years but have yet to see a single product or strategy that provides a better balance between growth and safety than a well-diversified portfolio, managed with patience and discipline. To paraphrase Winston Churchill, our methodology is the worst thing out there except all the other methodologies. We know our advice to be patient and disciplined is sound. We also know that in down markets, particularly with the media frenzy over the specter of a depression, it can be tempting to do otherwise.

In a classic case of solving one problem only to cause more problems, sales of Equity Indexed Annuities (EIA's) rose 21.2% to \$8.3 billion in the second quarter of 2009, according to research firm Advantage Group Associates. It is notable that this comes immediately following the low point for stocks. Sheryl Moore, Advantage Group President explains, "People don't want to lose any money, so they go to fixed annuities to preserve principal." Sadly, many of these annuity buyers will likely be disappointed in the results.



Buyers of EIA's do not grasp the consequences of purchasing any kind of deferred annuity let alone the pitfalls resulting from the intricacies of EIA's. One consequence with a great potential for harm stems from one of an annuity's most touted benefit - tax deferral.

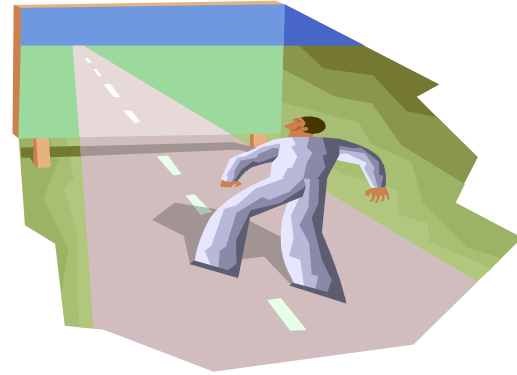
Annuities sometimes reduce today's taxes but that usually comes at the price of creating larger tax bills in the future. Putting money in an annuity converts items that could get taxed at the lower, long-term capital gains rate into income that will be taxed at the higher, ordinary income rate.

These taxes will be paid by the owner upon a withdrawal or by the owner's heirs at the owner's death, due to a provision in the tax code known as "Income in Respect of a Decedent" (IRD). Outside an annuity, any deferred gains - and the taxes that apply - are wiped out due to the "step-up in basis." If future tax rates are higher, the problem becomes worse. We frequently encounter people with annuity contracts and the ticking tax time bomb they created. Dealing with existing contracts is a subject unto itself but it is safe to say the solution is not an EIA.

Even if creating higher taxable income in the future for the owner and/or their heirs is acceptable, doing this through an EIA is not a good idea. No one seeks to buy an EIA, they are sold one. The EIA pitch sounds like an offer for the elusive super-product: one can get equity-like returns with no risk of loss. Hogwash.

We'll start with the upside potential. If the markets do well, there is virtually no chance the EIA will come close to the market's results. EIA's do not consider dividends, and crediting rates are limited due to caps and participation rates which the annuity company can change at its leisure. EIA's are a poor substitute for the stock market portion of a portfolio. Depending on crediting methods, many of these won't even match a CD rate. Theoretically, this lower result would be an acceptable trade-off because of the EIA's self-described guarantees, but these guarantees are an illusion.

An EIA is a poor replacement for the fixed side of a portfolio. In most cases, the initial guaranteed rate isn't very high, usually 3%. Over the 10-20 year time frame required for EIA's, a well-diversified portfolio of insured municipal bonds offers more than 3%, tax-free, without IRD or the restrictions and complications of an EIA. Worse, the annuity guarantee often applies only to a portion of the purchase amount, is changeable by the annuity company, and is frequently not actually credited until and unless the contract is annuitized. What's that?



In its simplest form, annuitization is the conversion of a lump sum of money into a fixed income payment for the life of the annuitant. When the annuitant dies, the income payments stop and the family receives nothing. Other arrangements are available such as covering two lives, building in an inflation adjustment, or providing some refund to heirs, but all dramatically reduce the amount of the income payments and therefore the underlying math. Annuitizing can be a good choice only if the annuitant lives well past life expectancy. If not, annuitizing is a costly choice to a family.



Once a contract is annuitized, that decision is irrevocable. This is important to know because EIA's typically credit interest and purchase bonuses toward an "annuitization value" (also called "contract value," "income value" or similar) that is only used if annuitization is chosen. For most, this "annuitization value" amounts to little more than "script" or funny money created by the annuity company.

Our research team has analyzed the provisions of specific contracts. We found the differences between the sales materials and the actual contract provisions to be tremendous. For example, in one of the country's most sold contracts, the actual interest rate calculated on annuitization was a mere 0.49% over ten years, far short of the rate implied in the sales material. If the client or the client's heirs chose not to take that, the amount they could take by cashing out - ten years after investing \$100,000 - was merely \$101,547. This contract even included a supposed 12% "bonus", a paper increase in annuitization value at purchase.

The sales materials for most EIA's usually highlight a common provision that allows the owner to withdraw up to 10% of purchase amount each year without surrender penalty. Another contract we analyzed had surrender fees starting at 20%, tapering down to 10% over a 12 year period, and not going away entirely until year 17. The sales material fails to mention that *any* withdrawal drastically and adversely alters the guarantees.

The EIA product is simply awful, and we don't say that about many things. We can usually find someone, somewhere that would be a reasonable fit for products we examine. But, EIA's seem to be the exception. Tax issues aside, our research reveals in order for a buyer of one top selling EIA to perform better than a diversified portfolio, the EIA buyer must:

1. Never make a withdrawal from the EIA **and**
2. Agree to the irrevocable decision to annuitize at below-market rates at the time of purchase **and**
3. Provide no inheritance to heirs (or accept even lower payments upon annuitization)

AND the annuity company must:

1. Never drop average cap rates below levels cited in marketing materials **and**
2. Never drop participation rates below levels cited in marketing materials **and**
3. Never drop the guaranteed crediting rate cited in marketing materials

AND Over a ten-year period, financial markets must produce results worse than 94% of those that have occurred in history.

Because the EIA product is considered a fixed-insurance product, the legal standard applied to its sale is no more than “buyer beware.” There is no prospectus to review and the seller does not need a securities related license, background, or experience to sell them. You may be wondering, “If they are so bad, why don’t regulators do something to protect the consumer?” Regulators are trying. If you search “Equity Indexed Annuities” on the internet, between the ads and glowing sales materials you will find a slew of lawsuits and consumer warnings.



If you or anyone close to you is approached by an EIA salesperson, “just say no.” If that fails, ask for a copy of the actual contract. Chances are the agent will downplay the need for such a sample and cite the “free-look” period that allows a buyer to change their mind. Don’t fall for this tactic. The agent is essentially suggesting it is OK to enter into a contract you haven’t read. These salespeople can be quite persuasive and aggressive, probably due to the typical 8%-12% upfront commission they earn when the EIA is sold.

We have only touched the surface of EIA’s in this commentary. Our research team has put together a briefing covering a plethora of terms and provisions present in EIA contracts. If you would like more information, we are happy to share our research with you or take a look at a sample contract to help you ferret out the truth.

EIA’s are so bad, Florida’s Chief Financial Officer Alex Sink felt the need to release a consumer alert recently which stated, “*The expectation of a return that mirrors that of a stock market index is unrealistic.*” Due to calculation methods and charges, “*...even with a so-called “guarantee,” investors may still lose money.*” The alert ended with the oft repeated axiom, “*If it sounds too good to be true, it probably is.*”