Annuity Suitability

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One of the key responsibilities for any financial advisor is to determine whether a recommendation is suitable for a particular client. In some ways, suitability is a nebulous concept to describe. Justice Potter Stewart famously wrote in a Supreme Court decision that pornography is difficult to describe but "I know it when I see it". The same could be said for suitability — there are no hard and fast guidelines as to what is or is not suitable, but unsuitable recommendations are relatively easy to spot.

Suitability should always be viewed from each client's unique perspective. Advisors should not start with a product to be sold and ask themselves "which clients would this be suitable for?" Rather, the advisor should carefully analyze the client's needs and circumstances to determine which investments may be suitable for that particular client.

All regulatory authorities place suitability at the center of their consumer protection regulations. While each organization may define suitability differently, all agree that suitability is the ***"appropriateness of recommended transactions when considering the risks associated with a transaction relative to a customer's financial situation, financial needs and investment objectives".*** (This is the language used in Florida state law. The SEC has a similar standard: "This duty generally requires an investment adviser to determine that the investment advice it gives to a client is suitable for the client, taking into consideration the client's financial situation, investment experience and investment objectives.")

An ethical corollary to the suitability requirements is that of fiduciary. Clients trust their advisors to provide objective investment recommendations. As such, advisors have a fiduciary responsibility to place the client's interest above their own self-interest.

In the previous chapter we reviewed various types of clients and their general investment objectives (accumulation, conservation, distribution and transfer). We also explored a number of other investment factors clients may have, such as:

- the need for liquidity,
- the client's tax situation,
- investment horizon,
- risk aversion,
- sophistication;
- the need for creditor protection, and
- estate planning considerations.

We also reviewed when various types of annuities might be appropriate in light of those factors. In this chapter we'll look at how a client's financial situation may affect their investment choices, and the recommendation of annuities in light of other investments in the client's portfolio and other investment alternatives in the marketplace.

Client's Financial Situation and Needs

Before making any recommendations, advisors should carefully review a prospect's current and projected financial situation. This starts with basic personal information such as

- the client's age,
- marital status,
- number of dependents and their ages.

As we learned in Chapter 4, an investor's age is a key factor in a changing spectrum of investment objectives over the investor's lifetime. Given the increasing lifespan of Americans, it's important to note that dependents are not limited to the client's children — many clients now find themselves supporting their parents in later life. Likewise, today's high divorce and remarriage rates create blended families that now present a wider set of dependents (e.g., stepchildren living in the investor's household or child support payments for natural children living with an ex-spouse) than the traditional, nuclear family.

Assets & Liabilities

Once basic information is obtained the advisor should review the investor's financial circumstances, typically in the form of a personal balance sheet and income statement. The basic balance sheet equation — assets minus liabilities equals net worth — is a convenient place to start the review. While it is helpful to be as accurate as possible, approximate values for assets and liabilities are usually adequate for this task.

In addition to the assets' values, advisors should be aware of the types of assets and liabilities the investors has. In the case of assets, it is important to distinguish between liquid assets and illiquid assets. Some investors are, as old farmers used to say, "land rich and cash poor"; others may hold nothing but liquid assets. The investor's liquidity position is an important factor in this decision to invest in deferred annuities, which typically impose steep surrender charges on withdrawals in the early years of the contract. All investors should have some liquidity cushion to meet everyday expenses and unforeseen emergencies.

Regarding the investor's longer-term assets and investments, the advisor should inquire as to the nature of those holdings. Some of these assets may be viewed as "pure investments" — holdings that can be redeployed without other personal considerations, such as a portfolio of stocks and bonds. Other investments such as the investor's primary residence and vacation homes, ownership in a business, real estate used by the investor's business or inherited property are much more entwined in the investor's lifestyle and have may have significant personal, as well as financial, considerations. Also, some investments, such as retirement plan holdings limit access to those funds during the employees working years, and the tax code imposes additional penalties for withdrawals at younger ages. Advisors should be aware of these constraints.

Advisors should also examine the investor's liabilities. Like assets, liabilities can be classified as short-term and long-term. The short-term liabilities should be viewed in tandem with liquid assets. Debts that need to be repaid in the near future will typically drain the investor's liquid assets. So what may appear to be an adequate liquidity position today may, in the not-too-distant future, become quickly inadequate. As for long-term liabilities, the advisor should distinguish between debts that are self-amortizing and those that will require a lump sum repayment. Most mortgages and car loans amortize over time and those debts are retired a little at a time through routine periodic payments. On the other hand, a mortgage with a balloon payment or an agreement to purchase a retiring partner's business interest create a need to raise cash at "maturity" — which in turn may affect the investment objectives, or at the least shorten an investor's investment horizon. Another question financial advisors should ask is whether the investor is prone to lawsuits or legal judgments. These may create new liabilities in the future. As we discussed in Chapter 4, annuities (and other insurance products) offer better protection against creditor claims than other investment options.

Before moving on to income and expenses, a quick note about life insurance. The cash value within a whole life insurance policy (or universal or variable policy) should certainly be viewed as a liquid asset on the investor's balance sheet. But the face value of the policy should not be treated as a long-term asset on the balance sheet. The policy's death benefits can provide protection for beneficiaries in the event of the investor's death — but will not provide any value during the investor's lifetime. Exploration of proper life insurance planning is beyond the scope of this course, but advisors should consider the investor's insurance needs (income protection for survivors, debt repayment, etc.) Annuities only provide for return of principal (and accumulated earnings), and therefore should not be viewed as a suitable substitute for true life insurance coverage, which can create a larger pool of capital in the event of the investor's death.

Income & Expenses

Before making suitable recommendations, advisors must inquire into their clients' income and expenses. An adequate income is the key to maintaining one's lifestyle (i.e., expenses). Income typically comes from one of two sources: earnings and investments. In the investor's younger years, presumably with few investments, most income will be earned income. As the investor accumulates wealth, some of his or her investments may generate "unearned" income — dividends from stocks and mutual funds, interest from bank accounts and bonds, rent from real estate holdings, etc. In later years, after retirement for example, the investor will rely primarily on "unearned" income from private investments, plus pensions and Social Security. An advisor should compare his or her clients' income with their expenses, to ascertain the need to augment current income from their investments.

All of this should be done with an eye on current — and projected — income and expenses. Over time, sources of income will vary — younger workers typically rely on earned income; older clients on investment income. Advisors should also note that some occupations are relatively stable sources of income, while other positions may be subject to wide variations. Consider, for example, two employees of the same company earning $75,000 this year — one is a salaried office worker and the other is a salesman working on commissions. While the current income level appears to be the same, the commissioned sales position is a less certain source of future earnings. A financial advisor should be aware of such differences, and adjust his or her recommendations accordingly.

Similarly, some career paths are shorter than others. Professional athletes have relatively few years to make their "nest egg", as do other physically demanding occupations — while less strenuous jobs allow clients to continue to work into their later years. Disability income policies can be helpful in assuring income in the future. Obviously, the client's projected retirement date also has an impact on projected future income. Projected expenses will vary over time, too. Clients may face college tuition, medical expenses, or long-term care costs for themselves or dependents. To the extent that these can be foreseen, financial advisors should take these into consideration when making recommendations. Some of these costs can be addressed proactively: pre-paid college plans, long-term care insurance, and medical expense policies, and so on.

If income falls short of expenses, investments can be redeployed from those seeking capital appreciation to those generating more income. The purchase of an immediate annuity can serve that function — as can annuitization of a deferred annuity.

Taxes

One expense bears special consideration: taxes. Annuities offer investors a bundle of features, and one of the most important of those is the tax-deferred growth they provide. That tax advantage is of more value to investors in relatively high tax brackets (and as was noted in Chapter 2, only “natural persons” can benefit from an annuity’s tax-deferral feature). An advisor should carefully review a client’s tax status including the client’s filing status (single, married, etc.), the client’s current and projected marginal tax rate (“tax bracket”), as well as the sources of the client’s taxable income. Different sources of income have different tax treatment: ordinary income from paychecks, capital gains from security trades, passive income from tax shelters, and business income passed through to the client from S corporations. In order to make suitable recommendations, an advisor must have a clear understanding of how an annuity fits into the client’s overall tax situation.

Financial goals

While the need to save and invest for a comfortable retirement is nearly universal for individual investors, that is not the only goal most investors have. Young families may want to save for their children's college education or a down payment on a new home. Budding entrepreneurs may want to start a business. Established businesspersons may wish to buy-out a retiring partner's interest. All of these require accumulation of capital. The thing that distinguishes them is the length of each investor's investment horizon. Recommending an illiquid investment to a client with a short-term investment horizon is unsuitable, even if the investment eventually turns out to be highly profitable. Generally speaking, recommendations of conservative and liquid investments are more suitable for clients with shorter investment horizons. Clients with long-term horizons can more easily handle illiquid and more speculative investments.

Existing investments

As the preceding discussion illustrates, no investment decision is made in a vacuum. Each recommendation must be made in the context of the client's unique circumstances. One aspect of the client's situation that the advisor must take into account is the type and amount of other investment holdings the client may have. As we discussed in Chapter 4, Modern Portfolio Theory is based on the investment principle of diversification — so it is imperative that advisors be aware of the client's existing portfolio before making any recommendations that may upset that diversification. A full discussion of portfolio diversification is beyond the scope of this course. Since the purpose of this course is annuity suitability, we'll limit our focus here to existing annuity contracts and how annuities may or may not be more suitable than other available investments.

Existing annuity contracts.

As we saw in Chapter 4, annuity contracts can be used to meet a variety of investment objectives: deferred annuities can accumulate wealth, fixed annuities can conserve wealth, an annuitized contract can distribute wealth and the minimum guaranteed death benefits can transfer wealth in an efficient manner to beneficiaries. Due to this versatility, advisors may find themselves recommending that clients with an existing annuity add another annuity to their portfolios. There is nothing inherently unsuitable about recommending an additional annuity contract. But the recommendation should be made in light of the other contracts the investor may hold. Quite often, fixed annuities complement variable contracts; one provides safety of principal, the other hedges inflation risk.

As an investor's financial situation changes, an existing annuity may no longer fit the investor's circumstances. For example, a number of years ago, a client purchased a deferred variable annuity to invest for retirement. As the client approaches retirement she wishes to convert the accumulated value in the variable contract into fixed annuity payments. Her advisor recommends that she exchange her variable annuity for a new immediate fixed annuity that has more favorable annuity payout options than offered under the variable contract. As we noted in Chapter 2, the IRS permits a tax-free exchange under Section 1035 from one annuity to another, so there would be no tax consequences to this "switch". Under Florida law, however, such an exchange is treated as a "replacement" of coverage — and is subject to **Florida's Replacement Rule**. The intent of the rule is to minimize the possibility that replacement is recommended solely to generate a commission for the agent. This rule spells out the steps agents must follow when replacing coverage, and these are discussed in greater detail in Chapter 6. Regardless of the procedure, recommendations of replacement are only suitable if the exchange of contracts benefits the client. Using the above example, the intent of the agent — to obtain more favorable annuity payout options for his client — is admirable. But does the exchange truly benefit the client? If surrender charges on the old contract cost more than the more favorable terms on the new policy will deliver, the client would have been better off not making the change.

The above situation, with annuitization as the investor’s purpose, is quite common. Typically, the minimum guaranteed payout schedule included in the original annuity will not be as favorable as payments currently available under new immediate contracts. One can argue that an advisor who does not consider replacement of the annuity under these circumstances ill-serves his or her client. Replacements for this reason are routine — they benefit the client's income needs and the advisor earns a commission on the sale of the immediate annuity. Replacements of one deferred annuity for another deferred annuity may not be so benign. Among the factors to consider when contemplating an exchange of one annuity for another:

Surrender Charges. The old contract may impose surrender charges if the policy is exchanged for another in the first few years following the contract's inception. This reduces the amount available for "reinvestment" in the new contract. Likewise, market value adjustment provisions may negatively impact the investor's principal balance.

New Fees. The new contract may impose new sales loads, policy fees and other expenses, which may mean that it could take the client years to break even in terms of total contract values.

Loss of Liquidity. The new contract will probably have new surrender charges, which will limit the contractholder's ability to access the full amount under the contract for a number of years. Often, contract replacement will extend the investor's effective surrender charge period.

Grandfathered Rights. If the old contract was purchased when tax laws were more favorable, replacement may entail the loss of "grandfathered" income tax benefits.

Riders and Endorsements. The old policy may include riders and endorsements not available under the new contract, or available only at an additional cost.

Investment options. The new contract may not offer the same investment options available under the old contract.

Annuities vs. Other Investment Alternatives

Fixed Annuities

Fixed annuities are sometimes compared with other fixed income investments such as certificates of deposits or bonds. From a safety of principal point of view, this comparison is a valid one. Fixed annuities (including indexed annuities) provide a fixed, guaranteed rate of return if held to maturity, as do certificates of deposit and bonds. The comparison, however, is not as valid if one considers liquidation of the asset prior to maturity. The market price of bonds fluctuates based on the current level of interest rates (and how current rates compare with the stated interest rate on the bond). If interest rates go down after an investor purchases a bond, the price of the bond will increase — and the investor could sell it at a profit. Conversely, if interest rates rise, the price of the bond will fall. Annuities are not marketable securities. There is no opportunity to sell a deferred annuity at a profit (or loss) due to favorable interest rate movements. The contractholder can simply withdraw his or her principal plus interest accumulated at the guaranteed rate, less any applicable surrender charges. In this respect, a fixed annuity is similar to certificates of deposit that impose penalties for early withdrawal. It bears repeating that annuities, like bonds, are not insured deposit accounts — there is an element of credit risk in both, that is, the "guaranteed" payments are only as good as the institution making the promise.

The rate of return on fixed annuities (and the guaranteed minimum rate on indexed annuities) is comparable to that of certificates of deposit of equal maturity. The income earned in an annuity contract is tax-deferred, while interest paid of CDs or corporate bonds is fully taxed as ordinary income in the year it is earned. (Municipal bond interest, in most cases, is free of federal income taxation. Interest on US government obligations is free of state taxes.) Tax-deferred interest income in an annuity is not included in calculation of the Alternative Minimum Tax (AMT) or taxability of Social Security benefits (taxable interest income from other investments is.)

Another tax advantage for annuity investors is that they may choose to time the withdrawal from the annuity when they are in a lower tax bracket. A disadvantage, however, is that withdrawals taken from a deferred annuity prior to age 59½ are subject to a 10% penalty. No such penalty applies to bonds or CDs. Depending on an investor's need for liquidity and age — fixed annuities may or may not be as suitable as investments in bonds or CDs.

Most fixed, immediate annuities do not impose upfront sales charges or annual charges (the costs incurred by the insurance company are factored into the payout schedule it offers). Immediate annuities do not charge surrender charges, as those apply only to withdrawals or surrenders, which are not permitted once the contract is annuitized (and for immediate annuities, that happens when the contract is established). Fixed deferred annuities are considerably more complicated than immediate contracts. Until fairly recently, many fixed deferred annuities imposed an initial sales charge, or "load". These were unpopular with investors, and today, very few fixed deferred annuities assess an upfront charge. Today, deferred fixed annuities impose a surrender charge to recover the company's "acquisition costs" (primarily commissions to sales personnel) if the contract is surrendered or large amounts withdrawn from the contract in the first years of the contract's life.

Variable Annuities

Variable annuities are typically viewed as an alternative to mutual funds or equities. (This discussion will assume that the investor in the variable annuity elects to invest in equity-based subaccounts. For variable annuity owners who choose to invest in the contract's fixed account, the annuity will behave more like the fixed annuities described above.) As we've mentioned, some variable contracts offer "clones" of popular mutual funds as their investment subaccounts — so this comparison seems to make sense at a superficial level. There are, however, substantial differences that may make variable annuities more (or less) suitable than mutual funds or stocks.

Income taxation. One of the prime advantages of investing in a variable annuity, as opposed to stocks or mutual funds, is that earnings in the annuity grow tax-deferred. And the investor has the opportunity of "timing" withdrawals to take advantage of lower tax brackets or net the annuity earnings against other ordinary income losses the investor may incur in a particular year. Another advantage is that the tax-deferred growth within the account is not included in calculating the AMT or determining whether Social Security benefits will be taxed. A disadvantage is that deferred variable annuities are subject to a 10% penalty on withdrawals prior to age 59½.

There is another tax disadvantage that variable annuity investors face. All withdrawals taken from a variable annuity will be taxed as ordinary income. This means that the tax-deferred growth that accumulates within the contract will be taxed at the investor's ordinary tax rate. By contrast, an investor purchasing shares of stock that appreciate in value will be taxed, when the stock is sold, at a reduced capital gains tax rate. Mutual funds must distribute any realized capital appreciation annually, but this too will be taxed as capital gains, not as ordinary income. Qualified dividend income received from a stock portfolio or mutual fund will be treated as dividend income and be taxed more favorably than ordinary income. The central tax question for the investor is: Will the accelerated tax-deferred growth (so-called "triple compounding") available under the variable annuity more than compensate for the higher tax rate applied to that growth when it is withdrawn? The answer to that question depends on the investor's current tax rate, the anticipated tax rate that will apply when the withdrawal is taken and how long the earnings will grow tax-deferred. Advisors should try to project which investment vehicle (variable annuity or mutual fund) will yield the greater after-tax net income to the client. Obviously, such projections are not always an easy chore. To further complicate the advisor's task, if the annuity is annuitized, rather than a simple lump sum withdrawal, the tax-deferred growth continues to be earned even in the annuity period. Depending on how long the annuity period lasts, continued tax-deferral can add significantly to the value accumulated by, and ultimately distributed to, the contractholder.

(Please note: this analysis does not apply to the comparison of fixed annuities and other fixed-income alternatives discussed above, since there is no difference in their tax treatment — both bond interest and annuity earnings are treated as ordinary income.)

Estate taxation. There is an estate tax difference between variable annuities and mutual funds. Upon death, beneficiaries inherit most securities, such as stock and mutual funds, at a "stepped up basis". This is not the case with variable annuities. Beneficiaries who inherit a variable annuity also inherit the original owner's cost basis. For example, Mr. Brill purchased 1,000 shares of OmniGrowth Mutual Fund at $50 per share. At his death, the value of his OmniGrowth shares is now $125,000. He leaves the shares to his daughter, who sells them six months later for $140,000. The daughter will pay capital gains tax on $15,000 ($140,000 sales proceeds minus her $125,000 stepped-up cost basis). If Mr. Brill had invested his $50,000 in a variable annuity subaccount identical to OmniGrowth, his daughter would inherit her father's contract with his original $50,000 basis. If she liquidated it for $140,000, she'd be faced with a $90,000 capital gain. For investors focused on the efficient transfer of wealth to the next generation, variable annuities may not be as suitable as other comparable investments. [Please note: the current federal estate system (rates, step-up rules, exclusions, etc.) is scheduled to revert to pre-2000 levels in 2010 — but Congress will probably revise the system before then.]

Death Benefit. Deferred variable annuities offer a minimum death benefit that mutual funds or other securities cannot. In most variable contracts, the minimum guaranteed death benefit is the greater of initial contributions to the contract or the current value at the time of death. These guarantees can be comforting to investors concerned with leaving as much as possible to their heirs. If the value of the subaccount falls and the contractholder dies, the heirs will be guaranteed the contractholder's principal. If the investment had been placed in a comparable mutual fund that declined in value, the heirs would receive only its current value. At first sight, this seems to be a major advantage for investments held in a variable annuity. But that protection comes at a cost. A

mortality expense is applied to the contract — and the protection it affords is only in the case of a market decline. If the value of the account at the time of death is greater than the original investment, the heirs will receive that increased value — the same as they would have had the investment been in a comparable mutual fund. In effect, the variable annuity's insurance component provides no extra value for the heirs if the investments in the subaccount grow. On the other hand, if the contractholder had purchased a life insurance policy and invested in a comparable mutual fund — upon his death, his heirs would receive the current value of the shares plus the life insurance proceeds. Assuming the life insurance proceeds exceed the amount of any decline in the shares value, the heirs would see a greater inheritance than the minimum guaranteed death benefit provided by the variable annuity. And if the value of the shares increased, the heirs would receive that increased value, plus the life insurance proceeds. The variable annuity, by contrast, would simply pay the increased value. Advisors should be keenly aware of the mortality charge a variable annuity contract imposes on the investor, and the amount of real protection the minimum death benefit provides. That is especially true when the contract offers enhanced death benefits for an "enhanced" cost. In these cases, the minimum death benefit is ratcheted up — in some contracts based on a fixed rate of growth, in others, based on actual growth in the subaccount. In periods of great market volatility, these enhanced death benefits may well be worth their price. A cost-benefit analysis may be difficult, but advisors should try to analyze the tradeoff, nonetheless.
One additional point is worth noting. The mortality charge is usually assessed as a percentage of the account value, usually 10-30 basis points (0.10 –0.30%) per year. If the value of the account grows, so does the mortality charge. Yet as noted above, the minimum death benefit is really only of value in cases where the account value has fallen at the time of the contractholder's death — it provides no additional benefit if the account has grown. So, perversely, the contractholder pays more in mortality charges as the guaranteed death benefit becomes less valuable to his heirs. Some annuity companies realize this illogical outcome and now base the mortality charge on the actual risk undertaken by the company.

The mortality charge should be viewed as a risk management decision. For some investors, the protection given to their heirs may be well worth the cost. Other investors, who are not particularly concerned with maximizing transfer of wealth to their heirs, may view the mortality charges as a drag on investment performance. For these investors, an investment in a comparable mutual fund might be more suitable.

Enhanced living benefits. Newly-issued variable annuity contracts offer many "bells and whistles": GMIBs, GMABs and GMWBs, or possibly provisions that include all of these in one package. All of these enhanced living benefits (discussed in great detail in Chapter 1) come at an additional charge. They all offer additional levels of protection to the variable contractholder that are not available to investors in a comparable mutual fund. The question for the investor and his advisor is whether the benefits justify the additional cost. Advisors should approach this question the same way they approach a variable annuity's enhanced death benefits — as a risk management decision. If the contractholder is not interested in the protection these provisions offer, then the additional cost simply acts as a drag on investment performance. If the contractholder feels the risk protection is of some value to him, then the question becomes: Is that value worth the cost? The cost is usually a straightforward amount set forth in the contract. The actual value of the enhanced living benefits for each prospective contractholder is more difficult to assess. Some annuity companies offer training seminars to provide advisors with the tools necessary to evaluate these benefits. If an advisor has access to such training, it would definitely be worth his or her time to attend. At a minimum, the advisor should seriously study all marketing materials and contract language (perhaps augmented by discussions with the company's marketing representatives) to better explain the true value of these benefits to his or her clients. For risk adverse clients, the peace of mind these benefits offer may more than justify the cost.

Surrender charges. Most deferred annuities impose a surrender charge on large withdrawals in the first years of the contract's life. If the contract is surrendered in the early years, surrender charges will reduce the amount of principal available to the contractholder. As noted earlier, surrender charges make annuities a less-than-liquid investment option. Surrender charges are used to cover the upfront "acquisition costs" incurred by annuity companies, primarily commissions to sales personnel. Some deferred variable annuities offer the investor the option of an upfront sales charge or a contract with surrender charges (known as Class A shares and Class B shares, respectively). Mutual funds have the same type of expenses to cover — many funds impose either an upfront "load" or sales charge (reducing the amount available for investment) or a back-end load (similar to the surrender charges on variable annuities). To avoid these costs, an investor could opt for direct investment in individual equities or no-load mutual funds.

Investment fees. Both mutual funds and variable annuity subaccounts are actively managed portfolios — and both charge a fee to cover the management expense. While a subaccount may be managed by a mutual fund company, and even share its name, there may be differences in the management fees. Advisors should be aware of the management fees charged by the annuities they represent. Typically management fees are higher on subaccounts invested in industry-specific portfolios or portfolios invested in less liquid assets (i.e., real estate holdings); lower on broadly diversified portfolios. The so-called "fixed subaccount" that pays a fixed rate of return usually does not charge a management fee. Knowledgeable investors could avoid (or minimize) these annual charges by investing in and holding a portfolio of individual securities.

Income payments. Annuities are the only investment option that can guarantee a lifetime income, regardless of the length of the measuring life. The periodic income stream from an annuity is part principal and part earnings (and therefore only partly taxable). Income streams from other investments, such as dividends and interest, are fully taxable and never guaranteed to last for a lifetime. Advisors should be careful to make those distinctions when discussing the relative merits of income payment from annuities and other investments. Many deferred annuities are never annuitized — that is, they are used to meet accumulation, not distribution, objectives. That said, all variable annuity contracts do offer guaranteed payout options — an opportunity not available in other investment options. Of course, other investment alternatives may be used to accumulate wealth, and if periodic lifetime income is eventually needed, that investment can be liquidated and used to purchase an immediate annuity.

Indexed Annuities

Equity indexed annuities — with their guaranteed minimum rate of return and market derived interest rates — fit somewhere between traditional fixed annuities and variable annuities. Advisors would be best served if they viewed equity indexed annuities as a fixed annuity with a fixed rate of return (if market returns eventually exceed that minimum, that's frosting on the client's cake).

Many commentators, however, view EIAs as an alternative to indexed mutual funds or investment in index shares (exchange traded funds, or ETFs). The comparisons are not entirely valid. One, indexed mutual funds and index shares (ETFs) are passively managed portfolios designed to mirror the market weighting of the index components — once the portfolio is established, the manger need only update it for changes in the makeup of the index. So, unlike actively managed mutual funds and variable annuity sub-account, management fees are minimal for index funds or shares. Equity indexed annuities rely on index options to mimic the upside returns of the index. Those options expire periodically and need to be replaced. This is a "hidden cost" of EIAs. Two, index mutual funds and index shares must distribute income annually, while EIAs grow tax deferred. Three, index mutual funds and index shares own the underlying stocks in the index, and many of those stock pay dividends. EIAs do not own the underlying stocks, and therefore do not generate dividend income for their contractholders. The upside market returns promised by EIAs are based solely on appreciation of the index's value, not the total return the index shares might generate (stock price appreciation plus dividends). Four, index mutual funds and index shares participate fully in the index's movement — up or down. The upside market returns promised by EIAs are limited a portion that movement (the participation rate, caps, spreads, etc.). Ratcheting and other mechanisms, as well as the minimum guaranteed rate of return, limit exposure to downside movements. Put another way, the contract holder in an EIA exchanges market risk for reduced upside potential (i.e., a less perfect, inflation hedge).

As with all annuities, equity indexed annuities impose surrender charges. EIAs, more than other types of annuities, are primarily a vehicle for accumulation. Investors in EIAs should plan to invest in the contract for the duration of the stated maturity. Withdrawals from equity indexed annuities prior to maturity can have serious adverse consequences to the actual return earned by the investor. In some contracts, the equity-based rate of return is applied only to contracts that remain in force until maturity. If surrendered prior to maturity, the surrender value of many contracts is based on only the minimum guaranteed rate, not the indexed value. These facts makes EIAs particularly illiquid. Advisors can partially overcome this illiquidity by "laddering" the maturity dates, just as they do with a bond portfolio. Instead of investing the full amount in one contract, with one maturity date, the investor could purchase a number of equity indexed annuities with progressively longer maturity dates. This allows the investor to access his or her principal, at maturity, over a period of years. For example, rather than purchase one large 20-year contract, a client could purchase a contract with maturity in year 7 (the end of a typical surrender charge period), another maturing in year 14 and another in year 20. The first contract would provide a return of principal (plus earnings) in year 7, that could be redeployed to meet the investor's need for income (or other purposes) between years 7 and 13, the second contract could be used to meet capital needs in years 14 through 19, and the final contract completes the return of principal at the end of the 20-year investment horizon. Of course, if the client has no need for the principal at the intermediate maturities, she faces the risk of reinvesting those proceeds on less advantageous terms.

Two centuries later, Mrs. Dashwood's admonition still rings true .... annuities are a very serious business, indeed.