

INVESTMENT GUIDE

FINANCIAL RIP-OFF

Protection Racket

Insurance salesmen invoking market gloom have pushed indexed annuity sales to record highs. The trouble is what's unsaid.

BY WILLIAM P. BARRETT

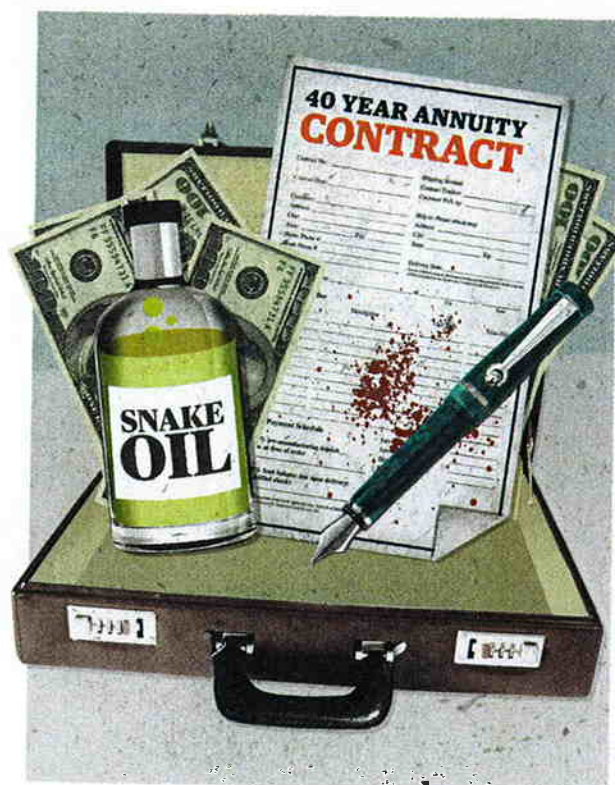
Pennsylvania resident Mary Lynch heard an alluringly simple pitch from an insurance salesman: If the stock market goes up, you win; if the market drops, you win even more because you don't lose.

With those prospects dangled in front of her, Lynch shelled out \$65,000 for an indexed annuity issued by what is now Aviva USA. Lynch and her heirs realized only afterward that the downside protection the product granted didn't come close to compensating for the upside potential it took away.

Lynch was 85 years old and living in a senior citizen home seven years ago when she was sold the "40-year annuity." It had hefty penalties for withdrawals the first decade. "The product was unsuitable for her," says her lawyer, Jonathan Auerbach.

Lynch became part of a class action Aviva USA settled last year in Philadelphia by offering annuitants better terms. A unit of London's Aviva Plc., and this country's second-largest seller of indexed annuities, Aviva USA denied any wrongdoing and said it made a "business decision" to end the litigation. The company also said it intends to strengthen its client-screening procedures.

We've said it before, and we're saying it again: What-



ever your station in life, indexed annuities are in all likelihood a lousy investment. If preserving capital is your main objective, there are much cheaper and simpler ways to do it.

Why, then, did sales hit a record \$30 billion last year, according to AnnuitySpecs.com? And why do they appear to be rising still?

"Indexed annuities are the latest in a long line of sizzle things," says Andrew M. Hudick, a Roanoke, Va. financial planner who clearly is no fan. "All they do is link two things and add a layer of costs."

The insurance industry has put a lot of money and muscle into keeping the sizzle sizzling. Several state regulators have sued or issued warnings about indexed annuities, usually alleging deceptive sales practices. Yet insurers just beat back a five-year effort by the Securities & Exchange Com-

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mission to regulate sales, arguing that indexed annuities are insurance rather than securities products.

A federal jury ruled last year that Allianz Life Insurance Co. of North America, the nation's top indexed annuity seller and a unit of Allianz Se, misrepresented one product by promising a 10% "bonus" to hundreds of thousands of buyers. The bonus was illusory and couldn't be cashed, according to testimony. Allianz said all terms were disclosed. But the Minneapolis civil jury awarded the class-action annuitants no damages, noting that they lost no money amid the stock market's recent 30% swoon.

"We went to trial at the wrong time," laments plaintiff lawyer Karl Cambronne.

Indexed annuities come in many flavors. Most require owners to plunk down a flat sum up front for a decade or, as in Lynch's case, far longer. The annuity then grows tax-free and generates a guaranteed minimum rate of return each year, often 1% or less. If the stock market index (hence the name) to which it's keyed goes up more than that, you get a share. If the market goes down—even way down—you still get the minimum for that period. At the end of the lockup you get back your stash and earnings and pay any applicable taxes.

What's not to like? Plenty.

Clip jobs

In years when the market is way up, indexed annuity investors enjoy a paltry portion of the gains. Their share is usually limited by "performance caps" of perhaps 8%. Last year, when the S&P 500 index rose 23%, such caps limited

One study says indexed annuities underperform a simple portfolio 99% of the time.

annuitants' returns to barely one-third as much. Indexed annuities, either separately or in tandem, often specify a "participation rate," too. A 60% rate means you get only three-fifths of the gain in the underlying index, even when it's less than 8%.

Investors are treated even more shabbily with dividends, which historically have generated about 40% of equity returns (capital gains throw in the other 60%) and are a big part of stocks' appeal. Indexed annuities' returns are calculated on gains only—not including dividends.

Another gotcha is something called a "market value adjustment." It's a mind-numbing calculation involving the

movement of interest rates after an indexed annuity is bought and often reduces the cash value of the account. If all this weren't enough, issuers reserve the right to change their initial promises.

Fee frenzy

Vanguard charges no sales fee on its S&P 500 Index Trust. But indexed annuities are sold by life insurance salesmen, and the sales fees alone—essentially their commissions—can top 10%. Rob Gianelli, a Los Angeles lawyer who has sued over indexed annuities, says that he's seen sales fees as high as 20%. Indexed annuity vendors also tend to charge higher annual fees than do mutual funds and ETFs.

Surrender bender

Contact a no-load mutual fund firm and it's legally obligated to refund your money the day you ask for it at your fund's net asset value. But if you want to pull large amounts of your money out of an indexed annuity in the early years, you're likely to pay surrender fees that can be as high as 25%. Even so, most buyers don't hold on to their indexed annuities until expiration, consumer advocates say.

Tax bite

Indexed annuity salesmen play up the fact that investments ride along tax-deferred. When it comes time to withdraw your money, however, Uncle Sam will charge ordinary income taxes on your earnings—as much as 35%. Stock and mutual fund gains, by contrast, are taxed at the 15% long-term capital gains rate. On a \$500,000 gain that's a \$175,000 tax on the annuity versus \$75,000 on the stock or fund.

Solvency risk

An indexed annuity is issued by a single life insurer, which, like a Wall Street investment bank, can go bust. State guarantee funds offer a backstop but have limits on coverage.

Better alternatives

Some 99% of the time indexed annuities underperform a simple portfolio that's 60% in zero-coupon Treasuries and 40% in a low-cost S&P 500 index fund, according to a 2008 study by economic consultant Craig J. McCann, who often works for investors and regulators. In a statement to FORBES, Aviva USA defended indexed annuities as useful "for consumers seeking to eliminate the risk of losing their principal or cumulative returns and [who] are focused on guaranteed income."

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