Indexed Annuities

If you want to participate in the potentially attractive returns of a market-driven investment but would also like a guaranteed return, an indexed annuity might be worth checking out.

The performance of indexed annuities, also referred to as equity-indexed or fixed-indexed annuities, are tied to an index (for example, the Standard & Poor's 500*). They provide investors with an opportunity to earn interest based on the performance of the index. If the index rises during a specified period in the accumulation phase, the investor participates in the gain. In the event that the market falls and the index posts a loss, the contract value is not affected. The annuity also has a guaranteed minimum rate of return, which is contingent on holding the indexed annuity until the end of the term.

This guaranteed minimum return comes at a price. The percentage of an index's gain that investors receive is called the participation rate. The participation rate of an indexed annuity can be anywhere from 50% to 90% or more. A participation rate of 80%, for example, and a 10% gain by the index would result in an 8% gain by the investor.

Some indexed annuities have a cap rate, the maximum rate of interest the annuity will earn, which could potentially lower an investor's gain.

Indexing Formula

Several formulas are used to calculate the earnings generated by an indexed annuity. These indexing methods can also have an effect on the final return of the annuity. On preset dates, the annuity holder is credited with a percentage of the performance of the index based on one of these formulas.

Annual Reset (or Ratchet): Based on any increase in index value from the beginning to the end of the year.

Point-to-Point: Based on any increase in index value from the beginning to the end of the contract term.

High-Water Mark: Based on any increase in index value from the index level at the beginning of the contract term to the highest index value at various points during the contract term (often anniversaries of the purchase date).

Indexed annuities are not appropriate for every investor. Participation rates are set and limited by the insurance company. Like most annuity contracts, indexed annuities have certain rules, restrictions, and expenses. Some insurance companies reserve the right to change participation rates, cap rates, and other fees either annually or at the start of each contract term. These types of changes could affect the investment return. Because it is possible to lose money in this type of investment, it would be prudent to review how the contract handles these issues before deciding whether to invest.

Most annuities have surrender charges that are assessed during the early years of the contract if the contract owner surrenders the annuity. In addition, withdrawals prior to age 59½ may be subject to a 10% federal income tax penalty. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company.

If you want to limit potential losses but still tap into the potential benefits of equity investing, you might consider an indexed annuity.

* The S&P 500 Index is an unmanaged group of securities that is widely reconized as representative of the U.S. stock market in general. You cannot invest directly in any index. You do not actually own any shares of an index. Past performance is no guarantee of future results.