# Indexed Annuities: Risk and Reward in Retirement Investing

*Advisers consider the pros and cons of complicated equity-indexed or fixed-index annuity products for risk-averse retirement investors.*

**By Robert Powell**

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If you're still accumulating assets to fund your retirement but your appetite for risk -- given the recent market volatility -- is diminished, now might be a good time to consider other tactics, investments and products.

To be sure, you ought not react to such events in the absence of an investment policy statement, the blueprint for your portfolio. But if your IPS calls for making adjustments, you might dial back allocation to risky assets. Instead, of having a 60% stocks, 30% bonds, and 10% cash portfolio, maybe you trim the percent you allocate to stocks to 55%, or 50% or less.

Or you might consider allocating a portion of your portfolio to a variable annuity that offers some guaranteed minimum accumulation benefit.

Yet another option might be an equity-indexed (EIAs) or fixed-index annuity (FIAs). These products combine guaranteed minimum returns (a floor) with the ability to earn a return based on changes in an equity index such as the Standard & Poor's 500 composite stock index.

According to Kaplan Financial Education, such products might be suitable for those who want to participate in equities market without the investment risks or costs of a variable annuity.

To be sure, the products -- which offer upside potential and downside protection -- sound great on paper. And there are plenty of advocates for such products, including Roger Ibbotson.

But there's much you need to learn before buying an FIA, chiefly the factors used in computing the interest rate. According to Kaplan Financial Education, those factors include:

- The floor: This would be the minimum rate credited to the contract, regardless of index changes.
- The participation rate: The participation rate determines how much of the increase in the value of the underlying index will be used to compute the interest rate credited to the contract.
- Interest rate cap: This is the maximum rate of interest the FIA/EIA can earn regardless of the participation rate and actual index return.
- The spread or administrative fee: The interest for some FIAs is determined by subtracting a percentage of up to 3% from any gain in the index.

Also worth knowing is the indexing method, whether it's annual reset, high-water mark, or point-to-point. More on that below. Examples of FIA rates offered by Schwab can be found here. An example of a FIA disclosure form can be found here.

## What Do Financial Advisers Say About FIAs?

For his part, Marty Reid, a certified financial planner and president of Reid Financial Consulting, says the most appealing features of the EIA/FIA are the guarantee of no loss of principal and participation in equity markets.

"However, as attractive as EIAs/FIAs might sound, the product includes both costs and limitations," he said. "While insurance companies may tout that the EIAs/FIAs have no internal costs, they make their profit by retaining the spread between its capped investment return and the actual return of the equity index."

So, for example, if the S&P 500's annual return is 15%, and the contract's capped return is 7%, the insurance company retains 8% to cover their expenses, Reid noted.

"In addition, EIAs/FIAs usually have long surrender periods, lasting seven to 10 years," he said. "So, if you surrender your contract early, you may incur surrender charges."

Finally, be aware of the annuity's tax treatment, said Reid. Realized gains are subject to ordinary income tax, and withdrawals taken before age 59½ are subject to a 10% penalty.

Reid also noted that according to an "Investor Alert" released by Financial Industry Regulatory Authority or FINRA, the guaranteed interest rate of an equity indexed annuity is usually 87.5% of premium paid with an interest rate of 1-3%. Read Equity-Indexed Annuities-A Complex Choice.

The "participation rate," which calculates its investment return, is perhaps its most confusing feature since various methods are employed and vary from contract to contract.

Reid also said you should fully understand how your rate of return is calculated before purchasing an EIA/FIA.

One way is the annual reset or rachet method. "This method locks in your investment return annually, but your return is limited to the actual gain as of your anniversary date," he said.

Secondly, there is the high-water mark method. "This method locks in the gain of the contract at certain intervals and may provide a better return for the long-term investor," he said. "However, if you surrender your contract early, you may significantly diminish your returns."

Furthermore, he said, many contracts require you to hold your annuity a certain time period before the highest value of your annuity is guaranteed. "For example, if your high-water mark, the highest value of your contract, occurs in the sixth year of your contract, you must hold your annuity for an additional five years before the high-water mark is guaranteed."

Thirdly, there is the point-to-point method. "This method calculates the participation rate to two discrete points in time, such as a day-to-day or quarter-to-quarter calculation," he said.

So when might an EIA be suitable?

According to Reid, a retiree who is risk averse and is seeking to hedge against "longevity risk" (outliving their money) may want to review his or her investment portfolio to determine if an EIA/FIA would be appropriate. "At the same time, be aware of any advice that would recommend this product as a 'catch-all' solution for your retirement-income planning," he said. "Most importantly, make sure that you understand the costs, features, risks, and limitations of the annuity contract."

Finally, as with most complicated investments and insurance products, Reid recommends that you consider reviewing your retirement plan with a certified financial planner "to help you determine what strategies and products are the best fit for your financial situation."

Other advisers, however, recommend that you steer clear of EIAs/FIAs. "I'm solidly against recommending equity/fixed indexed annuities to your readers," said Steven Podnos, the CEO of Wealth Care. "FIAs/EIAs are always sold and not bought," he said. "They are complex, carry terribly high commissions and surrender charges and high internal costs... in order to recover the high commission paid to the salesperson. I have never seen a good equity-indexed product."

Podnos's bottom line: "Tell your readers to stay away from these awful products." The deck is stacked against them."

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