Turning the Fixed Indexed Annuity Critic into an Advocate

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I was talking with a stockbroker friend recently, and he knew from previous conversations that a good portion of my business involves fixed indexed annuities (FIA's). He mentioned to me that he had only sold one FIA in the past, and that the sale had been a mistake, because the FIA did not perform well.

I asked him, "What do you mean when you say it did not perform well?" He said that after he had sold it, the stock market went up over the next few years, and the FIA's return was considerably lower than the stock market, so the client was disappointed.

Yes, the fact is that FIA's are only designed to credit a portion of any stock market index increase. So, how could I agree wholeheartedly with his observation, yet turn him into an advocate for FIA's?

He was working under a common misperception: that FIA's are designed to be alternatives to stock market investments. So, I asked him, "Do you recommend that your clients place all of their money in the stock market?" His answer was no, he typically recommends that clients place a portion of their money in assets geared to ensure safety of principal. In fact, as clients get older, he recommends they place a higher portion of their assets into non-stock vehicles that offer more safety of principal.

So, I asked him, "What types of safer assets do you typically recommend to clients?" He answered that he sometimes recommends money market accounts or certificates of deposit, but that mostly he recommends bond mutual funds. I asked, "What annual return do you tell clients to expect from bond mutual funds?" He said that they should expect to receive the annual yield of the fund, which is typically around 5%, considerably lower than they could hope for from their stock mutual funds.

He did not yet realize it, but he had just turned the corner to becoming an advocate for FIA's.

You see, FIA's contractually guarantee that neither the original premium nor any interest, once credited, is at risk of loss, subject only to a withdrawal charge, which is avoidable if the customer follows the annuity's free withdrawal guidelines. So, given that significant safety feature, I asked him if it would make more sense to compare an FIA to a bond mutual fund, and he agreed.

While an apples-to-apples comparison may not quite be possible, we discussed several key features of a typical FIA versus a typical bond mutual fund.

<u>Safety</u>: The bond fund's value fluctuates every day, and the value can decrease at any time. In fact, he called this one of the more frustrating aspects for his customers. He sells the bond fund for safety of principal, and then the value can drop. So, he agreed that the FIA, with its contractual guarantee not to lose value, is clearly safer.

Earnings: In retrospect, he agreed that the growth of the FIA that he had sold was comparable to a bond fund. When he considered that the bond fund could have a year where its dividend income was more than offset by a loss of principal value, whereas the FIA was guaranteed never to lose value, the FIA's earning pattern was probably more attractive to consumers.

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Tax Treatment: The bond fund throws off taxable income every month, like it or not, and it generates taxable gains even if the fund loses value during the year. Bond fund capital gains and losses would be eligible for capital gains tax treatment, but he agreed that he tells his customers to expect such gains to be minimal. His customers buy bond funds for stability, not for capital gains. On the FIA, taxes are deferred until the gains are withdrawn, so customers have more control over their taxation. So, he agreed that as long as his customers plan on taking withdrawals after age 59½, the taxation of the FIA is more attractive.

Access to your Money: Given that FIA's typically have withdrawal charges that apply for a number of years from purchase, whereas withdrawals can usually be taken from bond funds without any such charges, there is no question that bond funds offer better access to your money. But I asked him, do your clients typically pull their principal out of their bond funds? He agreed that they usually pull money out of their money market funds and certificates of deposit first, leaving the money they initially put into their bond fund intact. And, most FIA's allow you to take out your annual interest credit without a withdrawal charge.

This conversation opened up a whole new way of thinking for him. He saw that he was recommending bond mutual funds to most of his customers for a portion of their money, and yet FIA's were a better place for that money. FIA's offer better safety, similar earnings over time with an assurance of no negative earnings, better tax treatment of annual income, and adequate access to the portion of the money customers will likely want to withdraw.

The insurance industry has been saying for years in its footnotes and fine print that an FIA is not an alternative to a stock market investment. It is time we helped everyone to understand that we really mean that. Most financial advisors, even those who strongly favor stocks for large portions of their clients' money, recommend bond mutual funds and other assets geared towards safety of principal to their customers. When you compare an FIA to those types of assets, it compares very well.

The fact is that both FIA's and bond mutual funds meet customer needs, and that is why both are popular products. Depending upon the need for liquidity, the desire for protection from fluctuation in the value of the account, and the specifics of each client's situation, either may be more attractive based on each client's needs and objectives.

About the Author

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Mr. Conklin's expertise includes all aspects of the product development strategy and implementation functions performed by insurance companies. He has helped numerous carriers with the complete process from product strategy through implementation, including pricing and design, hedging and asset/liability management, policy forms, state filings, marketing materials, compliance issues, sales support, and in-force administration.

Chris was a long-time Vice President of Product Development for a major insurance carrier. He developed new products that resulted in the company achieving sales growth over a ten-year period from nearly zero sales to over $100 million annually in life sales and $3 billion annually in annuity sales. He led a department that brought to market over 170 new products and significant product enhancements in a 5-year period. Chris has played a major role in assisting large and mid-size carriers successfully enter new market segments over the last few years.

Chris also has developed working relationships with many key distributors in the brokerage life insurance and annuity marketplace, which has benefited many of Insurance Insight Group's clients. Chris has assisted several carriers grow their network of national marketing organizations.

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