Taking Stock: Stockbroker nephew has man crying uncle

by Malcolm Berko

Dear Mr. Berko: My wife and I are both 77 and recently sold our home for $266,000 after all costs. The only income we have is Social Security, one state pension and a small insurance check. We need income. Our nephew is a broker with a big New York member firm and has suggested that we invest $100,000 into this index annuity from which we can get $10,000 a year and is guaranteed that we can't ever lose any money. In fact, he told us that it would "easily increase value every year." And he has recommended that we put another $100,000 in his company's reverse convertible securities, which will pay us 14 percent each year. If it's with a big public company, it's as safe as the credit rating of that company. It seems that our $200,000 would be in two "win-win" investments.

F.E.

Joliet, Ill.

Dear F.E.: You may not want to believe this, but those investments are a "win-win" only for your darling nephew who has no more conscience than a fox on a poultry farm.

Even if your annuity were indexed to heaven with St. Peter at the helm, I still wouldn't buy it. I've watched many of the biggest New York Stock Exchange firms greedily vend some really bad and unsuitable products (rare coins, real estate tax shelters, index certificates of deposit, drilling leases, rare art programs, Hollywood movies, Section 21 investments, dot-com funds, jumbo-jet partnerships and heavy-equipment leases, just to name a few) to an over-trusting clientele. In my opinion, the typical indexed annuity ranks up there with uranium mines, bio-waste plants and other egregious Wall Street products. But even a semi-honest broker would find it alarmingly difficult to resist commissions that can be as high as 12 percent.

Don't worry, I won't mention the name of the annuity company nor will I disclose the name of your broker or his NYSE member firm. But I will tell you that your broker is a scoundrel, even if he is your sister's son. Family members are the easiest of all clients to rip-off because they won't complain to the boss. Now before you write a check to that shameful NYSE brokerage, listen up and listen good.

The income this immediate annuity earns is tied by a complicated formula (which I can't understand) to the stock market. Because the contract language is clear as split pea soup, I'd drop that annuity like a hot noodle and tell your nephew to stuff it in his ear.

I can tell you that the income, which accrues each quarter cannot be paid on demand. The language in the prospectus says that it must remain in the contract for eight years prior to being paid out. Did your nephew explain this to you?

While you can withdraw 10 percent of your principal each year, there's a hook. Did your nephew explain that when you take out $10,000 (that's 10 percent of your $100,000) that money earns zero income for the entire year even if you take it out in December? And if, the good Lord forbid, you need to get your hands on $50,000 or $60,000 due to a family crisis, your annuity company will blast you with a surrender fee of 20 percent? I don't suppose he told you that, either.

Finally the annual costs (3.5 percent) are high enough to choke a giraffe. They're also outrageous, flagrant and a tiny millimeter away from bordering on criminal. Frankly, I don't know of a single index annuity investor who is pleased with the index annuity he owns.

A reverse convertible security is a short-term investment (usually 12 to 24 months) that is linked to an underlying stock like Boeing, Bank of America or Intel. These securities have a predictable income stream (usually 9 percent to 15 percent) and at maturity the investor gets either (1) all of his money back plus interest or (2) a predetermined number of shares of underlying stock plus the interest.

While option (1) is the better choice, the investor usually gets stuck with option (2) in which the market value of the received shares of underlying stocks is worth less than your original investment. Did your nephew explain this to you? Did he tell you that an increase in the market value of the underlying stock does not increase the return on your investment? The attraction of this product is the high rate of interest and the danger is a very possible loss of principal. Did your nephew tell you about the risks?

These are high-commission products (5 percent and higher) and many times they may not have a secondary market if you need to liquidate. While the potential return on a reverse convertible appears attractive, it's more than likely that the real return will be significantly less than you were told by your nephew.

I suggest that you locate a real broker - someone who understands your goals, your risk tolerances and someone who cares more about how well your investments perform and their suitability than about the size of his commission check. Your nephew is a bum and you can tell him I said so. Visit with several other brokers in Joliet and take copious notes. Write me with their suggestions and I will help you make the right decisions.

Please address your financial questions to Malcolm Berko, P.O. Box 1416, Boca Raton, FL 33429 or e-mail him at malber@adelphia.net.

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