Equity Indexed Annuities Can Come Back To Bite You If Cash Needed

by Lynn O'Shaughnessy

An elderly woman in my community learned not too long ago that she needed dentures. She had enough money to pay for the new teeth, but she discovered that her funds, while technically hers, couldn't be touched. The bad guy in this pitiful case was an insurance company, which had capitalized on an ingenious way to make money off an easy mark. What the woman with the bad molars had bought was an equity indexed annuity. Promoters attract unsophisticated investors by suggesting that buying an EIA is like owning a handful of magic beans and a golden goose. An EIA, they say, will allow you to enjoy stock market gains without any of the risks. After listening to them, it would be easy to conclude that only a chump would continue to invest in mutual funds or individual stocks. If you put your money into one of these annuities instead, your EIA flak jacket will withstand all the nasty stuff that Wall Street tries lobbing at you. In reality, however, EIAs aren't a miracle investment. And they certainly aren't risk-free for those who experience buyer's remorse. Hidden inside these things are incisors that can tear customers' investments apart if they decide they need the money. EIAs are actually complicated insurance products that are being marketed to senior citizens who are terrified by stock market losses. The upside potential for EIAs, say the salesmen, is great, but if the markets crash, an EIA's return can't dip into negative territory. These annuities guarantee a base annual return, which is often 3 percent, for the length of the contract. One drawback to EIAs is their complexity. While many EIAs are partially linked to the fortunes of the Standard & Poor's 500 Index, for example, there are plenty of ways that an insurer can shrink the annuity's return. For starters, a customer might be promised a 50 percent, 70 percent or even 100 percent share of the S&P 500's annual performance. But that's misleading, because an EIA excludes the S&P 500's dividends as part of the return. Insurers also often put caps on the returns that you can capture. Just how much the performance will shrink can depend on which of the dozens of crediting methods that an insurer uses. "There are probably 100 different ways to credit interest in an EIA, and you literally need a degree in industry methodology to understand," suggests Scott Dauenhauer, president at Meridian Wealth Management in Laguna Hills, Calif. Critics contend that many of the best-selling EIAs rely on crediting calculations that provide customers with the most anemic returns. Why would someone recommend an EIA that stinks up the room? Hmmm. Would it shock anybody out there if I said that some insurance agents routinely select the EIAs that provide the highest commissions for themselves? Many popular EIAs pay agents 8 percent, 10 percent or higher. Some lucky guys can even get 12 percent on a sale. Because the sales commissions are so generous, insurance companies need the buyers to stay put for a long time so the insurers can recoup what they paid the agents. They keep customers by hitting them with surrender charges if they try to liquidate. EIAs, however, will typically allow investors to pull out 10 percent a year without a penalty. Surrender periods will sometimes last longer than the clients. Imagine an 80-year-old widower buying an EIA that locks up her cash for 15 years. It was one of these lengthy lockup periods that tripped up the woman needing dentures. Ronald A. Marron, an attorney in San Diego who has filed numerous lawsuits against EIA insurance providers, including two class-action suits, says he's seen surrender charges as high as 25 percent. And Marron insists that ditching an EIA can involve more than paying the surrender costs. He says one of his clients, who put $1.5 million into an EIA, would have had to pay $263,000 to bail after being hit with a double whammy: a surrender penalty and something called a market value adjustment charge. There are other reasons why EIAs are troubling. Insurance agents, who don't possess securities licenses, are forbidden from selling stocks, bonds, mutual funds or even lowly certificates of deposit. They can, however, sell all the EIAs they want, thanks to the way they are regulated. The U.S. Securities and Exchange Commission and the NASD don't consider EIAs to be investments - at least not yet. Consequently, these regulators don't have the authority to tell agents, who often market EIAs through free seminars, what they can or can't do even if the advice is reckless. Some EIA promoters, for instance, are urging people to refinance their houses or take out reverse mortgages so they can free up cash to buy EIAs. Obviously, that's nuts. The NASD did issue an investor alert on EIAs last year, which you can find on the regulator's Web site (www.nasd.com). It's also auditing EIA practices at some brokerage firms, while the SEC is conducting its own investigation. The NASD urges investors to understand how a particular EIA works before buying one. But that's a recommendation that even the people selling these complex annuities could have trouble following.Lynn O'Shaughnessy is the author of "The Retirement Bible" and "The Investing Bible." She can be reached at lynnoshaughnessy@cox.net. Copley

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