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Equity Indexed Annuities – Are They a Good Idea?

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Equity-Indexed Annuities, are they a smart choice? The answer depends, but I think most investors should be wary.

To get a better understanding of Equity-Indexed Annuities it is helpful to look under their annuity wrappers and see what's inside. In most of these products, the basic building blocks are similar to principal protected Equity-Linked Notes (ELN).

Principal protected ELNs give investors participation in the upside of the stock market without any risk to the downside. For instance, a note might offer 100% participation in the increase in the S&P 500 over the next five years. However, if the S&P 500 falls, you get your money back. Wow, most all of us say, that's pretty cool.

One of the keys to an ELN's attractiveness is how much participation it gives an investor in the equity market. If you can get a 100% participation rate, that is pretty good although you won't get any dividends. But if you are only getting 40% or 50% of the price appreciation, it is not a very good deal. If price appreciation averages 8% and you get 50%, that's only 4% at high end. If the market is down, you get your money back, but zero return. Why not just buy a 10-year bond and lock in 4.5%?

Participation rates fluctuate widely over time and are primarily influenced by interest rates and option prices. To illustrate how this works we need to dig a little deeper into ELNs. Most ELNs combine a zero coupon bond with a call option on an index like the S&P 500. The zero-coupon bonds provide the principal protection and the options provide the upside exposure to the market.

Zero-coupon bonds are sold at a discount to their face value and mature at their face value. Assume the face value of a bond is \$100 and one-year interest rates are 11%. You could buy a one-year 11% zero-coupon bond for \$90 and after one year it will mature at \$100. If the stock market has declined, this \$100 can be given back to the investor to make good on the principal protection.

Moving to the option side, after spending \$90 on the bond, there is \$10 left to buy call options. If options cost \$10, the fund could buy one option for each bond and give investors 100% participation in the price appreciation of the market. However if options

cost \$15, the fund could only buy 2/3s of an option for each bond. This would result in a 67% participation rate ($10 / 15 = 0.67$).

Hopefully, you can see that an investor's participation rate is dependent on two factors. The first is interest rates which determine how much money can be spent on options. And the price of options is the other critical component. When options are cheap, investors get a higher participation level than when they are expensive. Option prices are impacted by a number of factors but generally speaking the expected volatility of the market is the most important factor.

It is easy to see why ELNs are very popular when interest rates are high and option prices low. In England in the late 1980's, these products took off, especially for investing in Japan. British interest rates were very high and Japanese options were very cheap. Investors could easily get 100% participation or more without risking any principal. They were called 90/10 funds as 90% was used for bonds and 10% for options.

Today interest rates are low and long-term options are not cheap. These two factors work against investors getting high participation rates and at this time no product comes close to offering a 100% participation rate.

Most principal protected products are sold by insurance companies as annuities. So on top of the other issues of Equity-Linked Notes; add all the concerns about annuities.

Here are a few other issues for investors to consider before buying an Equity Indexed Annuity. First, watch the fine print on how the payout is calculated. This is often difficult to follow and remember almost none of these products include dividends.

Second, the tax benefits of annuities are often overplayed for equity investments. A buy and hold strategy in a taxable account will often outperform an annuity on an after-tax basis due to lower tax rates on capital gains.

Third, watch out for long surrender periods which average over 11 years. Lastly, be aware that commissions average over 7%.

The bottom line is most Equity Indexed Annuities are not good investments at this time. This is due to the economics of putting these products together as well as the annuity issues involved.

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