Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

High Returns -- for Whom?

Insurance companies are supposed to be in the boring business of pricing risk. For example, the company will estimate the number of people who will have a car accident and the subsequent costs to repair and/or pay any hospital bills. All of us will pay premiums that, in the aggregate, should pay for the expected losses, as well as the insurance company's administrative costs and profit.

But some insurance companies offer products that are more exciting and creative – as well as being more complicated and profitable. Consider equity index annuities -- where you give the insurance company your money to invest, and the company guarantees that you will get at least all your money back at the end of a certain period of time -- even if stock prices fall into a black hole and never re-emerge. If stock prices go up you get to participate in that growth.

Heads you win, tails you don't lose. Sounds compelling, right?

Despite the popularity of these products since the market downturn in 2008, there are a few considerations. One is that it is a contract that lasts for several years and the investor has limited liquidity (with any type of a guarantee). The second is equity index annuities tend to be expensive – in a variety of ways. Surrender charges, what you pay if you want your money back too early, are typically in the 12% to 15% range. In addition, the underlying investment options are often expensive. But, for many insurance companies, the major profit driver is the way your return is calculated.

Typically, you will be told that, in return for the guarantee that you'll get your money back, you have to give up some of the upside. The contract may specify that you'll get 80% of the upward movements of the stock market.

Since the market has historically gone up about 70% of the time, you are leaving real money on the table. In addition, what many investors may not realize is that they generally do not receive the dividends the underlying stocks are paying (since the investor technically does not own the underlying stocks). That approximately 2% falls right to the insurance companies bottom line.

In 2006, two PH.D's compared a sample equity-indexed annuity with a simple stock and cash investment, and found that the annuity would turn out less beneficial to its policyholder more than 96% of the time. Another approach (http://www.cbsnews.com/news/risk-free-stock-investing/) is to build your own annuity. If an investor has $10,000 to invest and a 10-year time horizon, they could invest $7,228 into a CD (currently paying 3.3%) with the remainder ($2,772) into a low-cost stock market index fund. Even if the stock value falls to zero, the investor would be guaranteed of having $10,000 at maturity. Total annual cost is about .05%.

Comparing the do-it-yourself annuity with the insurance industry's alternative makes it clear just how profitable equity index annuities can be – for the insurance company that is.