



# EDUCATORS RETIREMENT PLAYBOOK

Educators Retirement Playbook  
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## Indexed Annuities



*Like most annuity contracts, indexed annuities have certain rules, restrictions, and expenses. Some insurance companies reserve the right to change participation rates, cap rates, and other fees either annually or at the start of each contract term. These types of changes could affect the investment return. Based on the guarantees of the issuing company, it may be possible to lose money with this type of investment. Therefore, it would be prudent to review how the contract handles these issues before deciding whether to invest.*

An indexed annuity (IA) is a contract between you and an insurance company. You pay premiums in a lump sum or periodically, and the issuer promises\* to pay you some amount in the future. The IA issuer also provides a minimum guaranteed\* interest rate on your premiums paid.

With an IA, the interest earnings are tied to the performance of an equity index such as the S&P 500 or the Dow Jones Industrial Average.

With an IA, your interest earnings may increase if the market performs well, but if the market performs poorly, your principal is not reduced by market losses. Indexed annuities are generally subject to a lengthy surrender charge period. Most IAs pay a minimum guaranteed\* interest rate (e.g., 3%) on a percentage of premium (e.g., 87.5%). However, if the IA doesn't earn interest greater than the minimum, cashing in the account prior to the end of the surrender period may cause the investor to lose money.

Note, however, that any return, whether guaranteed or not, is only as good as the insurance company that offers it. Both the IA's principal and its earnings are entirely dependent on the insurer's ability to meet its financial obligations.

Also, be aware that buyers of IAs are not directly invested in the index or the equities comprising the index. The index is merely the instrument used to measure the gain or loss in the market, and that measurement is used to calculate the interest rate.

*\*Annuity guarantees are subject to the claims-paying ability of the annuity issuer.*

### Basics

The first IAs that were introduced worked very simply; the interest rate was determined by computing the difference between the value of the index to which the annuity was linked on the annuity's issue date and the value of the same index on the annuity's maturity date. If the difference was negative (i.e., the market

performed poorly and the value of the index decreased), interest was calculated using the minimum interest rate. If the difference was positive (i.e., the market performed well and the value of the index increased), the interest rate used was a percentage of the difference — but usually not the entire difference.

### Participation rates

The participation rate determines how much of the gain in an index will be imparted to your annuity. For example, if the difference (i.e., gain) in the index is 7% and the participation rate is 90%, then the interest rate is 6.3% (90% of 7%). Participation rates of 70% to 90% are typical. Obviously, the higher the participation rate, the higher the potential return. Participation rates are set and limited by the insurance company.

### Indexing methods

The indexing method is the approach used to measure the change in an index. The original method, which measures index values at the beginning and end of the term, is known as the point-to-point or European method. The point-to-point method is the simplest approach, but it fails to consider market fluctuations that occur in between the issue and maturity dates. This can result in unsatisfactory returns if the market declines at the end of the term.

Another approach, known as the high-water-mark or look-back method, looks at the value of the index at certain points during the term, such as annual anniversaries. The highest value of these points is then compared to the date-of-issue value to determine any gain to be credited to the IA.

A third approach, the averaging method, also looks at the value of the index at certain points during the annuity's term, then uses the average value of these points to compute the difference from either the date-of-issue value or the date-of-maturity value.



**All of an IA's features should be clearly spelled out in the prospectus or other sales literature, and if you purchase the IA, in your contract as well.**

The fourth main indexing method is known as the reset or ratcheting method. With this method, start-of-year values are compared to end-of-year values for each year of the annuity's term. Decreases in the index are ignored, and increases are locked in every year.

### How interest is credited to an IA

With some IAs, no interest is credited until the end of the term. With others, a percentage of the interest is vested or credited annually or periodically, which gradually increases as the end of the term nears. Further, some IAs pay simple interest while others pay compound interest. These features are important not only because they affect the amount of your return, but also because having interest vested or credited to your IA periodically instead of at the end of the term increases the likelihood that you'll receive at least some interest if the market thereafter declines.

**Caution:** Many IAs have surrender charges, which can be a percentage of the amount withdrawn or a reduction in the interest rate. Further, withdrawals from tax-deferred annuities before age 59½ may be subject to a 10% penalty.

### Interest rate cap

Some IAs put an upper limit on the interest rate the annuity will earn. Say, for example, that an IA has an interest rate cap of 6%. If the gain in the index is 7% and the participation rate is 90%, the interest rate will be 6% — not 6.3%.

### Asset fee/spread/margin

Some IAs charge an asset fee, also known as spread or margin, which is a percentage that is deducted from the interest rate. The asset fee may replace the participation rate or it may be added to it. For example, if the gain in the index is 7%, the interest rate on an IA with an asset fee of 2% will be 5%. If there is also a 90% participation rate, the interest rate will be 4.5%.

### Questions to ask about an IA

- What is the minimum guaranteed\* interest rate?
- What is the participation rate?
- What is the indexing method? How does it work? Is there an interest rate cap?
- Is there an asset fee/spread/margin? Is it in addition to or instead of a participation rate?
- What is the term?
- When is interest credited or vested? Is interest compounded?
- What are the surrender charges? Are there penalties for partial withdrawals?

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## IMPORTANT DISCLOSURES

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