Making The Case for Fixed Indexed Annuities

By Editor Test *Tue, Aug 24, 2010*

Jack Marrion and friends offer hard evidence that FIAs pay off when other investments don't. Their analysis is compelling, but I'm not ready to convert.

Champions of fixed indexed annuities, those quirky, complex and controversial niche products that were introduced in the mid-1990s, have had cause for celebration in 2010.

FIA advocates frustrated the Security and Exchange Commission's clumsy attempt to regulate them. And they saw FIA sales soar to $8.2 billion in the second quarter, up 22% from the first quarter, as investors looked for an alternative to volatile equities and low-yielding bonds.

One of the most ardent and steadfast champions of fixed index annuities, which are structured insurance products consisting of bonds with a dash of equity derivatives, has been Jack Marrion, a St. Louis-based consultant and self-published author of "Indexed Annuities: Protection and Performance" and, more recently, "Change Buyer Behavior and Sell More Annuities."

Earlier this year, he collaborated with David Babbel, a professor at the Wharton School and Geoffrey VanDerPal, chief investment officer of Skyline Capital Management, in scholarly defense of the products. Anyone interested in these products should check it out.

The charts in their study, Real World Index Annuity Returns, show that, based on data from 15 FIA issuers, FIAs outperformed conventional investments during much of the past 10 years —a paradoxical period when the S&P500's cumulative return has been roughly zero.

From 1997 through 2007, they say, the five-year annualized returns for FIAs averaged 5.79%, compared to 5.39% for taxable bond funds and 4.73% for fixed annuities. From April 1995 through 2009, FIAs beat the S&P 500 over 67% of the time and a 50/50 mix of one-year Treasury Bills and the S&P 500 79% of the time.

During eight five-year periods starting in 1997 through 2004, their data shows, the FIAs they looked at offered an average annualized return of 4.19% to 9.19%, with no negative years. By contrast, an investor in the S&P500 would have seen four positive five-year periods and four negative ones.

How do FIAs maintain such an apparently even keel? In a bad equity markets, their substantial bond component offers downside protection. In rising equity markets, their equity option component increases in value. Investors in FIAs therefore don't need to fear the bears and aren't as slavishly dependent on the bulls. Or, as the authors put it:

"By eliminating the prejudicial effects occasioned by significant stock market declines, and locking in returns annually or biannually, there is less of a need to try and capture large upside market swings to recover from the declines."

Besides insulating investors from volatility, Marrion and his co-authors say, FIAs do, contrary to certain media reports, offer liquidity (penalty-free withdrawals of at least 10% a year) as well as tax-deferred compound growth. (They don't mention, because it's not part of their argument, that many FIAs now offer the kind of lifetime income riders that variable annuities offer.)

In sum, the paper sets out to prove—by demonstrating the past performance of specific products—that FIAs as a concept don't deserve the smear-treatment that certain tabloid-TV investigators, plaintiff's attorneys and prosecutors, or past SEC commissioners have given them. And it does a compelling job of that.

So why then, as Marrion himself notes on his website, does the index annuity industry continue to "lose the media battle"? The FIA industry would probably argue that the media is biased in favor of the securities industry. But Marrion doesn't necessarily agree. In fact, he chides the FIA industry for failing to educate the media properly.

But there may be a more fundamental reason, one that's described in the last paragraph of Marrion, Babbel and VanDerPal's paper. I'm not referring to big FIA commissions, or long surrender periods, or the lack of transparency, or the unfamiliarity of derivatives, or the bonuses that inevitably confuse the average innumerate American.

The problem is that a contract's crediting method—the formula that determines how much the investor earns—can change each year at the whim of the issuer.

"Over 95% of index annuity sales are in products that may change at least one element of their interest crediting methodology after each reset period," the paper says. "The ultimate determining factor in setting index participation in future years is not the interest rate environment or the cost of options, it is what carrier management decides to do. This human element introduces a random variable that cannot be quantified, thereby making any attempt to project any returns ultimately subjective."

Unless I misread that passage, it seems reasonable to wonder why any advisor or trusted agent would advise a truly risk-averse investor—the target market for FIAs—to invest in something so unpredictable.