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Take note of warning signs

Popular equity-indexed annuities carry risks

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Penny-pinching savers need to tread carefully when considering any financial investment. And this advice certainly holds true when evaluating an increasingly popular investment tool called "equity-indexed annuities."

The investment, generally sold by insurance brokers, hit its 11th record year of participation with \$27.3 billion in EIA sales in 2005, according to Advantage Compendium, a St. Louis-based research and consulting firm. These investments are often pitched to senior citizens through advertised offers of free steak dinners at local restaurants, where the attendees hear a presentation for EIAs by a local insurance broker. Promoters say the investment's benefits include guaranteed payouts higher than what certificates of deposit offer, tax-deferred income and no fees.

Here's [a general explanation of] how they work: An insurance company takes the investment and agrees to pay a return that is based on changes in an equity index, such as the S&P 500. It guarantees a minimum return. At the end of the annuity term, the investor receives either a lump-sum payment or installation payments, depending on the contract.

Some finance professionals tout equity-indexed annuities as the best investment for senior citizens trying to protect their assets while investing in the stock market.

Other retirement planners, such as Burk Rosenthal of Fort Worth, say they're a poor investment.

"We looked at equity-indexed annuities a few years ago, and the commission (for the sellers) was about the only thing attractive about them," said Rosenthal, president of Rosenthal Retirement Planning. "We couldn't find anything good for our clients."

The National Association of Securities Dealers issued an investor alert last year discussing the potential downsides of EIAs: An investor who cancels an annuity contract can lose the minimum-return guarantee, lose interest payments and be forced to pay surrender charges.

"Don't believe anyone who tells you it's a risk-free investment," said Elisse Walter, executive vice president of regulatory policy and procedures for the NASD. "We're not saying it's a bad product, but it has to be appropriate for the consumer."

What's an investor to do?

One step should be to consider how the investment is regulated.

Although variable annuities are regulated as securities by the Securities and Exchange Commission and the NASD, equity-indexed annuities do not fall under that protection.

Instead, they are under the purview of state insurance commissioners.

Insurance regulators and industry analysts agree that the investments are complex – no two are alike of the more than 100 options – and there are some abusive practices among sellers.

Compared with other states, Texas provides few consumer protections for buyers of EIAs.

“There is abuse out there,” said Jim Poolman, chairman of the life insurance and annuity committee for the National Association of Insurance Commissioners and the insurance commissioner of North Dakota. “We want to make sure we have the proper regulations in place to stop abuses and bring abusers into compliance and punishment.” To that end, three years ago the NAIC approved suitability standards for annuity transfer for consumers more than 60 years old, Poolman said. “That’s where the most abuse has happened,” he said. The standards give commissioners “the hammer to go after agents, brokers or companies that make sales that are unsuitable.” Last December, the NAIC standards were expanded to include all ages, Poolman said. So far, about two dozen states have adopted the standards he said. Texas is not one of them.

“It’s a legislative matter,” said Jerry Hagirs, spokesman for the Texas Department of Insurance. Consumers who have complaints about their EIA can call the department’s consumer hot line at (800) 252- 3439 to learn how to file a complaint.

Poolman and Jack Marrion, president of Advantage Compendium, have these recommendations for investors considering an EIA:

Ask about all risks with the product. “Be aware of the products’ downside,” Poolman said. “Some agents will sell only on the benefits.”

Ask agents to disclose every fee. Fees vary by product and company. “These can be high-commissioned products,” Poolman said. “A dishonest person out to make a bundle may get people in who may not be suitable for the investment.”

Ask about surrender periods and charges. “EIAs should be considered long-term investments – 10 years, on average. Getting out early may mean penalties of up to 20 percent of the amount withdrawn,” Poolman said. “The biggest complaint of all annuities is people don’t understand the surrender periods,” Marrion said. “The insurance industry is not doing a good job of explaining the surrender charges.”

Check for tax consequences. The Texas Department of Insurance warns that the federal tax code includes an added 10 percent penalty for annuity withdrawals by individuals under 59 ½ years old.

Understand the product before you invest. “There are some products out there that I don’t think anybody can understand,” Marrion said.

“If the consumer can’t understand it, don’t buy it.”

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[Many Equity Index Annuities (“EIAs”) are designed for long-term investing and have long vesting periods. Growth may not be realized prior to fulfillment of the vesting period. Earnings are taxable as ordinary income when withdrawn. Guarantees are based on the claims paying ability of the issuing company. Investors cannot invest directly in these indexes.]

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