The Safety Trap

INDEX ANNUITIES Promise You’ll Share in the Upside of Stocks With No Downside. They Sound Like a Retiree’s Dream. The Reality Can Be a Lot More Painful.

By LISA GIBBS

This card that landed in mailboxes throughout central Illinois in early 2008 promoted “the most informative retirement workshop you’ve ever attended.” Pinnacle Investment Advisors, which had four offices in the area, was offering discussions of Medicaid planning, IRAs, and tax-efficient income over lunch or dinner. But of Pinnacle owners Susan and Tom Cooper mention their grandchildren, his Vietnam service, and her Bible study group.

A group of seniors soon assembled at the riverfront Embassy Suites in East Peoria to enjoy their free meal. There and in follow-up meetings, Susan and Tom, now 67 and 69, delivered a message that went something like this: Scared of stocks? They could help. Worried about outliving your money? They had a plan for that too. In fact, there was a product that offered the best of both worlds: returns that rise when stocks do yet are guaranteed to never be negative. And they were selling it.

Retired librarian Ruth Cline attended one of the Cooper’s seminars and liked what she heard. In 2008, when she was 71, she bought what they were recommending: an indexed deferred annuity. Often referred to simply as an index annuity, it pays interest that’s linked to the performance of a given investment index.

In fact, this was the second time Cline had bought one. The Cooper’s had sold her another six years before—and then advised her to move out of it and into the new version. The switch slammed Cline with an early-withdrawal penalty of 16% of her $38,000 account balance, according to court papers filed by the State of Illinois. Illinois’s securities division is now pursuing a case against Pinnacle, alleging that it moved Cline and 14 other people into new index annuities they didn’t need, costing the clients $208,000 in surrender fees and earning the firm $126,000.
WHAT TO AVOID

A MONEY investigation reveals why the problems with this controversial product persist—and what you need to know to protect yourself or your parents. Such knowledge is essential because buyers who have gotten a bad deal often don’t realize it.

When Illinois lawyer Finnigan summoned Cline and the other alleged pinch victims to the stand in Ostrowski’s lawsuit, he didn’t seem to understand why the Coopers were being accused of wrongdoing. Wasn’t Cline concerned about paying some $16,000 in penalties, Finnigan asked? “No,” she said. “Money I haven’t seen doesn’t affect me. Gasoline this morning was $2.87 a gallon. That I can comprehend.”

You Can Do Much Better

You may be familiar with a traditional deferred fixed annuity, in which an insurance company invests your money during an “accumulation period” of seven years or so, then lets you convert your account into a stream of income payments that are guaranteed by the company. An index annuity is essentially a fixed annuity that’s been juiced up by tying the interest rate to the performance of a stock market index such as the S&P 500. (See “Annuities 101” on page 141.)

If the index rises, the insurer exercises stock options it has bought against that index, and your account earns some percentage of the gain. If the index falls, you lose nothing: The insurer lets the options expire and still makes money from bond investments (where it has put the bulk of your money). The promise of zero losses led shell-shocked investors to pour some $30 billion into index annuities in 2009, even as they realized just 11% of annuity sales.

In senior-heavy Florida, it was 55% of complaints. “When you have a market incentive to sell, sell, sell, why would anyone be surprised that there are all sorts of abuses?” says Birny Birnbaum, a former consumer representative to the National Association of Insurance Commissioners (NAIC), who worked with New York’s insurance department to craft a new requirement that agents disclose compensation.

These expenses—plus the fact that you don’t benefit from dividends in an index annuity as you would in stocks or a stock fund—put a major drag on returns. For the five years ended in September, the average index annuity paid an annualized 3.83%, barely better than the 3.81% you would have earned in a five-year CD and appreciably worse than the 5.1% paid by taxable bond funds, according to the research firm Advantage Compendium. A typical index annuity would have lagged an investment portfolio of dividend stocks by a full 15% over the past five years due to the low interest-rate environ.

Sellers often tout the fact that money in index annuities grows tax-deferred. But 58% of buyers held these products in tax-deferred accounts such as IRAs anyway, according to industry researcher LIMRA. Even if you had held Reichenstein’s conservative portfolio outside a tax-favored account and were in the highest 35% income tax bracket, after the IRS took its cut you would have benefited from the index annuity in 94 of 100 rolling 10-year periods, assuming you used low-cost Vanguard funds with current expenses.

Insurance regulators have been saying that index annuities offer benefits that most investment products don’t. One is the option to annuitize the payout, thereby getting guaranteed income for life—increasingly a more valuable feature to buyers than potential returns, according to Gary Bhujwani, CIO of market leader Allianz Life. Another benefit is irrevocable safety. Annuity buyers are willing to trade off a higher return, he says, for the guarantee of never experiencing a negative one. “None of our customers have lost a penny of principal,” Bhujwani adds.

However, there are other ways of getting guaranteed lifetime income (more on that later). And PDC-insured CDs—or Treasuries held to maturity—provide equivalent or better safety. “The costs and onerous terms of an index annuity aren’t enough to compensate for the minimal extra return you get over a CD,” says financial planner Charles Fitzgarrald, a director of the Financial Planning Association of Florida.

Moreover, you can lose principal in an index annuity—lots of it—if you cash out too soon.

Surrender Fees Are Huge

Virtually all annuities impose penalties if you exit early, to recoup commissions and other costs that the insurer pays upfront. But index annuities carry the steepest and longest-lasting one: an average of 12.5% to start, compared with 7.5% for the typical plain-vanilla fixed annuity, declining gradually for up to 16 years.

Josephine Passanisi, a retired small-business owner
from the suburbs of Palm Beach, Fla., says she learned about such penalties too late. In 2006, when she was 70, she gave away 
$275,000—most of her life savings—to invest in an Allianz index annuity. (Like the vast majority of
generals who sell these products, Krakow was independent—that is, he earned a commission from the insurer 
but was not an employee.)

Passananti says Krakow never explained that she was 
locking up her money for 15 years, until she was 85; she 
ever wanted to do that. To get it back, she’d pay a 12.5% 
penalty. “He told me I’d be able to sleep at night,” 
Passananti says. “But I couldn’t sleep nights anymore.”

After she complained to the State of Florida, regu-
lators suspended Krakow’s license; in 2008, Allianz 
refunded her money in full. However, PASSENGER notes that 
Passananti understood the terms and was fine with her 
purchase until a compelling agent started criticizing it.

Insurers say that index annuities are meant to be held 
for the long haul. With the wave of complaints 
like Passananti’s, they have added provisions to most new 
index annuities that allow you to take out up to 100% 
of your money penalty-free if you are diagnosed with a 
terminal illness or enter a nursing home. (Some states 
also cap surrender charges, usually at around 10%.) 
That’s a positive step but doesn’t go far enough, says 
Brenda Cude, a consumer economics professor at the 
University of Georgia. How many index annuity owners wind up paying early withdrawal penalties? No industry statistics exist. But 
Karrel Kit, a personal finance professor at the 
University of Texas and a consumer representative for the 
NAIC, says that a look at insurers’ books implies the 
numbers are significant. For example, in 2009 American 
Equity Investment Life, which does 92% of its business 
in index annuities, collected $83 million in surrender 
penalties—equal to more than half its $101 million 
operating income.

Bonuses Can Cost You

Part of what sold Passananti on her annuity, she says, was 
that Krakow told her she’d get a $27,500 upfront 
bono. Roughly half of index annuities offer such bo-
nuses, usually totaling 5% to 10% of the amount you put 
in, as a way to encourage people to buy.

But “bonuses are never free,” says Jack Marriion of 
Advantage Companionship. They always come with trade-
offs such as higher surrender fees or lower caps on re-
turns, he says. And you typically have to satisfy certain 
requirements—such as refraining from cashing out 
early—or you forfeit all or a portion of the bonus. You 
might get diged even more than the bonus amount (see 
the chart on page 144).

There Are Too Many Moving Parts

Index annuities come with mind-boggling permutations. 
Not only can you split your money among as many as 
six different indexes, but you can choose among several interest-
calculation formulas. For example, you can base your rate on the year-
to-date change in each index (sub-
ject to a cap). Or you can have your rate 
calculated monthly (with dif-
ferent caps) and added together. 

With certain products, you can let 
one part of the money earn a fixed 
rate the first year and another rate 
through the eighth year.

Why so complicated? Says John 
Currier, an executive at Aviva, the second-largest index 
annuity seller: “Customers like choice.” But Kit believes 
index annuities are confusing by design. “Consumers don’t 
have the sophistication to understand them,” she says.

Even some large insurers aren’t fans. MetLife and 
New York Life say index annuities’ complexity is one reason 
they decided not to sell them. “With all of the moving parts 
that affect how these products ultimately perform,” says 
John Meyer, who runs the individual annuities division for 
New York Life, “we felt there was a high likelihood that 
clients could misunderstand what they were getting and possibly 
end up being disappointed.”

Executives at the major index annuity sellers, including 
Allianz’s Shopfro, say that in recent years their compa-
nies have improved the way index annuities get explained 
to buyers. Bhojwani adds, “Specialists call customers 
older than 75 to make sure they understand everything 
they’ve bought.” (Buyers can cancel the deal within a cer-
tain number of days that varies by state.)

Celnina and Alberto Grubicy, a retired couple from 
Vero Beach, Fla., were too young to have gotten such a call. 
In 2007, when Celnina was 66 and Alberto 65, they bought 
two Allianz index annuities totaling $1.1 million from agent 
Mitchell Storfer. The terms of each annuity were spelled 
out in the contract, but “the contract [might as well have 
been written in] Chinese,” says Celnina. “So we relied on 
what the agent told us.”

One of the things Storfer did, according to Florida regu-
lators, was misrepresent the interest-rate calculation, 
leaving the Grubicy’s to believe that they could earn more 
than they actually could—up to 16% a year, the couple says.

After investigating the Grubicy case and two more like it, 
Florida revoked Storfer’s license to sell insurance products. 
Storfer, who is appealing (the state is allowing him to sell 
to people under 55), denies wrongdoing, says that he did 
not explain the terms correctly and that the Grubicy’s signed 
forms saying they understood them. Allianz refunded the 
Grubicy’s money.

Stories like these aren’t unusual, says Kit, because the 
even the agents themselves often don’t understand how 
index annuities work. In Arizona, 33% of index annuity 
complaints in 2008 and 2009 claimed agents “misrepre-
sented” the product—whether owing to honest mistakes 
or fraud. Most insurers offer training in index annuities 
but don’t require the agents to complete it. (Some states 
do mandate training, as do a few insurers. For example, 
Allianz began requiring it in 2008 after a spate of lawsuits.)

And though most states have continuing-education 
requirements for agents, “most of it is about how to sell, not 
how the products work,” says Tony Babu, a former agent 
who evaluates annuities contracts for consumers for a fee.

Commissions Are Sky-High

An agent can make nearly twice the commission from an index annuity than from a plain-vanilla one—an average of 6.8% vs. 3.5%, reports Advantage Companionship and 
Beacon Research. And there are often extra incentives on top 
of that. Allianz offers a performance point over 
its standard 7% if agents meet certain sales targets, plus it

Annuities

Traditionally, deferred annuities are fixed rate, since the performance of at least one stock market index. A cap (currently around 4.5%) limits how much you can earn each year. When you cash out, your account value is compared with a guaranteed minimum (usu-
ally 85% of your premium plus interest), which is paid to you in cash. The worst-case scenario is that you lose money. Bottom line: Money left in a deferred fixed annuity is generally worse than a savings account, but still better than most other investments.

Variable annuity

How it works: An insurance company invests your money in bonds, creating a contract with a fixed amount of the interest. After a holding period, you have the option of receiving a guaranteed maturity sum for life. Bottom line: Money usually doesn’t recommend these products, in part because they tend to carry high surrender charges.

Immediate annuity

How it works: A fixed annuity with no deferred period. It starts paying interest the day you agree to your minimum investment. Bottom line: Rising interest rates make these more attractive.

Indeterminate annuity

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Early Withdrawals Can Really Cost You

If you take your money out before a decade or so, you may lose your bonus, plus pay fees that can eat into your principal. Here’s how the math works for one typical index annuity tied to the S&P 500.

<table>
<thead>
<tr>
<th>Year</th>
<th>Bonus</th>
<th>Penalty</th>
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<tr>
<td>10 Yrs</td>
<td>$146,500</td>
<td>$3,900</td>
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<tr>
<td>5 Yrs</td>
<td>$114,000</td>
<td>$2,530</td>
</tr>
<tr>
<td>1 Yr</td>
<td>$92,500</td>
<td>$1,190</td>
</tr>
</tbody>
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NOTE: Based on an annuity contract tied to the S&P 500. With this annuity your bonus could have increased to $160,000 if your index reached 200 percent of the contract value at the end of the 10th year.

of the 80 marketing firms it works with, says that it recently installed “suitability officers” at each of those nine firms to ensure agents’ sales methods are proper.

Regulatory Fixes? Don’t Hold Your Breath

The chorus of complaints about index annuities has led the SEC to try to reclassify them as investments. While such a change probably wouldn’t result in major reform, it would offer buyers stronger protections from fraud and conflicts of interest.

But when details of last year’s massive financial reform bill were being hammered out, Democratic Sen. Tom Harkin of Iowa made an amendment affirming that index annuities are not securities—and therefore are out of the SEC’s reach. Harkin is from Iowa, home of big index annuity sellers. “The assumption that the SEC is inherently better suited to regulate index annuities is incorrect,” says Harkin.

To bolster his case, he points to the latest anniversary suitability legislation drafted by the NAIC last year. It would strengthen the case for insuring sellers fairly and to train agents—requiring, for example, product-specific training and adding a one-time-four-hour anniversary course.

Consumer advocates who had wanted twice as much annuity education, say that the legislation doesn’t go far enough. And Birnbaum contends that it doesn’t address the core problem: restrictions. “If we ignore the financial incentives and instead layer on a bunch of vague responsibilities,” he says, “we’re not getting at the fundamental issue.”

What’s more, the states still need to pass the proposal before its provisions take effect. Making that happen is “my No. 1 goal,” says Iowa insurance commissioner Susan Voss, the incoming NAIC president. If history is any guide, though, it will be a long wait. According to the NAIC, as of April 1, it still had not passed 2003 and 2006 versions of the law.

A Better Alternative

If you or your parents are about to retire and find the benefits of an index annuity appealing—namely, a safe return with some upside if the market does well, plus the ability to generate income—you can easily put together a portfolio that gives you those benefits without all the negatives, financial planners say.

For equivalent safety, Baylor’s Reichenstein suggests putting 85% of your money into PIMCO-insured bank CDs (see page 178 for those paying the best interest rates) and 15% in a low-cost, diversified mutual fund in Vanguard 500 Index Fund (VFINX). “There’s never been even a three-year period since 1957 where this portfolio has lost money,” he says.

And when you’re ready to receive income, you might turn to an immediate annuity. You hand over a lump sum and right away this product starts paying a fixed, guaranteed amount each month for as long as you live.

Because you give up control of that money for good, limit the money you put in. MONEY contributor Walter Updegrave suggests that you put in just enough so that the income the annuity throws off—for income from your pension and Social Security—is sufficient to cover all or most of your basic living expenses. Keep the rest of your money invested in a diversified portfolio. This strategy can give you more for your money than you could get from an index annuity.

To shop for an immediate annuity that pays you the most income, go to moneycentral.msn.com. For example, at Mutual of Omaha, $100,000 could buy a 65-year-old male $641 a month.

Unfortunately, that advice comes a little late for Ruth Cline. Even if Illinois wins its case against Pinnacle—a ruling isn’t expected before spring—it’s unclear whether she would get her surrender fees refunded. Her best shot at coming out ahead: Choose to collect her money as monthly payments for a life— and live a very long time.