

Index Annuities: Looking Under The Hood

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**Financial Planning Association
of Northern VA**
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1

Index Annuities are-

- Very popular
- Complicated – sometimes incredibly so
- Controversial
- What we'll be doing in this session...

Index Annuities are *Fixed* Annuities

- They guarantee principal, *except to the extent of surrender charges*
- They guarantee a minimum rate of interest
- Their contract value does not depend upon the performance of a separate account.

How Insurers Invest Index Annuity Premiums

- They don't "buy the index". Why?
 - You can't buy the index
 - They don't even buy a proxy of that index. Why?
 - Because they must back the **guarantees**
- They first buy **bonds** – to back the guarantees
- With whatever is left over, they buy **call options** on the index.

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4

Example (10 Yr Term End Point)

- \$1 of index annuity premium received
- Cost of covering guarantee
 - 2% on 90% of premium = \$1.097 EOY 10
 - If 10 yr bond yield = 3%, buy \$0.74 bond now
 - Expenses =10 cents, 16 cents left to buy option
 - If \$1 10 year option on index =16 cents, can offer 100% participation in index gain
 - If index gains 100% in 10 years, credit 100% interest
 - If \$1 10 year option costs 25 cents, buy \$0.64 option
 - If index gains 100% in 10 years, credit 64% interest

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5

It's not that simple, of course

- The option markets don't work *quite* that way.
- Most index annuities sold today aren't 10 year "Term End Point", but "Annual Reset".
- So the option purchases and their timing would be different for an Annual Reset.
- But the basic strategy is the same:
 - Cover the guarantees first
 - Spend what's left over to buy options

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6

Is it possible for an index annuity to give *more* than 100% participation?

- Yes! If, given the previous facts, a full \$1 option cost only 12 cents, 16 cents would buy 133% of the growth of the index on \$1

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7

- If the index grew by 100% in 10 yrs and the annuity paid 75% interest, did the insurer keep the other 25%?
- No. Assuming reasonable pricing, the insurer would have bought only a 75% option. Why?
- Because there weren't enough "option pennies" left after bond purchase to buy more.
- Does this mean that bond and option prices affect the amount of index gain an annuity will credit?
- Yes. We'll see how. First, let's look at the "moving parts" that determine interest crediting

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8

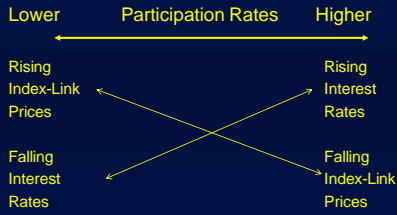
Index Annuity "Moving Parts"

- Participation Rate
- Yield Spread
- Cap Rate
 - Interest Rate Cap
 - Index Rate Cap

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9

Why Caps & Rates Go Up & Down



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10

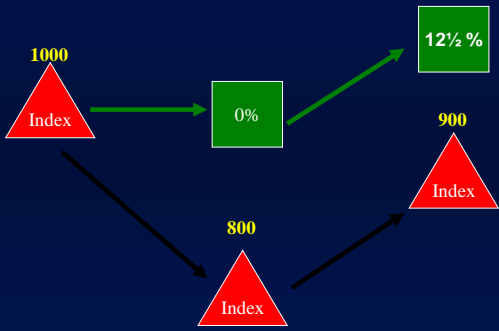
Averaging

- Reduces risk of loss from late-in-year or late-in-term decline
- Tends to "smooth out" volatility
- Moves credited return toward Average

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11

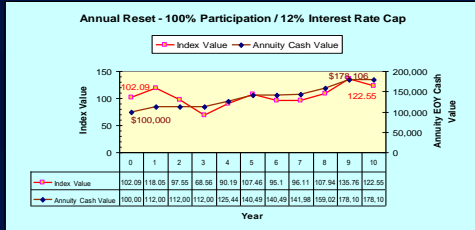
Annual Reset "Fresh Start"



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12

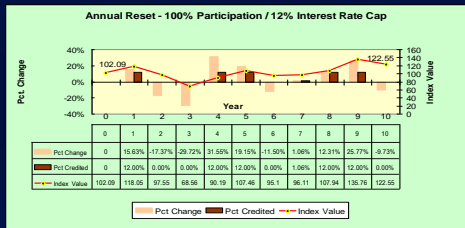
Annual Reset Index Annuity



Actual S&P500 values 12/31/71/ - 12/31/81
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13

Annual Reset Index Annuity



Actual S&P500 values 12/31/71/ - 12/31/81
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14

Term End Point Index Annuity

- Interest calculated *and credited* at *End of Term Period*
- Buyer cannot know value until end of Term Period.
- May offer higher participation rate and/or "cap" than Annual Reset.

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15

Other Factors To Consider When Evaluating An Indexed Annuity

- What's the value of the contract?
 - "Cash value"
 - "Accumulation Value"
 - "Annuitization Value"
 - "Surrender Value"
 - Market Value Adjustment (MVA)
- "Bonus" Interest – When is it forfeitable?
- Surrender Charges – When are they waived?

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16

Myths About Index Annuities

- "The insurance company keeps the dividends from stocks in the index"
- "It pays only *some* of the index gain and keeps the rest"
- "The buyer gets the *upside* of 'the market' with *no risk*"
- A low *guaranteed* interest rate is worse for the buyer than a higher one.

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17

Questions?

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18

For more information..

• Annuities in General

- Olsen & Kitces, *The Annuity Advisor* (National Underwriter Co., 2nd ed., 2009)
- Olsen, John, "Annuities and Suitability: Reflections on the State of the Debate", *Journal of Financial Service Professionals*, November, 2006
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- VanderPal, Marrion & Babbel, "Real World Index Annuity Returns", *Journal of Financial Planning*, March, 2011
- Huebscher, Robert, "Fantasy World Returns for Equity Index Annuities", www.advisorperspectives.com, May, 2011 – a rebuttal of VanderPal et. al.

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19
