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Downside Protection Has Its Downsides

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The Securities Exchange Commission (SEC) has been very critical of equity-indexed annuities (EIA). According to a June 25, 2008 Statement at Open Meeting on Equity-Indexed Annuities by SEC Chairman Christopher Cox, "And although the contract guarantees a minimum value, that's typically less than what the investor gives the insurance company in the first place."

According to the same Statement, surrender charges can be as high as 15% to 20% of the amounts invested and can last more than 15 years. If an investor needs the money sooner - for medical expenses or rent – they can be forced to forfeit a significant amount of the investment.

Caps are a wonderful thing…for the EIA issuer. According to the National Association of Fixed annuities the typical "cap" for these products is around 6%. Now matter how well the marker performs over the next 12 months, your return is limited to the "cap".

To provide some historical perspective, the 30-year average annual return (as of December 31, 2009) for U.S. large capitalization stocks (as defined by the S&P 500 Index) was 11.2%. Note: this includes the worst 10-year performance of the S&P 500 Index – ever.

To add insult to injury, the EIA issuer can reduce the "cap" at their discretion. They may reduce the "cap" just when the financial markets are ready to deliver better than average returns. Furthermore, many EIA remove dividends from their calculation of returns. Excluding dividends can reduce annual returns by 2% to 4% every year.

A well designed investment portfolio, without the use of EIA, can help you reach your financial goals. As President Franklin D. Roosevelt said, "The only thing we have to fear is fear itself."

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