Another fascinating and scintillating story "*Indexed Annuities Obscure Fees as Sellers Earn Trip to Disney*" written by Zeke Faux and Margaret Collins appeared on Bloomberg.com on January 20, 2011. This article, like so many that has preceded it, fails to do one thing that is so critical in the final analysis; "*With all thy getting, get understanding.*" (Malcolm Forbes.)

Please don't misunderstand me; this is a well written, very detailed, and heavily researched article. However, the article, like my response written here, is clearly biased. This response will not be as great a piece of "journalism" as the article certainly is because I will not fall into the trap of sensationalizing the points made within by dragging into the story a 72 year old woman* with trials and trepidations over purchases she made only to regret them in years to come. I am certain; of course, no investor in securities, equities, bonds, or even Government securities has ever made a decision they later regretted.

Despite my clear open-mindedness, much like Zeke's and Margaret's, I will not besmirch the simplicity of investing in the market. Clearly the *Alpha's*, the *Beta's*, the *Sharpe ratio*, *Geometric Averages*, *derivatives*, and *Standard deviations* to which they elude, not to mention, of course the *Capital Asset Pricing Model* used to measure the returns of what they insist on calling EIAs (Equity Indexed Annuities - a term abandoned by the industry about a decade ago) speak of the ultimate simplicity of market investing all by themselves.

Articles, such as this, want to compare, analyze, extrapolate, and drag into the discussion unhappy clients who claim to have been "misled" or not told about how these contracts function. Surely some misrepresenting or evasiveness can occur in some sales of this product, as is true with the sales of any product. Of course we all know that never occurs in the securities marketplace. This article even goes to the extreme of complaining about a "23-page packet explaining the terms" as being too complicated. It does make you wonder if these two investment Gurus have ever seen a prospectus, doesn't it?

The authors take issue with the compensation paid to the producers who find and secure the clients for the insurance companies. I often times am confused by this. If a producer sells a 10 year product with an 8% commission where the client does not have to pay the commission provided they keep the contract to the end of the term, this is a bad thing? Is it a better thing for a money manager charging a 1% fee and retaining the client for 8 years, or worse 10? And how about the fact the manager gets paid even if he looses the client's money, something we can't do contractually? Yes it is true the commissions paid to the producer are built into the product. But how is that any different than a mutual fund company selling no-load funds by purchasing full page advertisements in every major city newspaper in the country. No load? If they are no-load where is the money coming from to purchase millions and millions of dollars of advertising? And where does all the

* The article first introduces her as age 82 but this is clearly a typographical error(?) as later in the article we discover she was actually 72 when she made her original purchase.

money come from to pay the managers, the staff, and the cost of doing business? No Load? Truly, there is no such thing. And yes it is true, insurance companies can still offer incentives to their very best producers, like a trip to Disney, just like all the big investment houses used to do. This sounds an awful lot like sour grapes to me.

The difference between the investment world and the insurance world is vast. The insurance producer is selling a contract with guarantees backed by the assets of, hopefully, a well rated insurance company. The producer never touches the client's money, never takes a risk with that money and delivers a legally binding contract (some better than others) to their client. The producer gets paid once and it is never out of the client's money assuming the client meets the terms of the contract. Then, assuming they are a good producer, stays in touch and services that client for as long as they are in business. The "investment" guy sells historical data as hypothetical's - not to be relied on, because past performance is not an indicator of future performance. He uses asset allocation models, does his "due diligence" and then sells the same funds, or family of funds with which he or she has become familiar. Most clients get relatively the same portfolio as all the other clients with similar risk tolerance. For this the client pays a fee, out of their own money, forever. And with this there is no guarantee, no future promises to redeem even the investment let alone any gain.

All right, despite my reticence to do so, because I fear falling into the same trap many investment minded people fall into, I will attempt to dissect some of the numbers related to in the article that are available on the research paper from which they based their writing. The writers of the article complain that these **E**IAs, which are really just Fixed Annuities, had a geometric return of only 5.14 % based upon their long term analysis (going back to 1957 – more discussion on this point later) while 6 month bank Certificates of Deposit earned 6.20%. What they failed to add to this analysis is if the "investor" was in a 25% tax bracket the Geometric average return on the CDs would have only been 4.65% (using their numbers) and there is no mention of how today's "investor" may reduce or eliminate unnecessary taxes on their Social Security Income, investment income or increase their net after tax cash flow by eliminating taxes.

This is a valid point of discussion because "investing" should not be done in a vacuum. Tax considerations should not be made on a single investment without considering the client's other assets, their financial objectives, their goals, dreams, desires and wishes for heirs must always be considered. Investing is more about the people than it is the money. In addition, the impact one asset has to the whole and how they all work to drive the client's ability to absorb risk, absorb taxation, and achieve their ultimate objectives is often more critical than achieving the quintessential perfect investment with maximum return.

The writers do acknowledge the tax deferral of the annuity but only to ridicule that the gains are treated as ordinary income and not capital gains. Well, gee, it is interest that is paid on the principal it isn't capital gains…this is a fixed annuity, not an equity. And if you would stop calling it an Equity Indexed Annuity you may eventually stop making this mistake. Equities can produce capital gains (unless of course they are in a variable annuity-where they will be treated as ordinary income) but fixed guaranteed products do not produce capital gains they produce interest. This same mistake is not made by the authors when comparing to CDs because they completely ignore the tax deferral! These are very bright individuals who are writing this article, but when analyzing what they write I sometimes wonder if their intent is to intimidate and misdirect the audience rather than to inform.

Speaking of the analysis, the idea of comparing Indexed annuities to the actual returns of the S&P 500 going all the way back to 1957 is certainly alluring however it does not reflect the actual performance of the financial markets over the last fifteen years. This is the period of time Indexed annuities have been indexing to the S&P 500. The S&P 500 started out at 470.42 on January 2 1995. By December 1, 1999 the index was at 1469.25. Even with a few bad downturns during that period this was an incredible run. Indexed annuities performed extremely well, although the market with all of its risks certainly outperformed them as it should have. (However our "High Watermark Products", actually doubled our client's money over a five year period without any downside risk.) As the new millennium came forward, the market became incredibly volatile peaking on August 1, 2000 at 1517.68. Then it plunged. On Monday September 2, 2002 the index closed at 815.28. It is true our clients had two years of zero returns during this period, but not one of them lost a single dime of principal or any interest that had been credited. This is why clients appreciate what this product brings to the table, then and now.

Shouldn't an analysis take into consideration what an "investor" would have experienced throughout this period? Think of the emotional turmoil the client experiences through those times. Imagine seeing your hard earned savings plummet 46% in value. The article criticizes Fixed Indexed Annuities because of surrender charges; There is no annuity contract of which I am aware that has a 46% surrender charge. Who would want to put their good clients in a product like that? And interestingly enough, investment sales volume always manages to peak at that bottom. Right or wrong, educated, trained and fully aware of the principles of investing most people do not have the stomach for a 46% drop. Self preservation kicks in and many, if not most, investors and often "money managers" sell out, often at the worst possible time. The combination of fear and greed drive the market, not so with Fixed Indexed Annuities.

But the story continues: Over the next 5 years the market recovered climbing to a new peak of 1549.38 on October 1, 2007. What a great sigh of relief for those few that held on and didn't sell during the downturn and slow climb back. But in reality these clients took 5 years to get back to where they started. Fixed Indexed Annuities however never lost any of their original value and enjoyed 4% to 8% steady increases during this same period. But because they never lost value, they didn't have to climb all the way back from a 46% deficit in order to achieve additional gains! This is the beauty of locking in gains annually and preventing any losses of those gains.

Then to the disbelief of investors who had been investing since 1957, it happened again. From that high in October of 2007, the market dropped all the way down to 735.09 on February 2, 2009. In just 16 months the market crashed almost 47%, again. Not one of our indexed annuity clients lost a single dime this time either. Since then the market index has recovered to 1283.35. But those who were in the market over this period of time still have another 20% to go to get where they were already, twice!

Comparing indexed annuities to market performance since 1957 ignores the unprecedented "performance (or lack thereof) of recent times. Consumers don't relate to market performance in 1957, or 1987 for that matter. Consumers, who are the smart ones with the money to "invest" in the first place (not the PhD making the market analysis), relate more to recent memory and current financial circumstances. There are hundreds of articles written over the last decade talking about how these are unprecedented times in the financial markets and how the old philosophy and ways of investing should be adapted to recent events. Maybe, just maybe, many of the consumers purchasing indexed annuities intuitively sense they can't out smart the market with the "same old, same old" investment mentality the gurus continue to profess – even with their volumes of mathematical formulations.

The research article uses a "model contract" that has surrender charges for 14 years. This contract is no longer available for sale. (Our company never sold this particular "model" contract because there were provisions in the policy that were not client friendly.) If we actually compare the last 14 years, January 2, 1997 to December 31, 2011 the S&P 500 index investor would have received the equivalent of a 3.78% return. The return would have averaged 3.59 using 6 month Bank CD's, 3.30% using One Year Treasury Constant maturity notes, and 4.42% with an Annual Point-to-Point crediting method with a cap of 7% in an indexed annuity.

Now consider the tax-deferral. Which of the above investments have a guarantee return of principal? Which is tax deferred? Which has a guaranteed cost of surrender while you do not know what your cost of surrender might be on the other "investments"? In fact all of the above "investments with the exception of the S&P 500 investment is a "sleep-well-at-night" investment but only one of the above "sleep well at night" "investments" actually has a potential for a higher return as markets fluctuate.

Articles, such as this one, always seem to miss the point. Rather than "love" or "hate" any particular "investment" wouldn't it be wiser to understand where it is a useful tool and where it is not? Certainly we do not believe everyone should have all of their money in Fixed Indexed Annuities, nor do we believe everyone should have all of their money invested in any one particular "investment." The simple truth of the matter is all of these "investments" have their place in the market. All of these products have positives and negatives. All of these products can be used, misused and abused. The science in our business is to assist clients in recognizing where the tools we have to offer are appropriate and where they are not and then assist them with both their purchasing of the proper tools and in finding other professionals who focus on other products to assist them where their tools may be appropriate. Our prejudices do not make a good investments bad or vica-versa.

The biggest problem that exists in the battle between those who offer these products and those who don't is the recognition that these products have a valid and appropriate place within the market. If they didn't and consumers believed as these authors do, that these are bad and inferior products, we would have to assume all the people who purchased the hundreds of billions of dollars worth of fixed indexed annuities over the last decade were all either duped or stupid. We must also recognize as insurance and investment professionals we are not often in competition for the same dollars. Many if not most consumers understand some of there assets should be held dear while others should be at risk. Professionals need to understand this as well and not compete or sell product to the wrong dollar.

The truth is many consumers have the wisdom expressed here:

> *"What people want is both the assurance that they won't be poor and the hope that they will be rich.*
>
> *If you divide your portfolio into two baskets, one that is designed to keep you from being poor and the other that will give you a chance to be rich, then you're on your way."*

Meir Statman, Finance Professor
Santa Clara University, California
Wall Street Journal
September 8, 2002

We, us insurance guys and gals, appeal to the money for the basket where we can promise our clients that they won't be poor. Many of us do not have the capacity to deal in the world of hopes, dreams and fantasy. One of our most successful associates, Steve Kelley, has quoted the phrase "Its not planning until you eliminate the risk, it is hoping." Clearly many clients want both the security they will not be poor and the hope they may become rich and it is our responsibility, just like it is Zeke's and Margaret's, to assist clients in achieving their goals while reducing and eliminating unnecessary obstacles. Fixed Indexed Annuities are one excellent tool clients choose, by the billions.

Perhaps Zeke, Margaret and all those "investment gurus" could help themselves and their clients by listening to them and helping them to allocate whatever the proper amount of their resources may be into the basket that is designed to keep them from being poor by using some insurance products with guarantees. Recognition of the value of a product, concept or opportunity, which creates some hope but eliminates a client's worst fears, may promote far superior client relationships. Maybe it's not the product, silly, but the advice.

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S&P 500 historical data retrieved from:
http://finance.yahoo.com/q/hp?s=%5EGSPC&a=00&b=2&c=1997&d=00&e=24&f=2011&g=d
All investment data on bank CDs and treasury note are from the Federal Reserve Bank of St. Louis:
http://research.stlouisfed.org/fred2/series/GS1/downloaddata?cid=115
The index annuity performance numbers where calculated at http://GoFigureNow.com