What To Do In A Down Market

Equity Indexed-Annuities

by Bob Affronti

Since the introduction of equity indexed annuities (EIA's) several years ago, the U.S. stockmarket (as defined by the S&P Index for our purposes) has shown positive results up until about 18 months ago. Over this time frame (as of this writing on 12/13/01) the market is down 27% from its peak of 1527 in March of 2000. Now is a good time to ask, "How have EIA's performed during a down market?" The answer lies in the crediting method of each particular EIA product. Essentially, there are three different methods EIAs use to credit interest.

1. **Full term point-to-point**
2. **High-water mark look back**
3. **Annual reset**

Within each of these methods, we also have other provisions, such as daily or monthly averaging, use of caps on interest, and spreads or margins, etc. I will ignore these aspects for now and address the three methods listed above. Each of these other aspects certainly has importance as to the results achieved, but the overall crediting method by far outweighs the question at hand.

Since my firm first started offering a choice of EIA products, I believed that the annual reset method was the only choice. Some actuaries and home office-marketing people challenged me on this. I had always agreed that the full term point-to-point had probably the best gain potential. But this method also contains a potential to give back past gains. Since the final results were not determined until the end of the initial term, any drops or reversals would directly affect account values. Investors would see account values drop with the market. This is a feature of a variable annuity. Investors in fixed annuities do not expect to actually lose money. They won't lose the initial principal they invested, but they can lose money previously credited to their accounts. To see years of growth wiped out or vastly diminished in a fixed product is not what I suspect the client had in mind.

Another scenario to consider is when the market drops before any gains have been credited. Depending on the percentage drop in the market, it may be advisable for the client to surrender the policy and start fresh. For example, if the market drops 20%, it requires a 25% recovery just to get back even.

1000 x .20 = 200
1000
- 200
800
800 x .25 = 200

Most EIA's issued as full term point-to-point products have surrender charges that are much lower than 20%. In essence, it costs 25% to stay in the product (i.e. the gain required to get back to even) versus perhaps 8% to surrender. When the market recovers the 25%, the client receives 25% on 92% of the initial investment or an account value of $115,000 on an initial $100,000. In this down market, I would imagine that investors subject to this method of crediting are looking at losses or being a few S&P points below their starting measure. It is safe to say this method does not fare well in a down market.

Somewhat less damaged, are EIA investors subject to the high-water mark look back method. Since account values are locked at their highest level as determined by an anniversary measurement, account values will not go down costing the investor money. However, before future earnings can be added, the market numbers must fully recover from any downturns. A high-water contract, which goes below the initial measuring number in its first year prior to locking a gain, faces the same dilemma as the point-to-point investor in that market. The loss must be fully recovered before a gain can be credited. Therefore, it may be better to surrender and start again. Please note that when I say "surrender," I mean that the policy would be exchanged (1035) for a different policy. We don't want to lose our original cost basis. The exchange would be subject to surrender charges.

The final method, the annual reset (ratchet) design, is not subject to the previously mentioned problems of a down market. Don't get me wrong; this method has other aspects, which can be viewed as negatives when compared to the first two methods. But, the annual reset feature may be the most important. Why? Think about holding a beach ball under water (as some portfolios are today). If we push it six inches below the surface, we get a slight rise as we let it go. If we submerge that ball five feet under, it will shoot to the surface. The market can be like that — large drops followed by large gains. If we don't suffer from the large losses because of the ratchet feature, we can be rewarded by any large gains due to the reset feature. In this method, a large loss in S&P points is probably better than a small loss. Using the first two methods, the S&P is also reset, but only when it rises. Using this method, the S&P resets either up or down.

Granted, that if the market goes up every year and you are in an EIA, the first two methods would probably produce a higher return. If that were the case, a pure mutual fund would certainly be a better choice. Investors choose EIAs rather than mutual funds for safety. In some way, they can participate in market growth without the normal risks associated with market-based investments.

EIA's are fixed annuities. I don't think fixed-annuity investors would like to see year's worth of growth reversed or wait on the sidelines while the market takes a few years to get back to where it was. Clients invest in EIAs because they are afraid that the market will go down. When all is said and done, if the market had no risk of going down, no one would buy an EIA. Since they invest in EIA's, they must be concerned about down markets. Why use an EIA that suffers damage in a down market knowing this? Some EIA renewals have recently been reset at very attractive (low) S&P levels. The lower the reset is, the more opportunity there is for growth.

Previously, I mentioned potentially negative aspects of the annual reset method. Perhaps, most obvious is the daily or monthly averaging of the S&P to arrive at an average S&P level that is compared to the beginning level at reset. More often than not, the average will produce a lower return in an up year than a non-averaging method. However, in some years, the average may out perform the full year numbers. But it can't go backwards or freeze the account during recovery.

Now that we have seen that the market can also go down, EIA investors can see why they were willing to give up some of the upside to protect the downside. Many agents I work with tell me wonderful stories of senior clients who fled the equity markets, locked in gains and purchased EIAs. They are now waiting for the upturn, which will produce further gains for them, not just a recovery to previous levels. The use of EIA's has allowed their owners to sleep soundly during the market downturn. The EIA provided exactly the protection investors wanted. ❑

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