

Indexed Annuities and Dividends

What Security Brokers Don't Want Your Clients to Know

Security brokers and the media who write for them make a lot of noise about the fact that fixed indexed annuities do not pay dividends. NAFA, the National Association for Fixed Annuities, thought a reality check might be helpful with an explanation the tradeoff between annuity benefits and paying dividends and why paying dividends would cause your clients to lose more than they would gain.

Currently, no Fixed Indexed Annuity (FIA) explicitly incorporates dividends into the calculation of interest credits. It is probably safe to say that since this has been true for the past 15 years or so, the topic rarely comes up any more during the product development process, making the exclusion of dividends a de facto rule. But “that’s the way it’s always been done” is not a good explanation. There are in fact several consumer considerations why dividends are not and should not be explicitly included in FIA products.

First, there is **no free lunch**. Dividends *could* be included in FIA interest calculations. But if they were included, what would be the result? Insurance companies would simply have to pay more to deliver the dividends to you and the increased cost would result in lower crediting factors (i.e. caps, spreads, participation rates and fees). At the end of the day, the index return would be higher, but with a lower crediting factor. On average, the interest crediting remains neutral between a strategy that includes dividends and one that excludes them. In other words, the benefit of including dividends would be offset by lower credited interest.

The second consideration is one of **simplicity for the policyholder**. The inclusion of dividends would create a more complicated product. The interest crediting formula used by FIA products do not include dividends – 100% of the index gain limited to a maximum of 7% for example is easy enough math for most school children despite the opt-repeated of “complexity.” Ironically enough, those that lambast the FIA for not including dividends, in the same breath preach about the product’s “complexity.” This is obviously disingenuous because to include dividends, more formulas with more variables would need to be developed and incorporated into FIA policies. Would the dividends be reinvested? Would they simply be added to the return? Are index values with dividends re-invested readily available to most policyholders? Even if the extra complication is minimal, why include it when there is no financial benefit to the consumer?

And also, the practice provides **more efficiency for insurance companies**. Most companies hedge for index strategy credits by purchasing simple over-the-counter options or other financial instruments that do not reflect dividends. Including them would require the purchase of more exotic financial instruments, which would be more difficult to buy and sell, and likely more expensive as well.

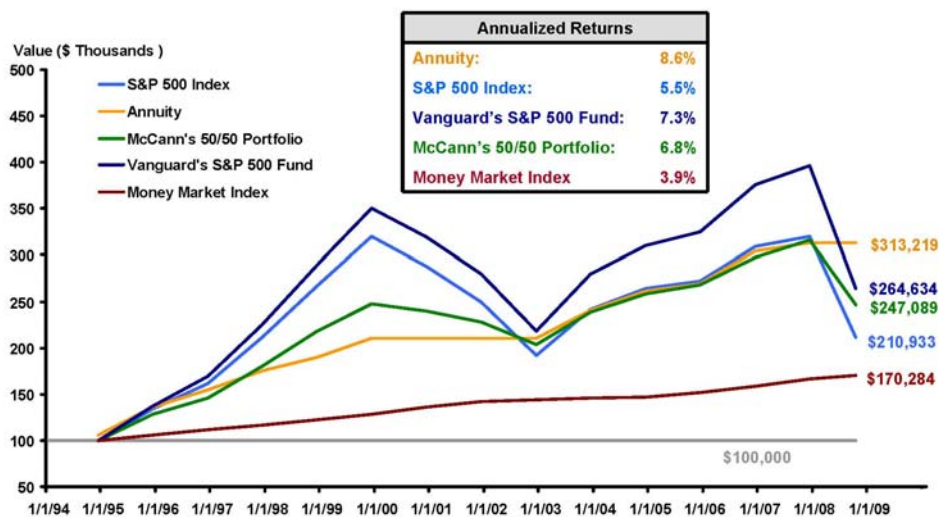
In the end, individuals should only purchase a fixed annuity when they desire to preserve and protect money from market downturns. This protection cannot and should not be

compared to investments, dividend producing or not, because indexed annuities are first and foremost insurance. How do you know if a fixed annuity is the right choice for your client's money? If they want a guarantee of minimum interest earnings and the opportunity for additional interest when the market is strong they should consider a fixed annuity. A fixed declared rate annuity will tell you how much additional interest you will earn in advance and for how long. A fixed indexed annuity will tell you how much additional interest you will earn based on the performance of an outside index (typically the S&P 500). What most media and detractors of indexed annuities don't know or fail to tell you is that most fixed indexed annuities offer a declared-rate option in addition to the indexed option and policyowners can put some or all of their account value at designated times during the contract. This is a great benefit for anyone who just wants to lock in a guaranteed interest rate or not at their discretion.

In short, the payment of dividends in a fixed annuity insurance contract is irrelevant because the interest earned without dividends or the interest earned plus the dividend will not likely have any positive or negative difference. But most importantly, your client's should purchase a fixed annuity for the guarantees and insurance protection with the added potential of modest additional interest¹.

14-yr Annuity v. Alternative Investments Value of \$100,000

1995



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18

Based on a report titled "Supermodels and the FIA" by David F. Babbel Professor of Insurance and Finance The Wharton School of Business University of Pennsylvania and Senior Advisor to CRA -Charles River Associates, November 11, 2008. Charts showing accumulation value of annuities and crediting rates derived from historical index returns are based on the assumptions of constant caps and participation rates. This assumption was adopted because it is the same as has been used by critics of annuities. Accumulation value of annuities and crediting rates derived from historical index returns may be higher or lower if caps and participation rates are not fixed. These charts are not projections of future annuity performance. The amount of upside participation in annuity crediting rates will depend, in part, on its cost, which is a function of interest rates and market volatility.