Indexed Annuity Magic: How Do They Do It?

September 7th, 2011 Article by Sheryl J. Moore

By Sheryl J. Moore AnnuityNews.com

One of the greatest mysteries in the indexed annuity market is how insurance companies are able to offer market-linked gains on an annuity with a principal protection feature. Many are familiar with the strong guarantees that fixed annuities offer, but it comes at the cost of low potential for gains. On the other hand, variable annuities provide unlimited potential for gains, but you must be willing to stomach unlimited risk to achieve it.

The indexed annuity is a unique gem amidst a pebble-lined beach – but how is this awesome feat accomplished? How can insurance companies offer purchasers market-linked interest without the risks associates with VAs and still afford to offer a guarantee? It is actually pretty amazing and extraordinarily simple to accomplish.

For comparison, let's explore what the insurer does with the purchaser's money when offering fixed annuities. When an annuity purchaser makes a premium payment into a fixed annuity, the insurance company turns around and uses that premium to purchase bonds. Generally, the bonds are high quality and they mature at the same time the surrender charges expire on the purchaser's annuity (i.e. I buy a 10-year surrender charge annuity and the insurance company then purchases 10-year Grade "A" bonds to cover my annuity's guarantees). This provides a relatively safe investment vehicle for the insurer to make enough interest off of in order to earn their spread/profit.

So, just for simplicity's sake, let's make the assumption that the bonds are paying 4 percent interest and the insurance company is crediting 3 percent interest on its fixed annuities. This means that the difference of 1 percent is what the insurance company is using to cover its expenses and anything that is left is its spread/profit. Makes sense, right?

OK, let's move over and apply this to indexed annuities: instead of putting 100 percent of the purchaser's premium payment in bonds, with an indexed annuity, the insurance company puts about 97 percent of the premium payment in bonds. (Some companies might use 96 percent, 98 percent, etc. of the premium payment; you get the idea!) The bond covers the indexed annuity's annual 0 percent floor, which protects the annuity purchaser from market losses. It also covers the minimum guaranteed surrender value, providing a return of premium plus interest to the beneficiaries in the event of death, in addition to providing the same benefit to the purchaser if the indexed crediting does not perform.

Now, let's get to the other 3 percent of the purchaser's premium payment, where the real magic happens: this portion of the purchaser's premium payment is used to purchase options. It is the options that provide the index-linked interest on indexed annuity contracts. Today, we might take that three cents of our one dollar to the options-seller and ask that he sell us an option for the S&P 500, using an annual point-to-point crediting method with a cap being used to limit the indexed interest. The option-seller might tell us that our three cents will buy our customers a cap of 3.85 percent which isn't so hot. Then again, the S&P 500 is relatively low right now.

However, if the market suddenly goes back up, and the S&P 500 returns to 1500 the next month, that option-seller will likely offer a much higher cap for our three cents. (After all, if it is already at 1500, what is the likelihood that the S&P 500 will increase tremendously over a one-year period?)

So there you have it, folks. No tarot cards, no voodoo dolls – just plain and simple math. And even though the logic behind indexed annuities is rather simple, it is magical nonetheless.