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## **Will Your EIA Clients Get Their Chocolate Chips?**

**By Mitch Maynard, Founder  
MCP Premium Software**

Expectations are a funny thing. My 14-year old daughter and I went to the frozen yogurt shop on a recent Friday afternoon after school. She asked me if she could get a topping that day because she had had a hard week filled with numerous tests and homework. (It is our custom not to get a topping because moderation is a key to calorie management.) I told her that it was okay and as my daughter saw her ordered filled, I could see her look of gleeful anticipation turn into disappointment. So where was this disappointment coming from? After all, she was getting the yogurt and chocolate chips as requested. It was because the amount of each was less than she had *expected*.

This story typifies the experience of many EIA purchasers. They purchased an EIA (perhaps because of a poor past experience with other accumulation vehicles) and expect a certain level of interest to be credited each year. Unfortunately, this is often not the case. This is not their fault; it is the fault of the agent who sold them the product. Customers base their expectations on the presentation their advisor delivers. If you are like most advisors, you probably focus on averaged annual returns over 10-year or longer time frames, and have never examined the short term. Let's face it, most customers who purchase an EIA and most advisors who sell them expect a positive return each time the S&P 500 has a positive return. However, if you sell an EIA with monthly averaging, daily averaging or monthly cap strategies, you would be wrong.

In Table 1 below, you will see that derivative crediting strategies (any strategy not based on a point-to-point measurement, (i.e., monthly averaging) have a higher incidence of negative returns — although, of course, the amount that would be credited to the EIA would be 0 percent.

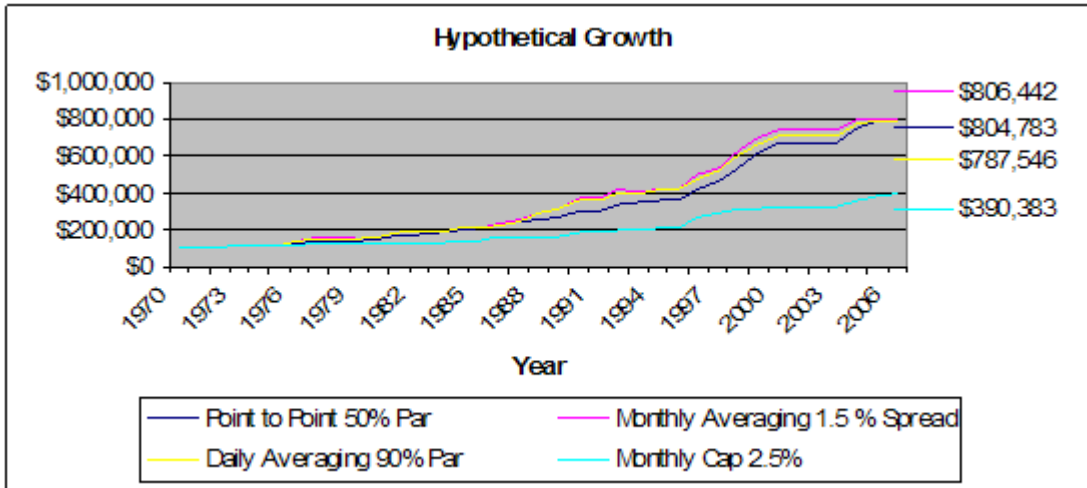
**Table 1: Annual Returns of Various Credit Methods**

	Point to Point	Monthly Averaging	Daily Averaging	Monthly Cap 2.5 %
1970	0.10 %	-9.36 %	-9.61 %	-13.79 %
1971	10.79 %	6.66 %	6.67 %	0.06 %
1972	15.63 %	7.53 %	6.87 %	11.75 %
1973	-17.37 %	-9.78 %	-8.95 %	-20.76 %
1974	-29.75 %	-16.47 %	-15.08 %	-46.04 %
1975	31.61 %	27.14 %	25.65 %	6.15 %
1976	19.15 %	13.97 %	13.08 %	4.27 %
1977	-11.50 %	-9.29 %	-8.60 %	-13.99 %
1978	1.06 %	0.38 %	1.06 %	-6.70 %
1979	12.31 %	7.50 %	7.13 %	2.07 %
1980	25.76 %	10.78 %	9.95 %	5.67 %
1981	-9.72 %	-5.83 %	-5.66 %	-14.12 %
1982	14.75 %	-1.86 %	-2.32 %	-4.80 %
1983	17.27 %	14.31 %	14.05 %	8.84 %
1984	1.41 %	-2.79 %	-2.69 %	-5.86 %
1985	26.33 %	12.99 %	11.66 %	8.67 %
1986	14.62 %	13.08 %	11.84 %	-2.36 %
1987	2.03 %	18.10 %	18.44 %	-15.75 %
1988	12.40 %	8.49 %	7.58 %	5.60 %
1989	27.25 %	17.50 %	16.26 %	10.57 %
1990	-6.56 %	-5.94 %	-5.29 %	-16.32 %
1991	26.31 %	15.54 %	13.87 %	6.80 %
1992	4.46 %	0.00 %	-0.32 %	2.37 %
1993	7.06 %	4.07 %	3.64 %	6.05 %
1994	-1.54 %	-1.24 %	-1.29 %	-3.68 %
1995	34.11 %	19.08 %	17.88 %	23.27 %
1996	20.26 %	9.57 %	8.82 %	10.50 %
1997	31.01 %	18.24 %	17.83 %	6.21 %
1998	26.67 %	12.10 %	11.80 %	1.82 %
1999	19.53 %	8.25 %	7.94 %	4.48 %
2000	-10.14 %	-3.37 %	-2.85 %	-20.06 %
2001	-13.04 %	-10.19 %	-9.51 %	-23.23 %
2002	-23.37 %	-13.89 %	-13.37 %	-34.88 %
2003	26.38 %	10.02 %	9.67 %	10.46 %
2004	8.99 %	1.98 %	1.68 %	6.78 %
2005	3.00 %	-0.36 %	-0.39 %	0.62 %
<b>Total Number of Negatives</b>	<b>9</b>	<b>14</b>	<b>14</b>	<b>15</b>
<b>Percent More Negatives</b>		<b>55.56 %</b>	<b>55.56 %</b>	<b>66.67 %</b>

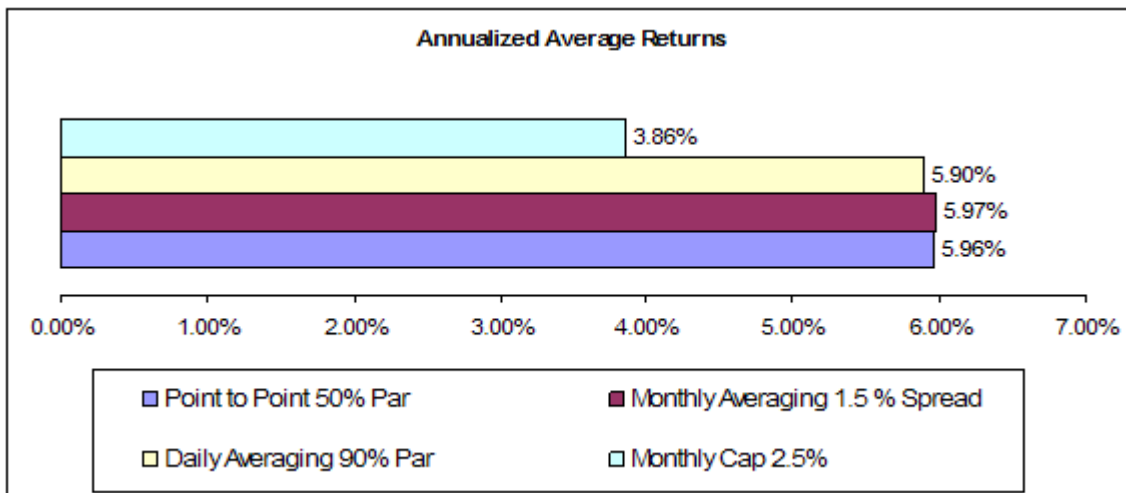
After reviewing the table above you will notice that the derivative strategies have more than a 50 percent greater incidence of negative returns (0 percent credited to an EIA) and monthly cap has the highest incidence of negatives overall (66.67 percent greater).

Advisors should conclude that there is a greater risk of annual return dispersion (i.e., missed expectations) with derivative strategies other than point to point. In a world where efficient markets are a determining factor, the expected returns on derivative strategies would need to be higher to justify the greater risk. But is this the case?

Let's look at a chart of the hypothetical growth of four popular credit methods with \$100,000 of premium deposited in 1970 and left until 2006:



You will see from the chart above that the point-to-point, monthly averaging and daily averaging have ending value within \$20,000 of each other. The standout result is the monthly cap strategy; it has an ending value that is less than half of the other credit methods, and therefore should be disqualified from further consideration.



After further analysis, it becomes evident that the annualized returns of the three remaining comparable strategies (point-to-point, monthly averaging and daily averaging) are within 0.07 percent each other.

Conclusion: Point to point can offer the best risk-adjusted return for your client since the correlation to the S&P 500 index return is positive and the overall return can be within 0.01 percent of the best return.

Remember that it is your job to properly establish appropriate expectations with your EIA clients. If you do choose to use the derivative strategies of monthly averaging, daily averaging or monthly cap, make sure that you prepare your clients for a bumpier interest crediting experience. This extra step can mean not only a happier client, but repeat business and the best of all satisfaction indicators: referrals.