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MCP *Insider* - EIA News & Commentary for Advisors

All Credit Methods Are Not Created Equal

by Mitchell Maynard

One might say that the Equity Indexed Annuity (EIA) was a product in the right place at the right time. The late 1990's had a drastic psychological impact on investors at large, who had become educated about what drives stock market returns and who sought investments offering returns pegged to the market; especially when interest rates dove to historic lows.

The essence of this fixed annuity's composition is that the pegging to stock market returns is derived from the issuer's purchase of Call Options on stock indexes. The complexity of this concept is not difficult to understand but the way it should be evaluated based on its return characteristics can be. Options for EIAs are unique to the marketplace. They are constructed so as to pass returns to the purchaser that emulate the ownership of the underlying security with very little impact of traditional market forces. The way that these Option contracts are structured results in an "index crediting method".

What drives the creation of EIA crediting methods? The investment return analysis is complex enough to believe that it is not the consumer. Most agents lack adequate tools for EIA due diligence, so it would be difficult for any agent to recommend any new index crediting methods. Even insurance companies typically lack sufficient resources to develop their own crediting method strategies. Surprisingly, most EIA index crediting methods are actually created by organizations that market insurance products to agents. IMOs know what product designs have the attributes that can drive sales to consumers.

Option contracts have a premium price most influenced by term of the contract and volatility of the underlying index. It is this fact that causes the EIA Option strategies to be expressed in variations of EIA attributes: Crediting Method, Participation Rate, Spread/Asset Fee, and Cap. Certain crediting methods can constrain the potential gain for an investor in the EIA. For example, a monthly averaging method has less volatile returns than a point to point method. If EIA participation rates, spreads, and caps were the same for both these crediting methods, the premium paid for the Option in the point to point calculation would be greater. To further make this point, a look at EIA products offered currently shows that point to point crediting methods have a lower cap than their monthly averaging brethren.

Although EIA are not securities and have no principal risk, they do have a risk of return distributions. EIA index credit method offers returns to the investor only when the index credit method is positive, otherwise the investor receives a 0% return (though some EIA products offer guarantees for minimum returns annually, most offer minimum returns over the life of the EIA contract).

All index credit methods (other than point to point) can be considered derivative strategies. Since derivative index credit methods are based on return calculations that do not directly relate to the actual return performance measure of the period reset, there is the risk that the index credit method will not have comparable returns.

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In the study below (Table 1) the study will analyze the performance of various index crediting methods versus the performance of the S&P 500 point value changes, as expressed through growth of a $100,000 investment. Since the EIA is primarily designed to protect the investor from loss of principal, a bear market historical time period has been used.

Table 1: A Bear Market Scenario
(Growth of $100,000 invested 10-yrs of Jan 1970 to Dec 1979)

	SP500 Index	Monthly Point to Pt 100% Participation 2.5% Cap	Annual Point to Pt 55% Participation No Cap	Monthly Averaging 100% Participation No Cap, 1.5% Fee
1970	$ 100,000	$ 100,000	$ 100,000	$ 100,000
1971	$ 100,100	$ 100,000	$ 100,050	$ 100,000
1972	$ 110,901	$ 100,060	$ 105,983	$ 105,160
1973	$ 128,235	$ 111,817	$ 115,097	$ 111,501
1974	$ 105,960	$ 111,817	$ 115,097	$ 111,501
1975	$ 74,437	$ 111,817	$ 115,097	$ 111,501
1976	$ 97,967	$ 118,694	$ 135,101	$ 140,090
1977	$ 116,727	$ 123,762	$ 149,328	$ 157,559
1978	$ 103,304	$ 123,762	$ 149,328	$ 157,559
1979	$ 104,399	$ 123,762	$ 150,194	$ 157,559
Arithmetic Avg	3.20%	2.43%	4.98%	5.53%
Geometric Avg	0.43%	2.15%	4.15%	4.65%
Standard Dev	17.59%	3.73%	5.66%	7.79%
Correl. Coeff	N/A	69.2%	100.0%	96.4%
Beta	N/A	0.25	0.55	0.73

In short, the more the potential for the investor to gain the more the issuer has to lose and therefore the Option premium is higher. This should always be considered first when you begin an evaluation of the attributes of an EIA index credit method.

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