Investor Alerts and Bulletins

# Investor Bulletin: Indexed Annuities

**Aug. 13, 2019**

*The SEC's Office of Investor Education and Advocacy is issuing this bulletin to educate investors about indexed annuities. Indexed annuities are complex products. Investors should carefully read the indexed annuity contract, and any prospectus, before deciding whether to buy the annuity.*

## What is an indexed annuity?

An indexed annuity is a type of annuity contract between you and an insurance company. It generally promises to provide returns linked to the performance of a market index. There are two phases to an annuity contract – the accumulation (savings) phase and the annuity (payout) phase.

During the **accumulation phase**, you make either a lump sum payment or a series of payments to the insurance company. You can allocate these payments to one or more indexed investment options. The insurance company credits your account with a return that is based on the indexed investment option's return. During the **annuity phase**, the insurance company makes periodic payments to you. Or, you can choose to receive your contract value in one lump sum.

Depending on the circumstances, an indexed annuity may or may not be a security. If an indexed annuity is a security, it is regulated by the SEC. All indexed annuities are also subject to state insurance regulation. If an indexed annuity is not a security, it will not be regulated by the SEC, but would still be subject to state insurance laws.

## How does an indexed annuity work?

The amount of money (contract value) in an indexed annuity is based on positive or negative changes to a market index. This return is calculated over the course of a specified period of time. These time periods are typically twelve months long, but can vary.

Indexed annuity contracts describe both how the amount of return is calculated and what indexing method they use. Based on the contract terms and features, *an insurance company may credit your indexed annuity with a lower return than the actual index's gain. If the annuity exposes your investment to some risk of loss, you could lose more money in your indexed annuity when the market index goes down than the index loses.*

> **Please Note:**
> *Indexed annuities are complicated products.* Before you decide to buy an indexed annuity, read the contract. You should understand how each feature works, and what impact it and the other features may have on the annuity's potential return.
>
> *You can lose money buying an indexed annuity.* Ask your insurance agent, broker or other financial professional questions to understand how the annuity works.

## How is the return calculated?

**Gains**. An indexed annuity generally promises to provide a return linked to the performance of an index. If the index has a gain, the contract value of your indexed annuity will also increase. But your indexed annuity may be credited with a return that is lower than the index's return because:

1. Dividends are usually excluded. Any gains in the value of the index are generally calculated without including dividends paid on the securities that make up the index. For example, a specific market index reports a total return of 7% one year, but 2.5% of those returns are from dividends. Many indexed annuities would consider 4.5% to be the index's return when calculating any gains to your indexed annuity (7% - 2.5% = 4.5%).
2. Only a portion of the performance of the index is usually included. Indexed annuities typically use one or more features that restrict the positive return that is applied to your annuity contract value. Some common indexing features include:
    - **Participation Rate**. The participation rate determines how much of the gain in the index will be credited to your annuity. For example, if the participation rate is 75% and the index return is calculated to be 10% during the measuring period, the return credited to your annuity would be 7.5% (10% x 75% = 7.5%).
    - **Rate Cap**. The rate cap is a maximum rate of positive return that your contract can earn. For example, if your contract has an upper limit, or cap, of 7% and the index return is calculated to be 12%, only 7% would be credited to your annuity.
    - **Margin/Spread/Asset or Administrative Fee**. This fee subtracts a set percentage from any gain in the index. It is sometimes called the "margin," "spread," "asset fee," or "administrative fee." In the case of an annuity with a "spread" of 3%, if the index return is calculated to be 9%, the return credited to your annuity would be 6% (9% - 3% = 6%).

Some indexed annuities combine these features. For example, if an indexed annuity uses both a participation rate of 75% and a "spread" of 3% and the index return is calculated to be 10%, the return credited to your annuity would be 4.5% (10% x 75% = 7.5%; 7.5% - 3% = 4.5%).

*These features reduce your return in the same way that a direct fee would even if the annuity is called a "no fee" annuity.*

**Losses.** Some indexed annuities specify that investors may lose money if the market index goes down in value. If they do, the indexed annuity may offer some limited protection against that risk. Some common protections include:

**Floor**. This protection limits investor exposure to a set percentage of potential loss. For example, if the floor is 10% and the index decreases by 12%, you would only lose 10% of your annuity contract value, before considering any adjustments imposed by contract terms such as surrender charges.

**Buffer or Shield**. This protection offers a set percentage of loss that the insurance company is willing to absorb before deducting value from the indexed annuity. For example, if the shield is 10% and the index decreases 12%, you would only lose 2% of your annuity contract value, before considering any adjustments imposed by contract terms such as surrender charges.

**Please Note:**
*Indexed annuity contracts commonly allow the insurance company to change these features periodically*. Changes can negatively affect your return. Read your contract carefully to determine what changes the insurance company may make to your annuity.

## What indexing method does the contract use?

Different indexed annuities use different indexing methods. Indexing methods determine how the change in the variable annuity's return is determined at the end of each time period. This return is then applied to your indexed annuity, as discussed above.

Some common indexing methods include:

**Point-to-point**. This method compares the index level at two points in time, such as the beginning and ending dates of the time period.

**Averaging**. This method compares an average of the index levels at periodic intervals during the time period to the index level at the beginning of the time period.

## Can you lose money buying an indexed annuity?

*You can lose money buying an indexed annuity*. Read your contract carefully to understand how your annuity works. You can lose money in the following ways:

**Withdrawals during a time period**. If you take your money out of your indexed annuity before the end of a time period, not all of the return from that time period may be applied to your annuity. In addition, you may lose some of the principal invested in certain indexed annuities if you withdraw amounts before the end of a time period, depending on the value of the market index at the time of the withdrawal.

**Surrender charge**. If you take all or part of your money out during the surrender period, you may have to pay a surrender charge. The surrender period is a set period of time that typically lasts six to ten years, or even longer, after you purchase the annuity. Surrender charges will reduce the value and the return of your investment.

**Tax penalty**. Under current tax law, if you take all or part of your money from tax-deferred indexed annuities before you reach the age of 59½, you may have to pay a 10 percent federal tax penalty.

**Market index drop**. You may lose money in some indexed annuities if the market index goes down (explained above).

**Insurance company failure**. Many indexed annuities promise to make payments many years into the future. But remember that all amounts payable are subject to the ability of the insurance company to pay. Circumstances may arise where the insurance company is unable to pay its obligations.

## Additional Information

Annuities

Investor Bulletin: Variable Annuities



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