Financial Literacy Month – April 2012

Risk, Return, and a Product with Which You May Not Be Familiar

ANNUITIES

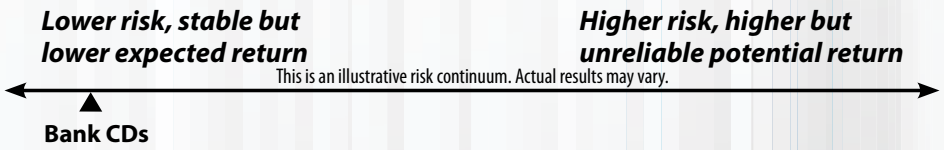
In 2004, the U.S. Senate unanimously passed a resolution declaring April to be National Financial Literacy Month, with one of its goals being to teach Americans how to establish and maintain healthy financial habits. One element of keeping your finances healthy is to understand the choices of financial products available to you. This article examines two products – fixed annuities and indexed annuities – that are quite popular yet are unknown to many people.

When many people set money aside for the future, they are looking first and foremost to accomplish two objectives: a safe return of their money and an attractive return on their money. In today's economy, this seems to be a particularly difficult combination to achieve.

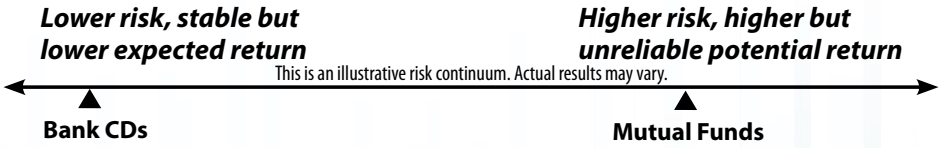
Why is that? Because these are opposing goals.

A common way that financial professionals compare investment alternatives is to look at a spectrum of risk and reward, that is, a spectrum of safety versus the expected rate of return. Financial vehicles that provide substantial protections against risk are able to attract money at relatively low returns, whereas risky financial vehicles must provide much higher potential and expected returns in order to attract money from investors.

Consider, for example, **bank certificates of deposit.** These are clearly very safe, as the principal is guaranteed first by the issuing bank and second, up to a limit, by the FDIC. The interest rate you will earn is also guaranteed for the duration you select. If you choose to take your money out early, the penalty is typically very modest, equal to only a few months of interest. According to BankRate.com, the average 5-year interest rate offered on a bank CD as of 3/19/2012 is a measly 1.49%. And yet, due to their safety features, banks have attracted $8.8 trillion of domestic deposits as of year-end 2011 at interest rates such as this, or even lower on their checking and savings accounts.[1]

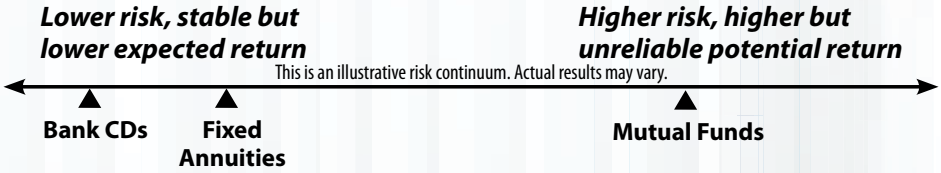


Mutual funds, on the other hand, are securities, and that gives you a clue that we are now entering much riskier territory. The principal is not guaranteed by anyone. The return in any one given year can be sharply positive or negative. For example, a common indicator for stock fund returns is the S&P 500 index, which rose 26% in 2003 and dropped 38% in 2008. Thus, for mutual funds to attract money, they must offer the prospect of a higher likely return than bank CDs. Over the last century, they have done so, although over the last decade or so, they have fallen woefully short of producing excellent returns. That is the nature of risk – it is unpredictable. And yet, mutual funds are very popular, having attracted $11.6 trillion of assets as of year-end 2011 despite the risk.[2]



Many people look at these two financial products – one with safety but very low returns, the other with higher potential returns but quite a bit of risk – and want to know more about products that may fit between these two, offering elements of safety and attractive potential returns. If you're one of those people, then you should know about fixed annuities and indexed annuities.

Fixed annuities are safe financial products, as the principal is guaranteed by the issuing insurance company. Fixed annuities are available in a range of surrender charge durations, many with interest rates that are fully guaranteed for the duration selected. While there are a variety of fixed annuities on the marketplace, surrender charges are typically higher than on bank certificates of deposit, thus the greater liquidity restrictions cause many purchasers to view them as a slightly higher risk product. An annuity is a long-term product where only limited access to the principal may be allowed for a period of time. The website AnnuityFyi.com lists fixed annuities with surrender charge durations ranging from 2 years to 15 years. As of 3/19/2012, it was advertising a fully guaranteed 5-year interest rate of 2.60%, which is considerably higher than the national average interest rate on a 5-year certificate of deposit.



Indexed annuities are a type of fixed annuity, and thus they are very safe. The principal is guaranteed by the issuing insurance company. Where they differ from traditional fixed annuities is that the interest rate is not guaranteed at as high a level as most fixed annuities, but the interest rate fluctuates from year to year depending upon movement of the referenced market index and the formula applied to that movement. The advantage is that the index-based interest crediting never puts the annuity's principal or previously credited interest at risk due to market declines, and the interest credited over time can be higher than on a traditional fixed annuity. According to IndexAnnuity.org, over the five year period ending 9/30/2011, the average indexed annuity earned an annualized interest rate of 4.06%.3 (Of course, past performance is not a guarantee of future results.)

As you can see, the appeal of fixed and indexed annuities is that they fit between bank certificates of deposit and mutual funds on the safety/rate of return spectrum. They offer an excellent level of safety, yet they offer a higher potential return than bank CDs. As long as you properly understand where annuities fit and make decisions on that basis, we find that annuities are valuable financial products.

Having financial literacy means knowing the financial products that are available to you. So while annuities may have been unknown to you previously, they are popular financial products, and now you know why.

[1]http://www.fdic.gov/bank/statistical/stats/2011dec/industry.html
[2]http://www.ici.org/research/stats/trends/trends_01_12
[3]http://www.indexannuity.org/IC2011.htm#5yr