Annuity Marketing Services Presents

Advisor

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The Truth About Monthly Caps

Let's say you were offering an index annuity that deducted a 4% yield spread or asset fee from the annual index gain. Would you tell the consumer that the potential return of this annuity was 60% or 120% or 200%? Of course not, because based on historical performance these are unrealistic returns that simply will not happen. And yet, there are producers offering index annuities using 3% monthly cap crediting telling consumers that they could make 36% a year. However, the likelihood of actually earning 36% with a 3% monthly cap structure is the same as earning 200% a year with that 4% yield spread method.

The monthly cap method determines index movement for each month, adds any gains – up to a cap, or subtracts any loss – without a cap, to the previous subtotal. At the end of the period – one, two or three years – any final gain is credited to the index annuity. If the period ends with a loss the annuity is credited with zero gain. The cap may be raised or lowered (subject to a minimum limit) at the end of the crediting period when the design resets. The method is okay, what is wrong is how it is often presented.

Don't Total The Monthly Caps

You will never hit the period maximum because what you need is for the index to steadily increase month after month at the cap rate or higher without ever going down. Historically, this has never happened! Stock indexes do not increase 12 straight months in a row, so it is wrong to tell a consumer that their potential gain is the monthly cap times 12 or 24 or however many months there are in the period. The correct way to describe a 3% monthly is by saying, "this method limits monthly index gains to 3% but any upward movement is not locked in and the cap doesn't apply to index losses".

Don't Cherry Pick

You can always find facts supporting one side of an issue if you select only the supportive facts. I have seen some sales materials implying certain monthly cap index annuities produced 20% or better returns in 2004. There are a few problems with this approach. The first is the particular index annuities mentioned were not around a year ago. So the truth is nobody ever actually earned these returns. The second is the sales material assumes current monthly cap rates for this "hypothetical" example. The only carrier with a monthly cap index annuity out during the time mentioned had a lower real-world cap, so the truth is assuming current caps for the period may well be invalid. The third problem is the sales

material cherry picks the best 12-month period to use as an example of returns to expect.

If you apply a 3% monthly cap approach to one-year periods ending during the first half of 2004 you get a band of 20% returns from mid-January through mid-March. However, if you missed this two-month period by six weeks on either side the returns drop down to 5% to 8%. So, I guess trying to earn the return publicized is a lot like buying a lottery ticket – you need to be very lucky on when you buy.

But the bigger picture is simply mentioning the possibility of 20% plus returns is wrong. If you plug a 3% monthly cap approach into historical index performance you find there are only three times since the Truman administration that you would have earned a 20% or better annual return. This means, historically speaking, that the odds of actually earning 20% in any one year were less than 1 in 20. So the truth is telling a client they could earn 20% is not really the truth.

The Method Is Okay

The monthly cap design has the potential for higher returns than some other averaging methods, but to be marketed showing realistic returns. The truth is monthly cap returns, like most other index annuities, will depend more on how the carrier treats you at renewal than the crediting method used.

Mike Sause
President, AMS