Why Wealthy Investors Need to Explore Other Wealth Protection Vehicles

By: Joseph D. Salvemini – Published April 13,2007

You have spent years taking risks and obtaining wealth, and now at age 50 or older you are looking for ways to maintain your wealth, and earn a good return without incurring any major losses.

The traditional ways of doing this have been with a diversified portfolio of bonds: Treasury Bonds, AAA Corporate Bonds, Municipal Bonds and Mortgage Bonds or Mutual Funds that contain these bonds - all great wealth protection vehicles for a large portion of your portfolio and still highly recommended.

However, bond coupon rates and returns are not what they used to be. As more and more of your bonds mature you will find that your overall portfolio coupon and yield will continue to decline. This is because bonds you purchased in the 1980's and early 1990's that are maturing today had significantly higher coupon rates which can not be replaced with comparable coupon rates in today's market. Once your portfolio becomes more weighted with newer bonds than older bonds you will actually see and feel the pinch. In the next few years the majority of your older bonds will mature and these higher coupon rate bonds will no longer be available in your portfolio.

Don't expect coupon rates and yields to get any better in the future. The attractive coupon yields for the last 30 years have now ended. The final adjustment has taken place from the bubble in interest rates that occurred in the late 1970's and early 1980's. This bubble was caused by the U.S. Government and U.S. Governmental Agencies' economic and tax policies of the mid 1960's through 1981. These policies caused inflationary pressures and inflationary fear that have now finally been wrung out of our economic system. Inflationary fear is what took so long to get out of the system and the final adjustment to this has now occurred.

Going forward and for years to come we will be in a long period of normalized interest rates. This is actually great news for our economic health as a country and as U.S. Citizens. Low inflation and a system that is moderately taxed, coupled with free and fair world trade is a driver of future economic growth and therefore our way of life.

This normalized period of interest rates will continue as long as the number one priority of the Federal Reserve remains inflation fighting, and that the U.S. Congress maintains a moderately low taxing policy. As the US Congress continues to delay the inevitable of entitlement reform (Medicare/Social Security, etc.), they risk the future of our economic health as a country and the economic well-being of our children and grandchildren.

So, going forward, what can you do to obtain the opportunity to earn higher interest (coupon) rates than a bond portfolio can provide - and still protect your wealth - without taking on additional risk as a bond portfolio has in the past?

Buy Fixed Index Annuities with up to 25% to 50% of what you are now allocating to taxable bonds in your current portfolio, or **add Fixed Index Annuities** as older bonds mature and build up to the 25% to 50%. You should still maintain a portfolio of treasury bonds, municipal bonds, corporate bonds and mortgage bonds, because diversification is always the very best for you.

You will need to make this decision and be the driver of adding fixed index annuities to your portfolio because your financial planner/advisor and investment firm will never recommend this, and the media and publications won't either. Why? Because they will no longer control the money, and thus they will not be able to draw a continuing revenue stream off of this money. The media and publications share in this revenue through advertising, and investment type firms are the largest advertisers by far. You see, fixed index annuities are only issued by insurance companies, and only through advisors who are licensed in insurance. Your current financial planner/advisor and investment firm will say anything to maintain control of this money and the revenue stream from it. They do not always have your best interests as a priority, especially when it conflicts with their long-term financial interests.

OK...so now you understand why you haven't heard of index annuities, and if you have, why you've been told they are not good for you. What are fixed index annuities? Why will they benefit you and how do they protect your wealth? Why should they be in your portfolio? Why should they be in everyone's portfolio?

Index annuities allow you to earn interest annually based on a portion of the upside movement in an equity stock market index such as the S&P 500, which is the most often used (other indexes are available even within the same annuity) with **NO DOWNSIDE RISK and COMPLETE SAFETY**.

The key to why index annuities perform so well is simple: **THEY NEVER SHOW A LOSS**. Richard Russell, founder and editor of The Dow Theory Letter, put it succinctly when he said, "He who loses least...wins!" With index annuities we never lose. Index annuities without caps are excellent vehicles for your financial security. Enjoy the gain and eliminate the pain.

The very best way to explain the benefits of fixed index annuities and how they work is with a question and answer format, so here we go:

How does an Index Annuity Work?

Like all annuities, an index annuity is a contract with an insurance company for a specific period of time initially or for which you may choose to hold for life. An index annuity tracks a particular stock market index, such as the Standard & Poor's 500, S&P MidCap 400, Russell 2000 Index, NASDAQ-100, DJIA, Dow Jones Euro STOXX 50, Lehman Brothers US Aggregate Bond, etc. One or all of these indexes may be available in the index annuity you purchase. Your rate of interest earned will be a pre-set percentage of the increase in that index in the corresponding index year. There is also a guarantee against losses. The surrender period on an index annuity is typically longer than other annuity surrender periods - about 7 to 14 years (some are now available at 4 or 5 years - but remember, in order to achieve a higher return you must give it a longer time frame to work just as any other instrument).

Can you give me an example of how the pre-set percentage works?

Yes. Let's say that your index annuity promises to give you 55 percent of what the S&P 500 Index returns that year. You invest $100,000 on November 1st. By November 1st of the following year, the S&P 500 Index has increased 15%. According to the terms of your index annuity, the insurance company has to give you 55% of that increase. Since 55% of the 15% is 8.25%, you will be credited with 8.25% interest on your original deposit or the beginning account value of that year, in this case $8,250. If the S&P 500 had gone up only 8% for the year, you would be entitled to 4.40% index gain and credited interest on your investment of 4.40%, or $4,400.

You say there is a guarantee on the downside. What if the S&P 500 goes down 30%?

Yes, there is a guarantee on the downside, which is why investors in index annuities are willing to accept only a 55% share of the gains in the S&P 500. In fact, for those who do not want to take any downside risk, the index annuity can be a good option. Unlike regular index mutual funds, where you claim 100% of the gains but also suffer 100% of the losses, in an index annuity your money can only go UP - it cannot go down. If you invest $100,000 in an index annuity on November 1st and by November 1st of the following year, the S&P 500 Index has fallen by 30%, you will still end up with $100,000 as an account value at the end of that year. The next year, when the market rises by 15%; you will be credited with 55% of that increase, in this case 8.25% or $8,250. After 2 years you would have a total of $108,250 in your account **{Being in a mutual fund you would have LOST $30,000 (-30%) in the 1st year with your account value down to $70,000 and gained back only $10,500 (+15%) in the second year with a total account value after 2 years of $80,500. This is a LOSS of $19,500 (-19.50%) over 2 years in typical index mutual funds or equity mutual funds}.**

This kind of annuity allows you to share in the upside no matter how high that upside is but effectively protects you from a downturn. Please note: This safety feature is not included in all index annuities, so be sure to ask whether it applies to the index annuity you're considering. You want what is called an **"Annual Reset".**

The other great thing about down index years (besides NOT suffering a loss or account value decline) is that your index starting point will RESET to the depressed level. In effect you are always buying the S&P 500 Index near the low in a down year, and are always positioned for future gains. Your index starting point resets each and every year. This is really the important key to why index annuities will perform better than all other fixed income instruments over the long-term, and why "buy and hold" truly works with index annuities.

Not being capped on the upside is very attractive; this specific method is called an "Annual Point-to-Point Participation Rate Only" crediting method. Other examples of how this method works follow:

Example A: Lets assume an investment of $100,000, the participation rate is 55% and this is Annual Point-to-Point with No Cap or Spread. Lets also assume the S&P 500 Index increases 40% for the year.

Your index annuity would be credited with 22% or $22,000 of interest (40% X .55 = 22% or $100,000 X .22 = $22,000). Your new account value would be $122,000 and is guaranteed never to go below this amount. This guaranteed floor is reset each year you earn interest.

Example B: Lets assume an investment of $100,000, the participation rate is 55% and this is Annual Point-to-Point with No Cap or Spread. Lets also assume the S&P 500 Index increases 10% for the year.

Your index annuity would be credited with 5.500% or $5,500 interest (10% X .55 = 5.50% or $100,000 X .055 = $5,500). Your new account value would be $105,500 and is guaranteed never to go below this amount. This guaranteed floor is reset each year you earn interest.

The following year, in example A and B, any interest earned would be calculated on your actual account value for that year: $122,000 and $105,500, so your money compounds interest just like any other savings instrument.

This design will give you more interest when the index has a big percentage gain for the year. In my opinion, this is the best indexing method, with the uncapped monthly average second. I say this because in order to obtain the highest rate of return over time it is very important to capture as much of the upside as possible in big up years. In single digit up years it will give you less than a "cap only" product design would.

The "Point-to-Point Participation Rate Only" crediting method is a very simple method to calculate and very easy to understand. The participation rate may change once each contract year and may be higher or lower than the initial rate. The participation rate is declared each contract year by the insurance company, and the primary driver is what it costs the insurance company to go out and buy options on the underlying market indexes to provide you the upside interest earning potential.

Are there any other safety features attached to index annuities?

Yes. Index annuities typically come with an overall guarantee as to the return over the life of the annuity. No matter which available index you choose to track, in the long run you can't lose. Why? Because once your surrender period is over, the insurance company typically guarantees that you will get back 100% of your initial deposit plus a minimum return (varies by index annuity and company) or the accumulated value/actual account balance of your account, whichever is greater. If you invest $100,000, the worst-case scenario will leave you with $121,000 at the end of the 7 year surrender period in one example. Based on what was explained above, the probability is high that your accumulated value/actual account balance will be higher than this overall minimum, but it's a good feature to have anyway.

Again, if you are willing to give up some of the upside potential of being 100% invested in the stock market, an index annuity can help you protect yourself against downside risk and thus provides wealth protection, both in the short term and the long term.

How do I know if an Index Annuity is right for me?

If you do not want to take any risks and want the opportunity to earn more interest than other fixed income instruments available, a good index annuity may be right for you.

For more on Index Annuities see: http://www.jdsannuities.com/index_annuities

To Learn about Immediate Annuities see: http://www.jdsannuities.com/immediate_annuities

To Learn about Fixed Rate Annuities see: http://www.jdsannuities.com/annuity_rates

Joseph D. Salvemini, CLU, ChFC has been an advanced financial planner, investment advisor and independent agent for 17 years. He now specializes in fixed annuities of all types and is owner of http://www.JDSAnnuities.com
Email: joe@jdsannuities.com

Copyright 2007