

## INDEX-LINK POWER - HOW IT'S DONE...

An index annuity provides the potential for higher index-linked interest and protects principal and credited interest from market risk. One of the objections sometimes raised when the index annuity story is told is that it seems too good to be true. How can the insurance company provide both potential and protection? Let us look at how the index-link approach really works.

**Another word for index-link is option.** If you've ever given a car seller \$50 to hold a car for you at a certain price you've participated in options. You put \$50 on the table to hold a car, the car seller agrees to accept your \$50, the seller is obligated to sell you the car at the agreed upon price. But as the option buyer you are not obligated to buy the car, you simply have a right to buy it at that price. You can walk away and the most you can lose is your \$50.

Equity options work the same way and I'm going to use a real world example to show how the index annuity approach utilizes options to provide the potential for higher fixed annuity returns. To make this cleaner I am going to ignore transactions costs and will state this is not an inducement to sell or buy any security and is for purely educational purposes.

## CHEERIOS, WHEATIES & CALLS

**Let's say we have \$50.** At the end of April the price of a share of stock of General Mills (symbol: GIS) closed just under \$50. At the same time you could have purchased a nine-month certificate of deposit from Indy Mac Bank of California with a stated annual percentage yield of 3.73%, which will produce 2.8% in interest for the nine-month period.

We know if we buy the CD it will return 2.8% in nine months. What will be the return on the share of General Mills over the same period? We don't know. It could be greater than 2.8% or it could be a loss.

**There is a third choice.** At the end of April a stock exchange listed call option giving the right to buy General Mills at \$50 at anytime within the next nine months last traded for \$2.05. If we buy the call option – or equity-link – we have the right to buy General Mills at \$50 a share and this right costs \$2.05.

## PROTECTION & POTENTIAL

Let's say our first requirement is to ensure we still have \$50 in our hands nine months from now. If we put \$48.63 in the CD it will grow back to \$50 at the end of nine months ( $\$48.63 \times 1.028$ ). This leaves us \$1.37 from our \$50. A full option giving us 100% participation in any growth in General Mills stock costs \$2.05, but we don't have \$2.05. The option seller says we can buy two-thirds of the option ( $\$1.37/\$2.05 = 66.8\%$ ) and he'll keep the rest.

## THE SCENARIOS

**It is now nine months later.** What if General Mills stock is at \$56 a share? We would use our option and buy the stock at \$50, sell it at \$56, and make \$6. Our "participation rate" in this increase is 66.8%, so our share of the gain is \$4 with the index seller keeping the other \$2. The CD is now worth \$50. We add the \$50 from the CD to the \$4 realized from our equity-link and the result is \$54, or an 8% return on our \$50.

**What if the price of General Mills stock had been \$50 or less at the end of the period?** We wouldn't use the option and the \$1.37 spent on it is gone. However, because most of our money was placed in the CD we still have \$50, and if we wanted to we could try this option/CD combo again for the next period.

**This is how an index annuity works. The primary differences are the insurer uses bonds instead of CDs, index options instead of stock options, and an annual period instead of nine months.**