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Annuities

# The Complicated Risks and Rewards of Indexed Annuities

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**Indexed annuities**, also known as fixed-indexed annuities or equity-indexed annuities (EIAs), have surged in popularity because of the way they incorporate features beyond those found in conventional **fixed annuities**.

Similar to fixed annuities, investors who buy indexed annuities are often guaranteed returns. But, unique to indexed annuities, a portion of those returns may vary because they are linked to a specific market index, such as the S&P 500. As a result, the return on these products generally may be higher or lower than the guaranteed rate of return on conventional fixed annuities.

As with conventional fixed annuities, indexed annuities are not subject to taxes until you begin receiving distributions.

While all indexed annuities are regulated by [state insurance commissioners](#), only those that are securities are regulated by the SEC and FINRA. Indexed annuities that are securities typically can expose investors to investment losses. If the indexed annuity is a security, generally a prospectus will be delivered to you.

Their popularity notwithstanding, indexed annuities are complex financial instruments, and retirement experts warn that such annuities include a number of features that may result in lower returns than an investor might expect.

## How Do They Work?

Indexed annuities have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity but not as much as a variable annuity.

The returns on indexed annuities, which come in the form of interest credited to the contract, typically consist of a guaranteed minimum interest rate and an interest rate linked to a market index. A market index tracks the performance of a specific group of stocks

representing a particular segment of the market, or in some cases an entire market. Many indexed annuities are based on the S&P 500 or other broad indexes, but some use other indexes or may allow investors to select one or more indexes.

The guaranteed minimum interest rate usually ranges from 1 to 3 percent on at least 87.5 percent of the premium paid. As long as the company offering the annuity is fiscally sound enough to meet its obligations, you will be guaranteed to receive this return no matter how the market performs. (To find a list of firms that provide ratings of insurance companies, visit the SEC's [website](#).)

## What Is the Rate of Return?

Index-linked returns will depend on how the index performs but, in general, the rate of return for an indexed annuity does not fully match the positive rate of return of the index to which the annuity is linked—and could be significantly less. One major reason for this is that returns are subject to contractual limitations in the form of participation rates, fees or caps.

**Participation rates** are the percentage of an index's returns that are credited to the annuity. For instance, if an annuity has a participation rate of 75 percent, then the index-linked returns would only amount to 75 percent of the gains associated with the index.

Some indexed annuities use a **spread, margin or asset fee** in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10 percent and the spread/margin/asset fee is

3.5 percent, then the gain in the annuity would be only 6.5 percent.

**Interest caps**, meanwhile, essentially mean that during big bull markets, investors won't see their returns go sky-high. For instance, if an index rises 12 percent but an investor's annuity has a cap of 7 percent, their returns will be limited to 7 percent.

Some indexed annuity contracts allow the issuer to change the fees, participation rates, and interest caps from time to time, which could adversely affect your return. Investors should read their contract carefully to see if it allows the insurance company to change these features.

In addition, different indexed annuities [use different methods](#) for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index. The variety and complexity of the methods used to credit investors can also make it difficult to compare one indexed annuity to another.

In addition, under the terms of some indexed annuity contracts that are securities, you could lose more money in your indexed annuity when the market index goes down.

## How Accessible Are the Funds?

Indexed annuities are long-term investments, and getting out early may mean taking a loss. Withdrawing the principal amount from an indexed annuity during a certain time period—usually within the first six to 10 years after the

annuity was purchased—may result in fees known as surrender charges and may also trigger tax penalties.

Also, under some contracts, if withdrawals are taken, amounts already credited from returns will be forfeited.

Surrender charges will reduce the value and return of your investment. The result: After paying surrender charges, depending on the returns and amounts forfeited, an investor may lose some of the principal invested by surrendering an indexed annuity too soon.

As with any investment, it's important to do your research and thoroughly review the contract for the product being offered to you to determine whether it meets your needs.

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