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Investors should beware of risky EIAs

Five years after the latest clean-up of Wall Street abuses began, a dangerous investment is allowing unscrupulous sales agents to fleece retail investors, and once again the regulators have missed the boat. The investment is "equity-indexed annuities" or EIAs.

Brokers and insurance agents too often sell EIAs as safe investments, but they are not. Equity-indexed annuities are illiquid, expensive and nearly guaranteed to lose investors money.

But the brokers and agents who sell EIAs make big bucks off these losers. Agents often reap commissions ranging from 10 percent to 12 percent.

Regulators impose little restrictions on the EIA salespeople, and the legislatures and courts have sharply limited the investor's right to recover losses in court. In this lax environment, EIA sales agents milk this "cash cow" by targeting the most gullible customers they can find.

What makes EIAs so bad? EIAs differ dramatically from fixed annuities.

Fixed annuities usually take the form of a customer paying a single dollar amount in exchange for a fixed monthly payout for life. The insurer bets that the customer will die before the payout exceeds the principal investment (adjusting for inflation and interest). The customer either makes the opposite bet or, more typically, is willing to give up the principal in exchange for a guaranteed stream of income.

Unlike fixed annuities, the EIA is an Enron-esque "black box." In broad terms, an EIA abandons the concept of a fixed prin-

cipal or fixed payout. Instead, the annuity "links" the principal value to a securities index such as the S&P 500.

But the EIA never invests in the market. It simply uses the index as an arbitrary reference. In fact, many EIAs give the customer no credit for the dividends that the underlying stocks in the index would pay.

The EIA's other features all but ensure that the investor will lose money or receive returns so far below the supposedly linked index as to make that linkage a joke. These features include:

- *Participation rates.* "Heads we win, tails you lose." The insurer has the right to say how much of the EIA participates in the index, and the customer has no right to dispute it. For example, if the insurer sets the participation rate at 75 percent, then only 75 percent of the investment participates in the market. This feature alone makes these investments almost impossible to justify to any customer going into them. Who would ever knowingly buy such a rigged investment?

- *Interest rate caps.* "Heads we win, tails you lose — again." These caps put another lid on the investor's upside. For example, if the index linked to the annuity gained 10 percent and the cap rate was 8 percent, then the gain in the annuity would be 8 percent.

- *Spread, margin and asset fees.* These squelch return even more. EIAs usually include a spread, margin or asset fee. This fee can reach 4 percent. If the index gains 8 percent and the fee is 4 percent, the return is 4 percent.

- *Punitive surrender charges.* "Substantial penalty for early withdrawal." Investors often find themselves needing their money sooner than they realize. But EIAs often impose surrender charges of 20 percent or more.

Investors get virtually nothing for the

supposed safety of an EIA. Economist Craig McCann recently compared one EIA to U.S. Treasury strips and found that the Treasury strips would have delivered more than 25 times the guaranteed return of the EIA he examined during the same term.

A red flag should go up when a Ph.D. like McCann describes EIAs as "the most confiscatory investments sold to retail investors."

When a broker or insurance agent proposes the purchase of an EIA, investors should be skeptical. Once the broker makes the sale, it is almost impossible to escape without major damage in the form of punitive surrender charges.

The EIA industry continues to thrive for at least three reasons.

First, the regulators treat them as "insurance" and not "securities," so they fall outside various registration and supervision requirements.

Second, the typical loss in an EIA is often less than \$50,000, which makes it hard to prosecute a case for a single investor (but enough to wreak havoc on that investor's portfolio).

Third, class-action relief holds little promise. The courts have strictly limited class-action claims for investors, and even if class actions were to succeed, individual customers would receive pennies on the dollar.

Absent intervention by the courts, Congress, or state legislators, unscrupulous insurers and their agents will continue to milk this cash cow at the expense of retail investors.

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