



What is an Indexed Annuity?

An indexed annuity is a special class of annuities that yields returns on contributions based on a specified equity-based index. One can purchase this annuity from an insurance company, and similar to other types of annuities, the terms and conditions associated with [payouts](#) depend on what the original [annuity](#) contract says.

BREAKING DOWN Indexed Annuity

Indexed annuities offer [annuitants](#) the opportunity to earn higher yields based on stock market performance with protection against market declines. However, it is also common for an annuitant to experience lower-than-expected yields due to the combination of caps on the maximum amount of interest earned and fee-related deductions. The real challenge is in understanding how an indexed annuity works, as it is much more complex than a standard [fixed annuity](#).

Indexed Annuities and Stock Market-Based Yields

The rate on an indexed annuity is calculated as a percentage of the gain in the [Standard & Poor's 500 Index](#). The actual percentage applied to the credit rate is based on the [year-over-year](#) gain in the index or the average monthly gain over a 12-month period.

In a year when the stock index realizes a gain, a portion of the gain is credited to the account based on a participation rate dictated by the life insurer. The participation rate can be as high as 100 percent, meaning the account is credited with all the gain, or it can be as low as 25 percent. Most products offer a participation rate between 80 and 90 percent — at least in the early years of the contract. For example, if the stock index gained 15 percent, an 80 percent participation rate translates to a credited yield of 12 percent. Most products offer a high participation rate in the first year or two, but then the rate adjusts downward.

Indexed Annuities and a Yield or Rate Cap

Most indexed annuity contracts include a yield or [rate cap](#) that can further limit the amount credited to the accumulation account. For example, a 7 percent rate cap limits the credited yield to 7 percent no matter how big the stock index gain. Rate caps can range from a high of 15 percent to as low as 4 percent and are subject to change.

