Comparing the Zone Annuity to Non-Qualified Equity-Linked Notes

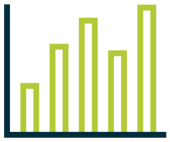
Investors nearing retirement often are interested in continuing to participate in the equity market, which historically tends to outperform bonds over the long term,[1] while controlling the risk and volatility that sometimes comes with investing in stocks. If the timing is unfortunate, such risk and volatility can decimate a retirement portfolio.

Two popular investment products that are designed to provide equity exposure with downside protection are non-qualified equity-linked notes ("ELNs") and registered index-linked annuities such as CUNA Mutual Group's MEMBERS® Zone Annuity. Both products give investors the opportunity to link their return to the upside performance of the stock market while mitigating downside risk. It makes sense, then, to compare and contrast some of the critical features of these two types of investments.

[1]Annual Returns on Stock, T.Bonds and T.Bills: 1928 - Current - from Stern.nyu.edu January 5, 2019

		EQUITY-LINKED NOTES	ZONE ANNUITY
INDEX PARTICIPATION	**Terms (cap and floor range)**	Complex. Have many options including caps, participation rates, floors and buffers.	Simple. A cap determines the maximum upside potential and a floor determines the maximum downside loss potential.
	Upside potential /downside protection reset	Uncommon.	Available annually.
CREDITING		Returns are typically paid out at maturity.	Returns are credited annually based on index performance.
INCOME		No lifetime income options.	Can utilize many annuity payout options including guaranteed lifetime income regardless of account value.
CREDIT/SOLVENCY RISK		Unsecured debt of issuer (usually a regulated commercial or investment bank).	Contractual obligation of regulated insurer, subject to the insurer's financial strength and claims-paying ability.
TAX TREATMENT		If not held in a tax qualified account, possibility of imputed tax liability every year, even if returns are not distributed.	Tax deferred growth, if held past age of 59 ½.
LIQUIDITY		Limited or no access to invested funds until term is completed. Variable by issuer.	Limited access allows up to 10% of invested funds annually without penalty after one year.

INDEX PARTICIPATION



The basic structure of most ELNs and index-linked annuities is similar; investors receive some, but not all, of the increase in an equity index and, in exchange for forgoing full upside participation, they receive protection on the downside. However, ELNs offer many different crediting strategies and indices, increasing the complexity and need for understanding the tradeoffs.

For upside potential, ELNs offer two options: a cap or a participation rate. The cap is the maximum gain that can be earned. A participation rate gives the investor a defined percentage of the gain. The Zone Annuity offers a cap.

The downside protection of ELNs can be structured to act like a buffer, where the investor is shielded from annual losses up to a certain percentage, but then incurs 100% of any losses beyond that threshold. With this design, the full amount of downside loss potential remains unknown. ELNs and the Zone Annuity also offer a maximum annual loss level, sometimes called a "floor," beyond which all losses are protected.

Because the levels of downside protection and upside participation—and many other terms—are variable in both the index-linked annuity and ELN markets, it's not possible to do a direct, apples-to-apples comparison. But it's fair to say that the creators of both products are working with the same general set of tools—fixed income securities and equity derivatives—and financial engineering expertise. So, if they are being priced competitively, the tradeoffs between upside exposure and downside protection should be similar.

However, the Zone Annuity is more flexible than many ELNs. With ELNs, the sponsor (typically a commercial or investment bank) usually structures the investment with a single preset upside participation rate and a single preset downside protection level. Take it or leave it—all buyers must invest at those levels.

The Zone Annuity is different in that investors can specify the initial level of upside potential and downside protection to suit their own risk tolerance. And, while the initial upside potential and downside protection levels are typically locked in for the duration of the investment for ELNs, the Zone Annuity lets investors reset their levels once each year at their contract anniversary. This feature allows investors whose market view and/or risk tolerance has changed to adjust their risk and market exposure accordingly.

INCOME

As they move into retirement, investors often need a source of regular income to replace their paycheck, and ELNs do not offer guaranteed income for life. An investor could use investment gains from an ELN as income, but many ELNs only pay gains when the note matures and there is no guarantee that there will be a gain or that those gains will last a lifetime. With the Zone Annuity, investors participate in the performance of their underlying accounts, and may additionally elect a payout option to begin receiving guaranteed income over a desired fixed period of time, or remaining lifetime.

CREDIT/ SOLVENCY RISK

ELNs typically are structured as unsecured debt of the sponsoring bank. Unless they are issued in the form of a certificate of deposit—in which case they may be backed by the Federal Deposit Insurance Corporation—they are not usually backstopped by any other institution. Investors in principal-protected ELNs issued by Lehman Brothers found out about their credit risk the hard way, when the firm declared bankruptcy in 2008, and their securities became almost worthless overnight.[2]

Index-linked annuities like the Zone Annuity, on the other hand, are considered contractual obligations of the insurer. Insurers are highly regulated and provide frequent reporting on their financial condition and business operations. Still, guarantees under the contract are subject to the insurer's financial strength and claims-paying ability and, therefore, to risk that the insurer may default on those guarantees. An insurer's financial strength and claims-paying ability should be considered before purchasing a contract.

TAX TREATMENT

Taxes can vary significantly for individuals, and they should consult with their tax professional before purchasing *any* structured investment product. As a general matter, annuity products enjoy significant tax deferral advantages on unrealized gains. Investors in ELNs that are not held in a qualified retirement account, on the other hand, are sometimes taxed on imputed gains, even when no profits or distributions have been taken.

LIQUIDITY

Both annuities and ELNs are intended to be long-term investments and, as such, are considered less liquid than other investment products such as high-grade bonds or common stocks.

For some index-linked annuities, like the Zone Annuity, investors have limited access of 10% of their investment to distribution without additional fees, and generally must pay a penalty for distributions over that limit if their circumstances change and they need access to their balance during an initial "surrender charge period"

[2] '100% Protected' Isn't as Safe as It Sounds - NYTimes.com May 22, 2010

LIQUIDITY
(continued)

of several years. This compensates the insurer for the costs of "unwinding" the contract and for any embedded sales and marketing costs that have not yet been covered. Still, index-linked annuity investors know at the outset that they can exit early if they need to and generally what it will cost them.

Any liquidity for ELNs is usually only available from the broker-dealer that initially sold the investment—with pricing in a market with only one natural buyer. And, there is no requirement that broker-dealers buy back the ELNs they sold. In times of market stress and volatility when ELN holders might be especially needy of liquidity, the broker-dealer might not be willing to transact at all or might be willing to do so only on the most severe terms.

Investors who want to maintain equity exposure while controlling downside risk have lots of choices. While the return profile for ELNs and index-linked annuities may be similar, there are many additional features—including income opportunities, credit risk, tax treatment and liquidity—where they may differ significantly.

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