Downside Protection Has Its Downsides

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Money has hemorrhaged out of U.S. stock funds for 18 weeks in a row, with an estimated $15 billion flowing out in August alone. Much of that is being soaked up by a form of insurance sold as a safer alternative to stocks.

Fixed-indexed insurance products, commonly called "equity-indexed annuities," offer the promise of protection on the downside combined with a guaranteed minimum upside. They racked up a record $8.2 billion in new sales in the second quarter and hit an all-time high of $168 billion in total assets as of June 30, according to Limra and Beacon Research.

But while you can avoid the downside of the stock market with these annuities, you expose yourself to another set of downsides.

These products, issued by life insurers like Allianz, ING and Lincoln Financial, are typically structured as "deferred annuities," which, after you lay out money up front, can be used to generate regular income payments down the road. Any earnings in the meantime aren't taxable until you begin drawing on the income.

The insurer guarantees that your principal won't go down in value and will pass to your heirs as a death benefit if you kick the bucket before you tap the account for income. The insurer also promises to pay a minimum annual income of 1% to 3%. In addition, through a formula linked to the price changes of indexes like the Standard & Poor's 500, the Russell 2000 or the Nasdaq 100, you also get a slice of any gains generated by the stock market. (Bond and other indexes also are available.)

Nowadays, these products have a typical "cap" of around 6%, according to the National Association for Fixed Annuities. The cap sets the maximum return you can pick up over the coming 12 months, no matter how high the market index goes. If you have a 6% cap and the S&P 500 goes up 8%—or 20%—then only 6% will be added to your account. On the other hand, if the market drops, you won't lose anything.

Since many investors remain ravaged by fear of another crash, that makes a good sales pitch. "With principal protection, guaranteed income and a piece of the upside potential of the stock market," says, a vice president at Allianz Life, equity-indexed annuities are "a one-package solution for consumers."

But look closely if you unwrap that package. With commissions around 5% to 8%, some agents might be so eager to make the sale that they underemphasize an important point: Many insurers can reset the cap, usually once a year. Not long ago, caps of 8% or more were common, says, an annuity specialist at Advantage Compendium Ltd. in St. Louis.

Today, one version of Allianz's top-selling MasterDex X annuity is capped at 5.25%. But the cap resets periodically and can go as low as 1% at the company's discretion. (It also could go higher.)

If interest rates fall further, caps could drop again, constricting your gain if stocks do well—as they often do when rates decline. Your return from stocks could go down even as their performance goes up.

Indexed annuities aren't for anyone who might need the money any time soon. While you can withdraw up to 10% of the account at no charge, you generally won't have access to your full balance for 10 years. On larger withdrawals, a "surrender charge" of up to 12% will apply in the first year, typically declining by one percentage point per year.

Allan Roth, a financial planner at Wealth Logic in Colorado Springs, maps out a functional equivalent you can build yourself at low cost and high certainty of return. Say you have $10,000. You could put $7,260 into a 3.25% 10-year certificate of deposit from Discover Bank and $2,740 into Vanguard Total Stock Market, an exchange-traded index fund that invests in more than 3,000 U.S. companies.

Even if the U.S. stock market goes to zero over the next 10 years, the yield on the CD guarantees that you won't lose any money overall. If stocks gain an annual average of 4%, your combined return will work out to 3.5% yearly. If stocks return 6% annually, your total gain will be 4.1% a year. And if interest rates rise, Mr. Roth says, you can invest in a new CD at a higher rate and still come out with an increased net return even after paying the penalty for early withdrawal.

Finally, if stocks take off, your profits on the fund will be taxable as long-term capital gains; in an indexed annuity, withdrawn gains get taxed at the higher ordinary-income rate. If you want to bequeath money to your heirs, Mr. Roth's approach is probably more tax-efficient on that front, too.

If you want only some of the gains from a bull market in stocks and none of the losses from a bear market, I would advise rolling your own.

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