MANAGING RISK WITH FIXED-INDEXED ANNUITIES

Abstract

The role of fixed index annuities in the pre-retirement years

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Managing Risk with Fixed-Indexed Annuities in the Pre-Retirement Years

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The United States has experienced a low interest rate environment in recent years, leading to lower returns for fixed income assets. This creates unique challenges for those approaching retirement, as the practical impact of low interest rates is an increase to the cost of funding retirement goals.

Households may seek to offset these rising retirement costs in numerous ways. On the fixed-income side, they may seek higher bond yields by either investing in longer-term bonds with greater risk of capital losses if interest rates rise, or in higher yielding corporate bonds that create greater credit risk for the financial plan. Longer maturity bonds may offer higher yields, but they will experience capital losses with a rate increase. Shorter-term bonds may not experience losses with rising rates, but their lower yields may lead to unsatisfactory returns. Though bonds are generally perceived to be less risky assets, they are exposed to interest rate risk. Near-retirees who are depending on bond funds to maintain the value of their assets may be vulnerable to having their financial plan steered off course by a rise in interest rates during these key pre-retirement years.

A second option is to shift toward a higher equity allocation to avoid the low yields and potential risks from bonds, but this creates additional risks. A particularly important matter for near retirees is sequence of returns risk. Two individuals who behave the same way over their careers—saving the same percentage of the same salary for the same number of years—can experience disparate wealth accumulation outcomes based solely on the specific sequence of investment returns that accompanies their career and retirement. This sequence of returns risk is generally discussed within the context of the retirement phase. But sequence risk also exists prior to retirement if individuals add new savings to their investment portfolio over time. Investment losses (either through stock market downturns or capital losses on bonds) experienced as the retirement date approaches have the biggest impact on final wealth accumulations, because these returns affect a longer history of contributions and savings into the account.

However, there is another option for pre-retirees to consider that provides structured returns to better manage downside risks. Fixed-indexed annuities can also function as an asset class within an accumulation portfolio to better manage downside risks, while still allowing for participation in the market upside. The ability to better manage downside risks can lay a foundation to either reduce the asset level necessary to successfully retire, or to enhance the returns produced by a given asset base.

Risk averse households will seek a high probability of success that their financial plan will work, which implicitly leads them to assume a lower rate of return from their investments. By managing downside risks through a more structured approach that prevents negative market returns, a fixed-indexed annuity may allow for greater wealth accumulation at lower percentiles of the distribution of outcomes when markets perform poorly. This protection may make it easier to retire successfully in down market environments. By limiting participation on the upside, the positive impact on wealth accumulation in good market environments may also be reduced, resulting in a set of tradeoffs for clients. These tradeoffs can be analyzed through calculators comparing financial performance for investment strategies with and without a fixed-indexed annuity.

Great American Life®'s Index Protector 7 fixed-indexed annuity can serve as an investment option alongside traditional stocks and bonds. The fixed-indexed annuity offers four different indexed strategies, which all provide downside protection with a 0% floor on returns, while allowing for some participation in the market upside through indices linked to the stock market or exchange-traded fund. It may serve as a suitable replacement for bonds or other asset classes with a low correlation to the stock market within an accumulation portfolio.

Fixed-indexed annuities provide some protection against interest rate risk and other sources of investment volatility. Unlike a bond fund or individual bonds not held to maturity, fixed-indexed annuities do not experience investment losses if interest rates rise. Principal is protected and secured. Fixed-indexed annuities also offer tax deferral, unlike investment assets held in taxable accounts that face ongoing taxes on their growth.

Advisors should explore the role of fixed-indexed annuities in helping clients consider the range of potential outcomes for different investment strategies. The inclusion of a fixed-indexed annuity impacts the range of wealth outcomes both on the downside and upside. Even if the overall portfolio standard deviation increases with the inclusion of a fixed-indexed annuity, the ability to protect from downside losses, as returns for the annuity do not follow a traditional bell-shaped distribution, may serve to reduce risk for the distribution of wealth outcomes. Strategic inclusion of a fixed-indexed annuity in a portfolio can raise wealth accumulations across the distribution of potential outcomes, which serves as a means of helping the client understand that the annuity may add value to the overall financial plan.

A fixed-indexed annuity serves as a tool to enhance retirement asset protection by managing market volatility and the sequence of returns risk in the pivotal years leading to retirement. This can better set the stage for retirement and for creating more lifetime retirement income from a given asset base.

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