Your Retirement Advisor
Fixed Indexed Annuity Guide

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Understanding the Value of Fixed Indexed Annuities in a Retirement Portfolio

Retiree Need for the Balance of Security and Growth

Many baby boomers are approaching retirement with fresh memories of the 2008 financial crisis. That experience, understandably, has caused some to focus on insulating their retirement savings against sudden market declines. But the concern that many of those same individuals should be having is whether their money will last through retirement.

It's imperative to manage these challenges so a retirement portfolio provides the right mix and balance of stability and growth. The process starts by mapping out the full scope of the risks that retirees face in retirement, then creating a plan that adequately addresses those risks. For many individuals, fixed-indexed annuities (FIAs) can be a valuable key piece of those plans, as the products offer an appealing combination of upside potential and downside protection. However, there's a lot of confusion, myths and misinformation when it comes to Annuities. Some of this is perpetuated by investment advisors who aren't licensed to sell an FIA, which is an insurance product vs. an investment product. Still more is from the negative baggage that has come from other types of annuities. FIAs are different and they serve a different purpose in a retiree's portfolio. It's critical to take the time to learn and understand the role of an FIA in your retirement and to be open minded to what the "research" tell us about FIAs vs. the hearsay.

The following information is designed to be an educational resource and objective information on the benefits and features offered by FIAs. You will learn that there are many different variants of FIAs, yet all offer a unique combination of growth potential with absolute guarantees. High quality, low cost FIAs can be play an important role in the development of a properly constructed retirement portfolio as an alternative to the low returns offered by high quality bonds in today’s economic environment.

What Are Fixed Indexed Annuities?

Fixed indexed annuities (FIAs) are insurance products that combine protection from loss due to market downturns with growth potential, as well as guaranteed lifetime income. They give clients the potential to accumulate interest without exposure to downside market risk by offering a guaranteed minimum interest rate, along with the potential for additional interest credits based in part on the performance of one or more reference stock market indices, such as the S&P 500®.

Like all fixed annuities, FIAs can help address two major concerns of clients nearing retirement: the annuity's guarantees help insulate against market volatility, while guaranteed income protects against longevity risk.

How do FIAs work?

Fixed indexed annuities offer a guaranteed interest rate for a set period, as well as the opportunity for additional interest credits based in part on the performance of a market index.
Retirement savings held in an FIA are not invested directly in the markets. Instead, interest credits fluctuate based in part on the performance of one or more reference indices. When a particular index is up, the annuity's value may increase. Interest credits are applied to the portion of the annuity's accumulated value that is allocated to that index's crediting strategy. When the market is down, the interest rate declines to zero, but the value of the annuity holder's initial premium—as well as prior credited interest—remains intact. Thus, retirement savings are protected from market downturns.

While all FIAs share the same overall characteristics—the potential to benefit from market growth without taking on the risks of direct market participation—the details may vary. Indexed annuities differ in terms of which benchmark indices they track, how often they calculate changes in the indices, how they determine crediting strategies, and what additional benefits they may offer.

FIAs follow the performance of the market without investing directly in market assets by offering interest credits based in part on the performance of reference indices. As a result, FIAs protect against market downturns. While it's possible to earn zero interest in any given crediting period, interest credits will never be less than zero. In addition, once earned, interest credits are locked in and cannot be lost to future market downturns.

To provide that guarantee, FIAs' interest crediting strategies include a limiting mechanism, in the form of a rate cap, spread fee or a participation rate.

- **A rate cap** is a ceiling applied to interest based on the index change. For example, an FIA with a 4 percent cap will receive an interest credit of 4 percent whether the underlying index returns 4 percent, 8 percent or 12 percent.

- **A spread fee** is deducted from an index return. For example, an FIA with a 2 percent spread will receive an interest credit that's two percentage points lower than the index's returns—2 percent if the underlying index returns 4 percent; 6 percent if the index earns 8 percent; and 10 percent if the index returns 12 percent.

- **A participation rate** calculates interest credits based on a set percentage of any index increase. For example, an FIA with a 90 percent participation rate will receive an interest credit of 3.6 percent if the underlying index returns 4 percent; 7.2 percent if the index earns 8 percent; and 10.8 percent if the index returns 12 percent.

Whatever the crediting strategy, money in annuities grows tax-deferred. To supplement these interest credits, FIAs may also include riders that offer additional benefits, such as a death benefit or liquidity options.

What types of individuals should consider an FIA?

Annuities can be a good option for the following types of people:

- Those who are approaching retirement and have a lower tolerance for risk, but still want some exposure to the stock market's growth potential

- Those who are looking for higher potential returns than those offered by fixed income alternatives, particularly in a low-interest rate environment

- Those seeking a guaranteed stream of income for retirement date

- Those who have maxed out their 401(k)/IRAs and are looking for other sources of tax-deferred savings growth

- Those who want to leave a legacy, because an FIAs accumulated value or minimum guaranteed contract value (MGCV) can be passed to beneficiaries at death. All FIAs offer a guaranteed death benefit that can never be less that the initial purchase payment made regardless of market conditions.

Key factors that impact how FIAs function

- **What underlying indices does the annuity track?** While about half of all FIAs use the S&P 500 as their benchmark, other FIAs track hybrid or alternative indices designed to pursue specific strategies, such as non-correlation to the major equity indices and/or targeting specialized groupings of asset classes.

- **How does the annuity calculate index returns?** FIAs may calculate changes in the index from the start and end of a specific period, such as a month or year. This is called a point-to-point strategy. In addition, the tracked return may include or exclude dividends (total return) or returns in excess of the risk-free rate (excess returns).

- **What is the annuity's crediting strategy?** An FIA's interest credits typically are based on a formula such as a cap (an upper limit on return) or participation rate (the percentage of an index's return credited to the annuity), or a percentage-based fee such as a spread. For example, if the benchmark index returns 8 percent, an FIA with a 4 percent cap will receive an interest credit of 4 percent; an FIA with a 90 percent participation rate will receive an interest credit of 7.2 percent; and an FIA with a 2 percent spread will receive 6 percent

- **Does the index offer additional riders?** Clients may opt to add features to their annuity at an additional cost. FIAs may offer such riders as guaranteed lifetime income, liquidity options, a premium bonus or death benefits.

The Importance of Index Selection

Despite sharing the same basic structure, all fixed-indexed annuities (FIAs) are not created equally. While the S&P 500® is the most popular benchmark for FIAs, a growing segment of the market is made up of annuities that track alternative or hybrid indices.

The distinction is critical: Although fixed-indexed annuities do not make direct investments in the markets, their performance is linked to that of their underlying index or indices. By tracking alternative indices, FIAs can target specific return characteristics while also potentially generating greater value for investors than annuities that use the S&P 500® as their benchmark.

The rise of alternative indices has created more options for retirement savers. To maximize an FIA it is imperative to understand how the features of alternative indices can impact performance.

Four design elements to consider when examining an FIA's index selection

1. **Specific objectives or strategies**
   Alternative indices are often structured to suit a specific strategy. For example, an index may track an equity index that's broader than the S&P 500®, or it may target a specific sector (say, only utilities stocks) or a geographic region (such as international versus U.S. equities). Likewise, an index may be composed of assets with low correlation to the S&P 500®.

An index's objectives can help individuals who are attempting to target specific strategies within their overall savings plan and can offer diversification benefits alongside a portfolio that already has significant exposure to the S&P 500®.

2. **Custom blends of asset classes**
   Many FIAs feature custom or "bespoke" blends of several underlying indices, with the goal of reducing risk through diversification. This flexible approach allows the indices to vary their exposure to a mix of asset classes using proprietary methodologies to determine which constituents offer the best risk-reward profiles for the prevailing market conditions.

3. **Tactical rebalancing and reweighting**
   The frequency with which an index's components are rebalanced and reweighted can affect an annuity's performance. For example, the composition of the S&P 500® changes relatively infrequently, meaning that annuities tracking this index have little opportunity to generate performance that's substantially different from the U.S. stock market.

   By contrast, alternative indices might be rebalanced and reweighted at the end of every month, or perhaps even every trading day, making them more responsive to changes in the financial markets. This strategy can result in annuity interest rates that follow a different path than a client's equity investments.

4. **Risk-control mechanisms**
   Many alternative index FIAs use a risk-control strategy that seeks to manage performance to a particular volatility level. These products rely on dynamic asset allocation—including an allocation to cash—that is adjusted based on market conditions. If markets are stable, the annuity typically is fully exposed to the benchmark index's mix of assets, such as stocks, bonds, and commodities. However, if the market shows signs of volatility, the annuity can reduce exposure to the index and increase exposure to cash, cushioning against sharp declines.

These risk-control mechanisms are managed to avoid very high positive returns and very low negative returns, resulting in more predictable, stable performance. And by narrowing the range of both positive and negative performance, annuity providers can offer greater rates of participation in the index's upside.

Translating Design Features into Potential FIA Performance

Many of the alternative indices on the market include a combination of several of these factors. For example, an FIA might track an index that focuses on 50 dividend-paying domestic stocks and employ a 5 percent volatility control level. This level of customization makes it possible for FIAs to offer different performance profiles.

Understanding the components that go into alternative indices can help assess how an FIA might perform in various market conditions, as well as the potential value of a product. That way, individuals are in a better position to properly steer toward the FIA that best suits the portfolio, goals, and appetite for risk.

How Fixed Indexed Annuities Protect Against Downside Risk

Investing directly in the market exposes investors to both volatility and market risk. This uncertainty can make it difficult to create a reliable retirement income plan. Fixed indexed annuities (FIAs), which track market indexes but aren't invested directly in the market, allow some exposure to market gains while avoiding market downside.

FIAs – How Interest Rates Are Calculated

To see how these formulas translate into returns for annuity holders, consider a hypothetical FIA that tracks the S&P 500 as its benchmark, uses a participation rate of 70 percent and a one-year point-to-point strategy with a 2% Spread Fee:

Hypothetical Example

Beginning Index Value: 2,300
Ending Index Value: 2,500
Participation Rate: 70%
Percentage change in the Index: (2,500 – 2,300) / 2,300 = 8.7%
Interest calculated: 8.7% x 70% = 6.09%
Spread fee (annual): 2% - 6.09% = 4.09%
Note: In this hypothetical example, the interest credit at the end of one year is 4.09%

How Do FIAs Compare?

FIAs versus 10 Yr Treasury Bond & S&P 500 Index

The table below demonstrates how the S&P 500's historical performance and the 10 year Treasury Bond index compares over the past 5 years (2012-1016) against the growth of an FIA that tracks the S&P 500 Index.

Though the amount of interest you can earn with an FIA will typically fluctuate depending on the specific terms of the annuity contract, performance is more stable than in the underlying index. This stability provides an opportunity to pursue growth without risk of loss due to market downturns.
FIAs should be compared to the "low risk" component in a retiree's portfolio, such as 10 year T-bonds and are NOT an alternative to the stock market. The table above compares the FIA to the S&P 500 only to validate the growth potential of stocks while the FIA will be limited by the cap, participation rate or spread rate and will offer a percentage of the index utilized.

This hypothetical example assumes a $100,000 initial premium, a *one-year point-to-point index strategy* utilizing the *S&P 500 Index*, a *2% annual spread fee* and a *70% participation rate with no cap*. The contract term is for 10 years, with no withdrawals or rider fees taken. The accumulation value of a fixed-indexed annuity could decrease if the investor purchases an optional rider and receives no interest credits. This example is for informational purposes only and is not indicative of past performance, nor intended to predict the future performance of any specific product.

	S&P 500 Index (with dividends)		**10 Year T- Bonds**	**FIA**
2012	15.89%		2.97%	7.58%
2013	32.15%		-9.10%	19.14%
2014	13.52%		10.75%	6.12%
2015	1.38%		1.28%	0.00%
2016	11.74%		.69%	4.31%
Average Rate of Return (2012-2016)	**14.94%**		**1.32%**	**7.43%**

Source for S&P 500 Index and 10 Year T-Bonds: Annual Returns on Stock, T.Bonds and T.Bills: 1928- Current; www.stern.nyu.edu

In summary, the FIA does offer a guarantee that the value of the portfolio will not decline in an adverse market like 2007, 2008 and 2009. Stocks can experience high levels of risk and volatility and losses of 20% to 30% or more can be realized during economic downturns. This is why a combination of stocks and bonds is typical for the average retiree and why FIAs can be an attractive alternative to bonds in this low interest rate environment as can be seen in the table above.

Indexed Annuities: FAQ

What is a fixed indexed annuity (FIA)?

A fixed indexed annuity (FIA) is an insurance product that combines protection from loss due to market downturns with growth potential as well as guaranteed lifetime income. A FIA gives clients the potential to accumulate interest without exposure to downside market risk by offering a guaranteed minimum interest rate, along with the potential for additional interest credits based in part on the performance of one or more reference stock market indices, such as the S&P 500®.

What indexing methods are commonly used?

A fixed indexed annuity's credited interest rate is calculated based in part on the upward movement of one or more major stock market indices. The most commonly used stock index is the S&P 500®. FIAs can also track alternative and custom indices.

How is the index-linked interest rate calculated?

FIA rates are set at the beginning of a crediting strategy's term period and are typically calculated based on mechanisms such as a participation rate or a cap. The participation rate determines the amount of an index's gain that will be credited to the policy value in the form of an interest credit. The cap is an upper limit on the amount of an index's gain in value that will be credited to the policy value.

How do FIAs provide downside protection from market loss?

Like traditional fixed annuities, FIAs guarantee a minimum interest rate. Thus, the annuity owner's premium incurs no market risk. What's more, any previously earned interest is also locked in and becomes part of the annuity's accumulated value.

How do riders affect FIAs?

Riders add further benefits or agreements to an annuity contract, generally for an additional charge. FIA riders vary depending on the specific product selected; they can include options such as guaranteed lifetime income or death benefits.

Are there tax benefits to owning an FIA?

Yes. Interest credited to an FIA premium is not taxed as earned income until it is withdrawn. When annuitized, a percentage of each annuity payment, known as the exclusion ratio, may be excluded from taxes. Annuity providers use IRS life expectancy guidelines to calculate this ratio.
Under current tax law, the Internal Revenue Code already provides tax deferral to qualified money, so there is no additional tax benefit obtained by funding a qualified contract, such as an IRA, with an annuity; consider the other benefits provided by an annuity, such as lifetime income or a death benefit.

Can individuals lose money in an FIA due to market losses?

Retirement savings in an FIA are not invested directly in the market and offer a guaranteed minimum interest rate. Thus, there is no market risk to an annuity premium.

What happens if individuals want to withdraw their money before the end of the term?
Annuity owners will pay a surrender charge if they withdraw a portion of or the entire contract's accumulated value during the surrender charge period. The surrender value is the amount in cash the owner is entitled to collect upon terminating the annuity contract prior to maturity or death. However, most FIAs offer an individual to withdraw earned interest or 10% of the original contribution per year without triggering a surrender charge.

Glossary of Terms

Accumulation Period
The time between the first premium payment on a fixed indexed annuity and when the payout begins. During this time, the premiums paid into the contract "accumulate" with interest.

Accumulated Value
The value of the annuity. The accumulated value may differ from the amount an annuity owner may receive if he or she surrenders the annuity.

Cap
The upper limit on the amount of an index's gain in value that will be credited to the annuity value.

Compounding Interest
The type of interest that is earned on both the original principal amount and on the interest accumulated from earlier periods.

Exclusion Ratio
The percentage of each annuity payment from an annuitization or single premium immediate annuity (SPIA) that is excluded from taxes. Annuity providers use IRS guidelines for life expectancies are used to calculate this ratio.

Fixed Annuity
Under the terms of a fixed annuity, the annuity provider agrees to pay a guaranteed minimum interest rate to the annuity. There is no market risk to the annuity owner's premium.

Fixed Indexed Annuity
A fixed indexed annuity offers the same type of minimum interest rate guaranteed by a traditional fixed annuity, but has the potential to pay additional interest depending upon the performance of an external measure, typically a market index.

Market Value Adjustment (MVA)
Some annuity contracts have a market value adjustment (MVA) provision. An MVA applies to withdrawals in excess of the free amount during the annuity's withdrawal charge period. In general, if interest rates in the market are higher than, or the same as, when an individual purchases an annuity, the MVA is negative, which reduces the cash surrender value. Conversely, if interest rates are lower than when the annuity was purchased, the MVA is generally positive, which may increase the cash surrender value.

Participation Rate
For a fixed indexed annuity, the participation rate is the amount of an index's gain that will be credited to the policy value.

Premium Bonus
An annuity provider may credit an additional amount to an annuity contract owner's initial premium in the form of a premium bonus. This bonus increases the contract's accumulated value immediately. A premium bonus may have a vesting schedule or recapture schedule, which means that a surrender or withdrawal in excess of a free withdrawal amount may result in forfeiting all or a portion of the premium bonus.

Surrender Charge
A surrender charge can be charged to an annuity contract owner when he or she withdraws a portion of or the entire contract's accumulated value during the surrender charge period.

Surrender Value
The cash amount a contract owner is entitled to collect upon terminating the annuity contract prior to maturity or death. The surrender value consists of the accumulated value minus any surrender charges and the application of a market value adjustment.

Tax Deferred Growth
Description of a fixed indexed annuity's tax status. Interest credited to an annuity is generally not taxed as earned income until it is withdrawn.

To help you learn even more about Fixed Indexed Annuities, consider these resources:
Fixed Indexed Annuity Council

Read Your Retirement Advisor co-founder, Brian Saranovitz's views in this U.S. News & World Report article: Fixed Annuities Are an Option Over CDs

Learn more about Your Retirement Advisor's Multi-Discipline Retirement Strategy

Take our e-class, Retirement Income Planning

To discuss and learn more about the role of annuities in your retirement portfolio, we offer a complimentary 30 minute discussion with an advisor

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participation or returns in significant ways. Any guarantees offered are backed by the financial strength of the insurance company, not an outside entity. Investors are cautioned to carefully review an index annuity for its features, costs, risks, and how the variables are calculated.

Investments in securities do not offer a fix rate of return. Principal, yield and/or share price will fluctuate with changes in market conditions and, when sold or redeemed, you may receive more or less than originally invested. No system or financial planning strategy can guarantee future results. Therefore, no current or prospective client should assume that future performance or any specific investment, investment strategy or product will be profitable.