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Fixed Index Annuities: The Importance of Index Selection

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In this paper we outline some of the features of Fixed Index Annuities (FIAs) and share our observations regarding their performance, developments in underlying index design and the important role asset managers are increasingly playing within the space.

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Introduction

Planning for a comfortable retirement in today's environment is challenging. The shift from employer-sponsored Defined Benefit plans to Defined Contribution plans has placed the burden of investing for retirement on the shoulders of individual investors. In a low-return environment, it is critical that individuals make sensible investment choices that enable them to achieve their savings goals.

Annuities may be an attractive investment option for individuals who want to protect a portion of their retirement portfolio from a variety of risks. Whilst there are many different types of annuities, from variable to fixed, the focus of this paper is on developments within the FIA market. FIAs are tax-favored accumulation products generally issued by insurance companies. With an index annuity, growth is benchmarked to an index rather than an interest rate. Indexes used in FIAs range from well-known market benchmarks, such as the S&P 500, to custom, multi-asset indexes designed by financial companies such as banks and asset managers. An FIA's growth is subject to floors and caps, meaning it will not exceed or fall below specified return levels even if the underlying index fluctuates outside of those set parameters. In simplest terms, the insurance company bears the risk when an

FIA's benchmark index declines. Investors will not lose their principal, but there is often a ceiling on their potential gains.

We will focus briefly on the potential benefits and risks of investing in these vehicles and the importance of selecting an annuity with an appropriate index.

The Impact of Index Selection on Fixed Income Annuities

A key benefit of FIAs is that they shift downside investment risk from the purchaser to the provider. Another attractive feature of annuities is that they often provide lifetime income for an additional fee. The certainty of income that an annuity provides may discourage investors from making poor decisions during periods of short-term volatility, such as panic selling or attempting to time the market's ups and downs.

As with any investment, it is important to be aware of the potential drawbacks of investing in annuities. Investors may incur penalties for early withdrawals; therefore they must be financially capable of bearing a certain level of illiquidity and be appropriately compensated for doing so. In addition, annuity fees may be significant, and investors in capped FIAs often forego upside gains beyond a pre-specified level.

A central issue to consider when selecting an FIA is the nature of the underlying index. If the annuity provider assumes the downside investment risk and guarantees both the principal and the future level of income, why does this matter? The answer is that the likelihood that the index will meet certain performance and volatility targets factors into the overall pricing of the annuity and the ability of the provider to offer investors other attractive product features.

Insurance companies are willing to assume the downside market exposure stemming from the annuity because they employ various hedging strategies to mitigate much of this risk. The costs of these strategies are factored into the overall level of fees charged to the annuity holder. The less expensive it is to hedge the index, the lower the level of fees that the annuity provider may potentially charge the investor. Factors that impact the cost of the hedge include the volatility of the index, its complexity, transaction costs and ease of trading. It is important to note that lowering the cost of the hedge is not, in and of itself, enough to provide quality returns to an investor. An attractive annuity is able to find a balance between the cost of the hedging strategy and the return potential of the index.

Asset Managers are Driving Improvement in Fixed Index Annuity Design

Recently there have been significant improvements in index design coinciding with increased involvement by asset management firms with expertise in portfolio construction, dynamic management, investment selection and long-term wealth accumulation. Modern portfolio theory considerations surrounding investment efficiency and diversification are now becoming more prevalent in the index design process. Evolved index designs allow annuity providers to make use of diversified multi-asset class indexes in their products rather than single-asset class indexes (e.g., standalone equity or fixed income indexes). Key benefits of diversification are the potential to lower volatility and to contribute to a higher level of index return.

Annuities tend to be structured with terms that vary from 5 to 12 or more years. As such, investors and insurance carriers must be comfortable with the asset classes that they will be exposed to at the beginning of the annuity term and the process in place to manage the annuity when the market environment changes. For example, if an index is based on a single market segment, such as U.S. large cap equities, and that segment of the market crashes, the owner of the annuity is cushioned from the fall but may not benefit from short-term market rebounds. Fortunately, insurance carriers have been mindful of these challenges and have started to work with asset managers to help address these issues. Beyond the natural risk mitigation of diversification, index providers have developed solutions that are more mindful of investment risks in areas such as asset allocation. Recent improvements include the addition of risk metrics beyond volatility into index construction (e.g., duration risk), dynamic risk controls (such as increasing allocations to cash in response to spikes in volatility), accounting for cross-asset-class correlations and incorporating market factors such as momentum and valuation.

Conclusion

Annuities in general, and FIAs in particular, may provide a sensible tax-deferred investment option for individuals saving for retirement. Adding annuities to a diversified portfolio may enhance the level of income that is available to investors during their retirement. Fortunately, for both annuity purchasers and providers, FIA design continues to advance and, in our view, should continue to result in better investment management solutions for clients. Investors should question their insurance providers not only about the features of the annuity, but also about the benefits and drawbacks of the underlying index as well.

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