The power of fixed index strategies

By Ali Hashemian, CFP® on February 4, 2015

There are a few rules of investing that most people have heard of and can relate to in some way. One of them is "don't lose money." This rule is so well-known that many have come to believe that it is the first (and most important) principle when it comes to investment strategies. Many people regard this rule so highly that they would say the second principle when it comes to investment strategies is "don't forget rule number one."

The other commonly known rule of investing is the concept of "buy low; sell high." And while these are very good rules for investors to consider conceptually, it is extremely difficult to actually implement them without some sort of crystal ball.

Fortunately, a new industry in the financial services market has developed that can help retail investors enjoy the benefits associated with a product that can automatically follow the rules of investing mentioned above. The fixed index, sometimes simply referred to as indexed, marketplace can offer investors products that don't lose money (or protect the clients' original principal investment). On top of that, these products usually offer two features that, in a sense, help these investors lock in the various indexes at low points and lock in the higher index values annually. But instead of trying to do this based on timing or emotion, this is done automatically on a contract year-by-year basis. The two features that make this possible are annual lock-in and annual reset (both of which are built into most of the fixed index products available). These two features may be the most important, undervalued advantages of this type of asset class.

Annual lock-in

Every contract year in which there is a positive interest credited due to an increase in the associated index, that positive credit (or dollar amount of gain) is locked into the contract value. At that point, regardless of future negative performance of the index that is linked to the product, that gain can never be lost due to future loss of index value. This has a similar effect to “selling high."

Annual reset

Every contract year in which there should be a negative result credited due to a decrease in the associated index, that negative credit (or dollar amount of loss) is not applied to the contract value. At that point, the starting point of the index for the following contract year is set at the new, lower index value, regardless of how much higher the initial index value was. This has a similar effect as “buying low."

Since most fixed index products offer principal protection, they inherently conform to the first and second rules of investing: Don't lose money. With the benefits of annual lock-in and annual reset, investors are able to own a product that has the added value of the “buy low; sell high” rule built into the product’s structure.

Of course, investors should be aware of the obvious and significant disadvantages of these fixed index products and consider those issues when deciding where to use these instruments in the overall portfolio construction. Some disadvantages include, but are not limited to: index caps, index participation rates, index spreads, and contract surrender penalties.

While these products are not perfect or “too good to be true” in any way, they can offer a significant risk-adjusted return advantage for a portion of investors’ portfolios.