FIAs Shine A Light In A Foggy Financial Picture

By Charlie Gipple May 27, 2015

As the Federal Reserve has indicated, we expect an increase in the federal funds rate at some point during 2015. If this happens, it is possible your fixed income investments could decline in value, hurting the broader retirement portfolio.

Older retirement income plans included an increasing shift to traditional fixed income solutions such as bonds as your savers approached retirement. An individual bond held to maturity will return 100 percent of the principal invested regardless of interest rate fluctuations. But the current interest rate outlook may suggest looking at alternative solutions to preserve principal. Here are several alternative solutions that may help meet your income goals.

Fixed index annuities

Fixed index annuity (FIA) sales have increased exponentially since the beginning of the millennium. As a matter of fact, FIAs posted their biggest year ever in 2014 with almost $47 billion in sales volume, according to Wink Inc.'s fourth-quarter 2014 report. Why are FIAs so popular with advisors and, ultimately, consumers? FIAs offer both upside potential and downside protection as well as guaranteed income for life. Let's examine each feature.

The performance of FIAs is linked to a major benchmark index such as Standard & Poor's 500 index. Considering the historical long-term performance of the U.S. stock market as well as the more than 200 percent rally that we have witnessed in the S&P 500 since the market bottomed out on March 9, 2009, many consumers find this "link" appealing. Even though FIA interest is usually "capped," or otherwise constrained, many consumers like the fact that FIAs have the potential to generate interest that is greater than what they have the potential to generate from a money market account or certificate of deposit.

This is especially true when you consider that the nationwide average payout for a 5-year CD is only 87 basis points (bps).

And what about consumers who may not be so bullish on the stock market because they believe that the bull market is getting a little long in the tooth? After all, this bull market is six years old, the fourth-longest bull market since World War II and well beyond the average bull market of four years, according to DealBook. These FIA products not only guarantee no loss of principal based on index declines, but they also can capitalize on market fluctuations. I will explain using simple numbers and a simple comparison to an index fund.

Let's assume $100,000 being saved for retirement. If the funds were in an S&P 500 index fund, and in the first year the index declined from 1,000 to 900, the retirement account would lose $10,000 (not including dividends, expense ratios, etc.).

If the retirement money were allocated to an FIA, they would not have lost one penny to the market decline. They would still have $100,000 of retirement money (assuming no rider charges, etc.) and any interest credited for the next year would be based on the new starting point of 900 in the S&P 500. That means if the market finished higher than 900 in that second year, there would be an interest credit on $100,000 versus $90,000 in the index fund. With the index fund, the S&P 500 would have to pass the 1,000 mark to be back to the starting point and recover the $10,000 loss that occurred in the first year (not including dividends, expense ratios, etc.).

The index fund would have to increase by more than 11 percent to recoup the 10 percent loss it originally incurred. Interesting math isn't it?

Historically, the market hasn't gone straight down for long stretches of time. For instance, from 2000 to 2010, the S&P 500 finished down 21 percent (not including dividends) over that entire "lost decade." However, in six of those 10 calendar years, the market was actually up! Wouldn't it be nice to take advantage of the "ups" but not participate in the "downs"?

As they approach retirement, many consumers tend to utilize traditional thinking -- that is, they allocate more of their portfolio to the "safe haven" of bonds. However, many are not aware of the fact that bonds may no longer be a safe haven. In other words, 30 years of dropping interest rates may have given consumers a false sense of security with bonds, especially if they don't know what happens to bonds or bond fund values if interest rates inevitably change directions.

This is one area where there is a huge knowledge gap with consumers. As a matter of fact, a 2013 study by Edward Jones revealed this: "63 percent of Americans don't know how rising interest rates will impact investment portfolios such as 401(k)s, individual retirement accounts and other savings platforms. In fact, a full 24 percent say they feel completely in the dark about the potential effects." It is important to understand that an individual bond will continue to pay out interest and, if held to maturity, will pay back 100 percent of the principal that was invested in the bond.

For many investors today, especially those approaching or already in retirement, a principal loss in their bond holdings may be difficult to offset since there may be very little time to recover those principal losses before they enter the decumulation phase.

An FIA can protect consumers who are approaching retirement from the principal-decaying concerns that may exist with traditional fixed-income securities if interest rates increase, while still providing growth and accumulation potential.

Guaranteed Income

Part of the comfort of turning to fixed income is that it provides another stream of steady income, via interest payments, to complement pension, Social Security and other retirement income streams. But those interest payments aren't guaranteed for life!

When you look at industrywide FIA sales, LIMRA research shows that around 70 percent of FIAs sold have an optional guaranteed lifetime withdrawal benefit rider, for which they generally pay extra.

Most index annuities in the marketplace offer an income rider which can guarantee income for the lifetime of the annuitant, regardless of what happens to the contract value and regardless of how long the consumer lives.

For example, for a 60-year-old with $100,000 who wants to defer income until age 65, purchasing an annuity with an optional lifetime withdrawal benefit rider can guarantee a lifetime of withdrawals for the rest of your life, without "annuitizing" the contract. Compare that to using a traditional securities portfolio and withdrawing 4 percent per year without any guarantees, and these riders are extremely powerful!

Outliving their retirement nest egg in retirement is one of retirees' biggest fears. For an annual charge that generally ranges from 0.75 percent to 1.15 percent, this fear can be solved while providing upside potential, downside protection and a level of control over the balance.

In-service withdrawals

Regarding retirement income, there is currently $4.2 trillion in 401(k) plans, and approximately 60 percent of those assets are owned by consumers in their 50s and 60s, according to the Investment Company Institute.

For consumers over age 59½ who have yet to retire, there is a solution for this, known as the age-based in-service withdrawal. According to a recent study by Aon Hewitt, 90 percent of defined contribution plans allow age-based in-service withdrawals.

An age-based in-service withdrawal, if completed properly, can allow active employees — typically age 59½ and older — to initiate a direct rollover of all or a portion of their funds from a qualified retirement plan into an IRA without incurring income taxes or penalties while they continue to participate in the 401(k).

Although the tax code generally allows such rollovers, some plans impose more restrictive rules. The IRA can be funded with an index annuity which includes a guaranteed lifetime withdrawal benefit rider. This creates guaranteed lifetime income and protects hard-earned money from market downturns.

So whether there is a large chunk of savings in non-qualified money or in 401(k) plans, in many cases an index annuity can be used to:

1. Provide more upside potential than conservative vehicles.
2. Provide downside protection from market fluctuations.
3. Provide protection from the income erosion of rising interest rates.
4. Provide guaranteed lifetime income.

The current investment environment is unprecedented. Investors have experienced two major bear markets in just the last 15 years, three decades of dropping interest rates, and an environment in which many believe there is a bond bubble that may burst. We're consistently seeing more consumers treat FIAs as an alternative type of fixed income in their retirement income portfolios.

Given how these products have been tailored to pre-retiree and current retiree needs, we are optimistic that they will remain a shining light in an otherwise foggy global financial picture.