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FIAs: The Right Strategies At The Right Time

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Financial professionals have a multitude of options to choose from in helping their clients save for retirement. But with interest rates at historic lows, stock market volatility high and clients concerned about risk, the job of choosing has become more challenging. As annuities have come further into focus, a number of additional savings options are now available for consideration.

Fixed annuities provide tax-deferred accumulation potential and security for savers, especially if they hold the contract through the guarantee period. Fixed index annuities, however, have many of these same unique features but usually with even greater accumulation potential.

An FIA offers contract owners the opportunity for growth linked to a portion of the positive changes in one or more financial indices, while protecting the contract from all market loss. Your client's funds are never directly exposed to the financial markets but can receive interest credits based in part on the performance of the available indices.

FIAs' range of interest crediting strategies offers accumulation potential in various market conditions. Because of this protected accumulation potential not found in investments, and multiple crediting options, FIAs are becoming an integral component of many clients' overall retirement planning.

Investment Management Is Key

Similar to a fixed annuity, the return from an insurance company's general account runs the FIA engine; a superior fixed income investment strategy is required, and the gross earned rate on the GA is the starting point for funding the various index crediting options.

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Factors in enhancing the index crediting and potentially delivering better contract value growth include an issuing insurance company's higher gross earned rate, more efficient derivative hedging, reasonable profit target and a lower expense model.

Negative index returns do not decrease the owner's account value, as crediting rates are floored at 0%. In order to guarantee this downside protection and afford the derivative that sits behind the index credits, the issuer limits a contract's interest credits through a combination of index account parameters including caps, participation rates and spreads. They are reflected through the various derivatives purchased by the FIA-issuing company.

Common Crediting Options

Typically, clients are locked into their selection of a crediting option through each index account's term, at the end of which they have the opportunity to reallocate the value in the account. The benefit of having a variety of index crediting options is the ability to diversify how you approach your client's interest potential, depending on current market conditions. Here are a few examples of common crediting options.

» **Fixed account.** These typically provide a predictable rate of interest each year that is credited daily. Issuers credit an interest rate that is guaranteed to be no less than the contract's guaranteed minimum interest rate for each contract year. This kind of reliability appeals to clients who are most risk averse or require a consistent and fully predictable rate of interest.

» **Annual point-to-point index account.** One of the most common options, an annual point to point account, allows an interest rate to be paid (usually up to a cap) based on the growth of the underlying index (ending index term value compared to the starting index term value).

Interest is credited annually, on the contract anniversary. So, in years when the underlying index rises, a portion of its performance is credited to the contract. In years when the index drops, the contract receives no interest, but its value (the original principal and any accumulated interest) is locked in. This protects the client from losses and any ongoing downside volatility. If the index experiences steady growth, so does the annuity.

» **Multiyear point-to-point index account.** In this variation of the annual point to point option, interest is credited on every multiyear (every two, three or more years) contract anniversary. Issuers calculate how much interest to credit to the contract value based on the percentage change in the underlying index from each multiyear contract anniversary to the next. An annual spread or a participation rate often applies.

» **Annual average index account.** The annual average is also a commonly offered index option. The sum of each monthly ending index value is totaled and divided by 12 to get the average ending monthly index value. Interest is credited to the client's contract (up to a cap) based upon the average monthly index value compared to the starting index value.

» **Monthly sum index account.** The monthly sum is another commonly used index option. As its name implies, it looks at the index change from month to month. It adds all the monthly gains (up to a monthly cap) and losses to determine a total interest rate to be applied at the end of the index term.

In all of the common crediting strategies discussed here, if the index experiences a negative change over the measurement period, the contract value is credited with 0% (it is protected from negative index returns).

How Caps, Participation Rates And Spreads Work

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Caps limit how much interest the contract is credited from the underlying index and are in force at the time your clients choose an index crediting strategy and enter the annuity contract.

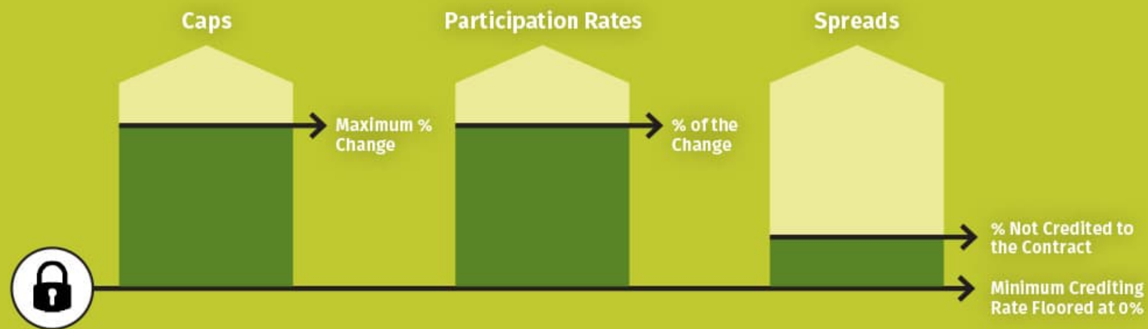
When your client chooses an index crediting strategy, the index account is subject to the rates offered at that particular time.

In an uncapped strategy, your client may benefit from higher interest credits compared to capped index account strategies. **So, if the cap is 5%, 5% is the most your client will receive in any given period. If the index earns 12%, they get 5%. If the index earns 3%, they get 3%, and so on.**

Participation rates are similar to caps but limit interest credits to a percentage of the index return for the period. If the participation rate is 75% and the index returns 10%, your client is credited 7.5%. If the index is up 20%, your client gets 15% or 75% of the index performance.

Spreads offer a baseline over which interest may be credited. If the spread is 3%, your client receives interest only if the index performs better than 3%. If it returns 3%, your client's contract value does not change. If it returns 8%, the client's contract will be credited 5% and so on.

With all three of the rate methods discussed above, caps, participation rates, and spreads, if the index is negative, the contract value does not change (the credit is 0%).



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Accumulation Strategies

Financial professionals need to help clients decide how to allocate their funds among the various FIA crediting options and evaluate the underlying indices.

Historically, FIAs have used the S&P 500 as a common index to tailor many types of index options available inside the FIA, while guaranteeing a floor of 0%. Today, a broad variety of traditional and proprietary indexes are being used to provide retirement savers more options to consider for the underlying index. The various crediting strategies also come into play depending on your view, and your clients' view, of market conditions.

For example, the annual average strategy could be used during a period of market volatility from a sharp decline in stocks, versus the annual point to point strategy. The annual point to point could potentially lose gains before the index term ends. The annual average would average out the gains and losses, while still giving the client an opportunity for interest despite the volatility.

The monthly sum strategy typically gives the opportunity for greatest interest but also includes in its calculation negative months with no cap on the negative. Therefore, this strategy is typically best during terms when you expect more consistent growth and less volatility.

Financial professionals often use a diversification approach by employing two or more index strategies in client contracts.

Current market conditions make many clients uneasy about their retirement, raising the need for additional savings options that help ease these concerns while providing a way to continue accumulating assets. To be clear, though, FIAs do not replace equity holdings with equitylike returns. Instead, they provide some of the upside potential of a market index in return for downside protection. And importantly, FIAs also benefit from tax-deferred accumulation.

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