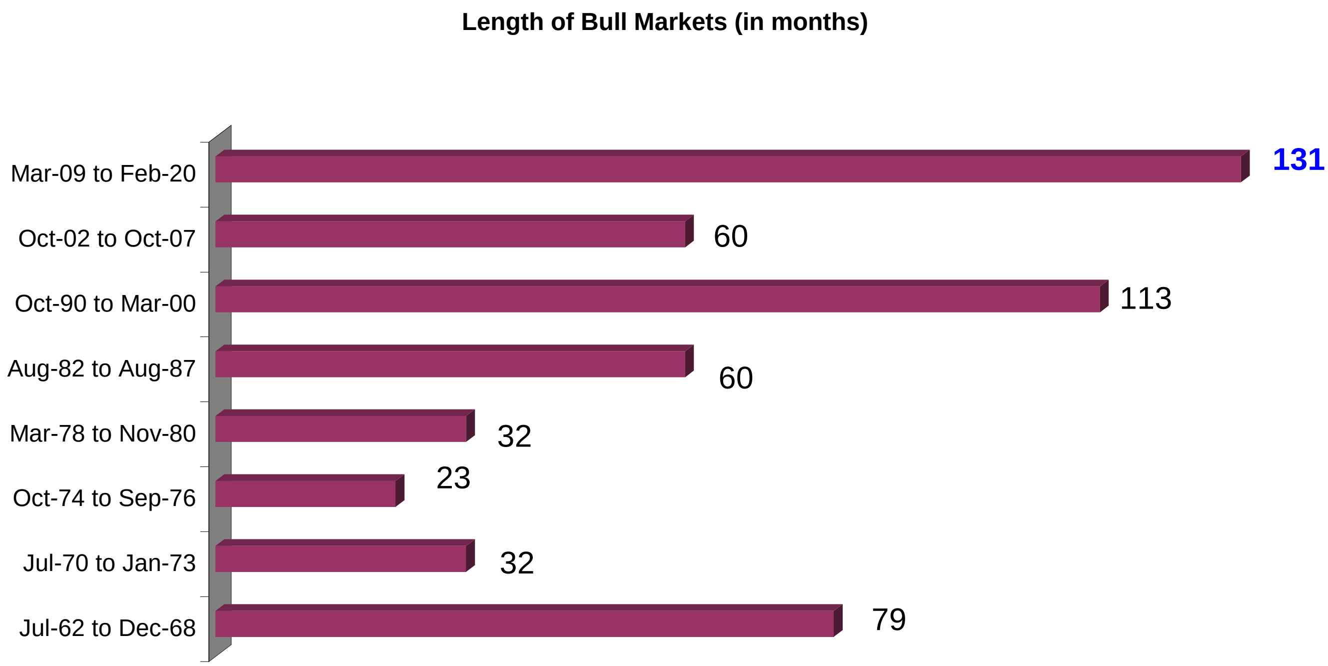
ADVANTAGE
COMPENDIUM

Prepared for IAMS 2020

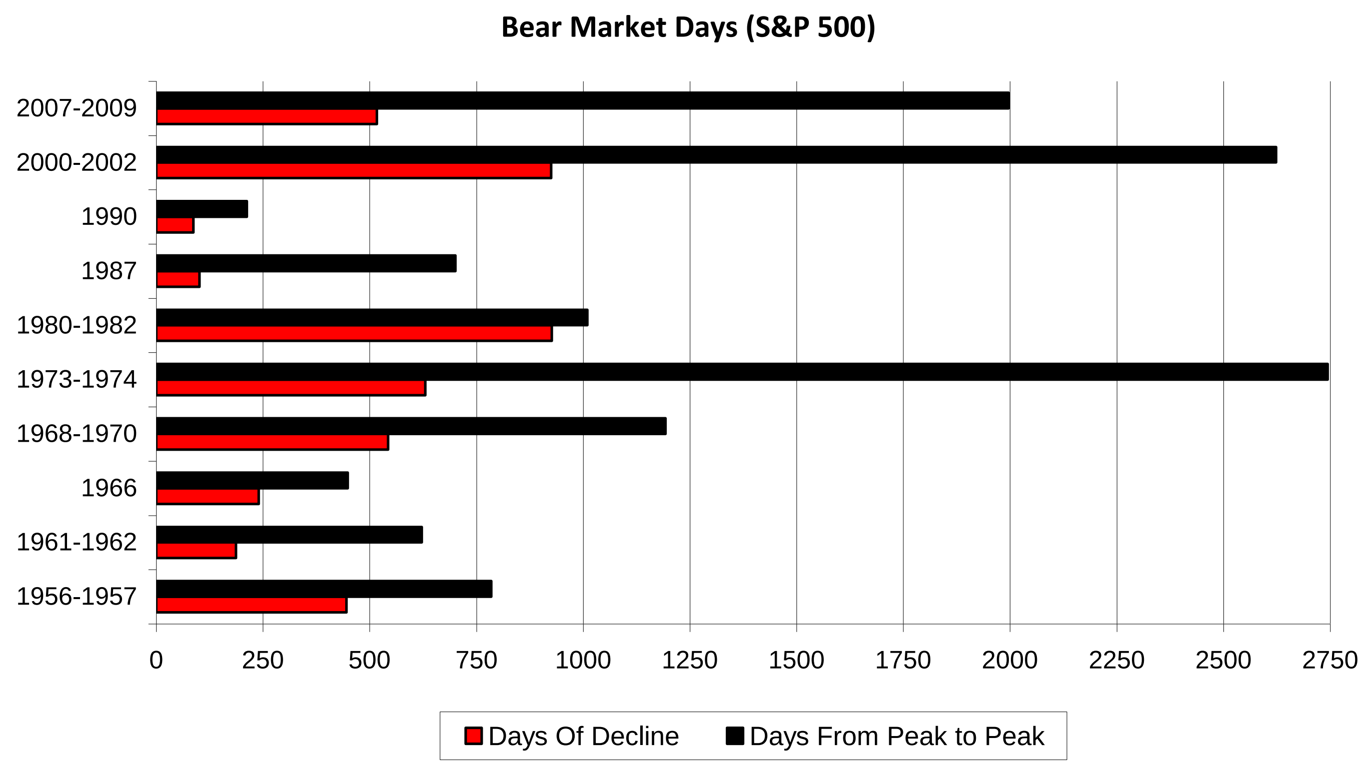
Fixed Annuities as a Response to Market Concerns

The bull market officially ended in March 2020 when stock indices sunk well below the 20% marker, signaling the start of a bear market. By many measurements this was the longest bull market in the last century and a half.

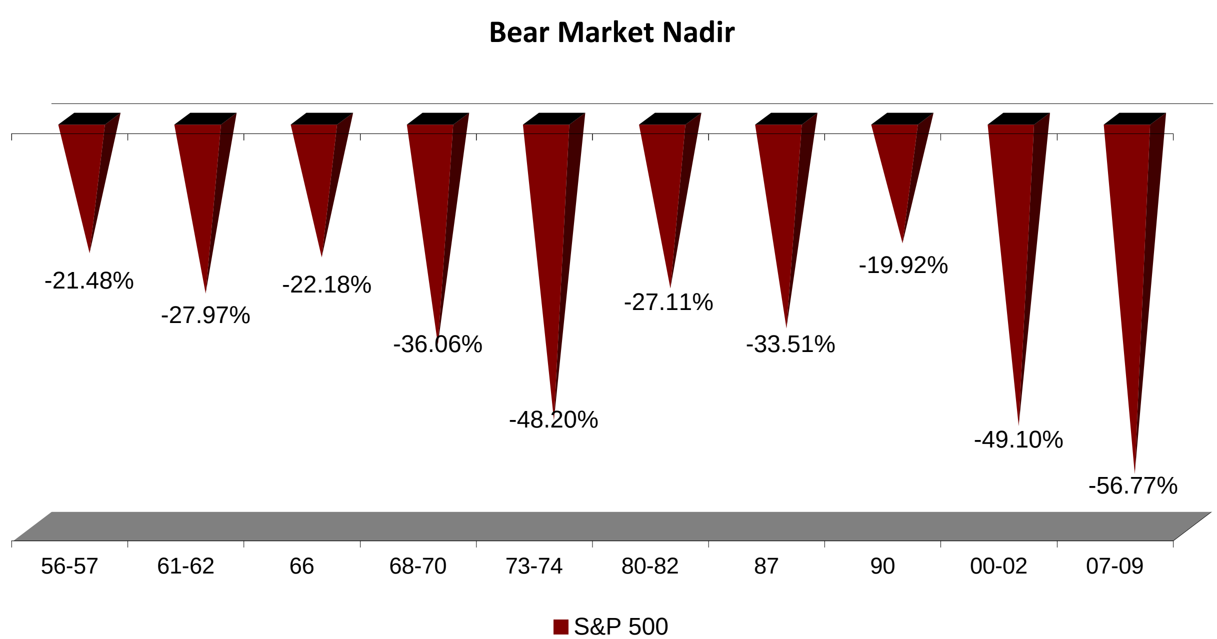


The next question becomes how long and deep will this bear market be? As I write this, the NASDAQ Composite index surpassed its previous February high in June and has now entered a new a bull market. However, the basic question remains as to whether the near future will resemble the long and nasty bear markets of the 1930s, 1970s and 2000s, that followed the long bull markets of the 1920s, 1960s and 1990s, or whether it will break with history.

In the two previous times with long bull markets, the decade and a half that followed produced end points that did little to justify a buy-and-hold approach to investing. The late 1950s and decade of the 1960s was a succession of short bull runs with much of the gain taken back in the next bear episode.



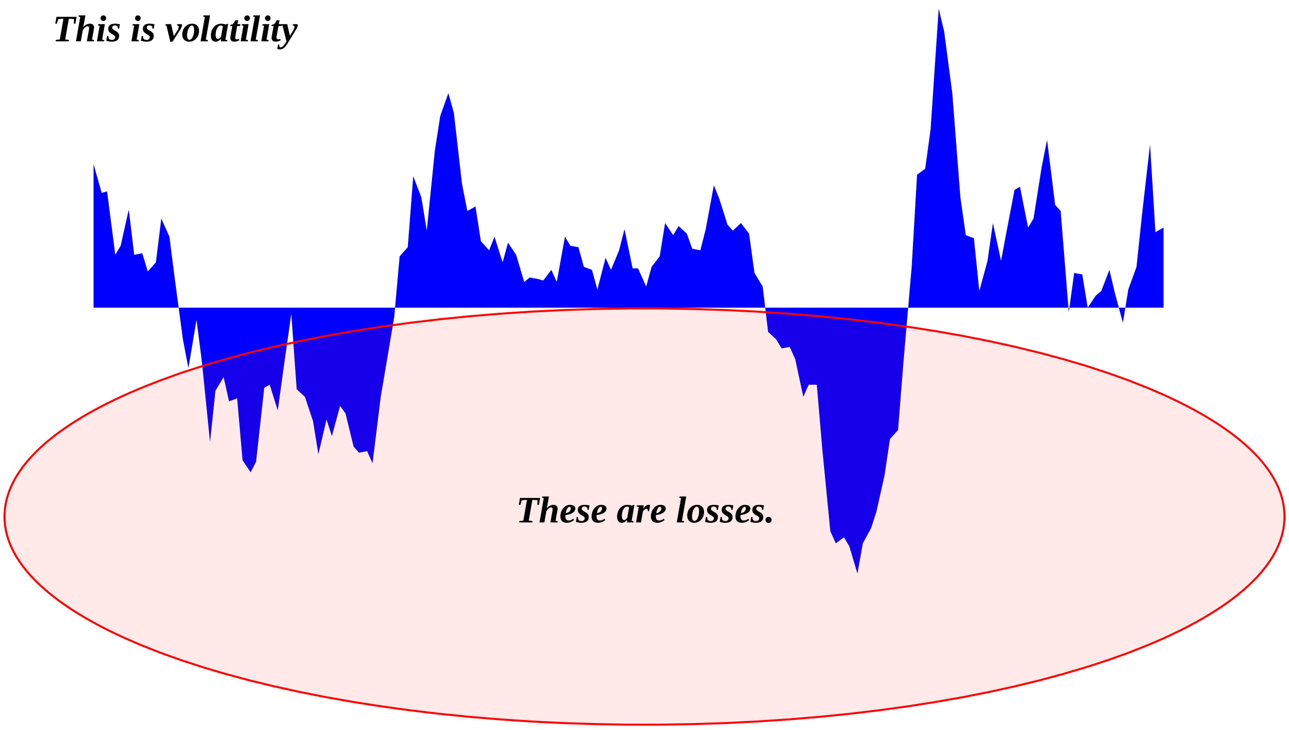
The bear markets of the 2000s were cataclysmic with the first one rivaling the brutality of the 1973-1974 drop and the latter barely avoiding a freefall last seen in the Great Depression.



This does not mean one should try to time the market; market timers ultimately wind up with a broken watch. It also does not mean avoiding the stock market completely; stock market returns have been significantly higher over the long-term than other vehicles. What it does mean is that the only money invested in the stock market should be those dollars you won't need to touch for several years, if a prolonged drop occurs. For those no-market-risk-to-principal dollars it is worth taking a look at fixed index annuities (FIAs).

The Difference Between Volatility, Loss and Risk.

The financial dictionary definition of ***volatility*** is the degree of price movement over time. The financial dictionary definition of ***loss*** is a decrease in financial value. And yet, especially since 2007, Wall Street has tried to delete the "loss" word from the vocabulary and replace it with "volatility" – even though they are not remotely the same thing.



Lowering the former does not eliminate the latter

By itself, volatility is neither good nor bad. If your stock market goal was to double your investment – and you did this – you should be indifferent to the intensity of the roller coaster ride the investment took to get there. There are places where you probably don't want volatility – being told your Social Security check still averaged $2,000, would probably not relieve the anxiety if every month the amount received was a surprise that ranged from $1,000 to $3,000.

A justification for limiting volatility is that losses often accompany times of great volatility so that volatility reduction lessens risk. Reducing volatility may lessen risk of loss – there isn't enough real world data yet to tell – but even if it is true it is meaningless in the fixed annuity space.

Securities-to-Fixed Annuities Dictionary: Risk
Securities: Risk is the degree to which it is possible to lose what you already have – loss of actual dollars.

Fixed Annuities: Risk is the possibility of earning less of a return (interest) than you might otherwise get.

Risk in the FIA world is different from the investment world. With securities risk usually means possible loss of money made, with a past perspective. By contrast, FIA risk is largely opportunity cost, meaning that the future interest earned might turn out to be less than earned in another no-market-risk-to-principal vehicle.

Dollars allocated to fixed index annuities are those that the person wants protected from losing what they have, with the goal of earning more interest than one might get from certificates of deposit, fixed annuities and such. If this period of time resembles those at the end of other long bull markets, there are many people with money invested in the stock market that, based on risk needs, should not be there. However, often their concern is that they will miss out on one more market upswing.

Timing Your Move Into FIAs

When do you take your money off the stock market table? If you take out your money too soon, you risk missing out on gains. Even if you do take it out, where do you put it? Traditional thinking says to put the money in traditional savings instruments, but rates are at historic lows. The counter-intuitive choice is to take the money you don't want to lose and put it in a fixed index annuity. Fixed index annuities proved their mettle in the last two bear markets. Based on the actual performance data I collected, a person getting out of, say, an S&P 500 index fund in 1999 or 2000 and getting the average of the FIA returns collected had three times the gain ten years later, compared to the person that stayed in the fund. [https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1482023]

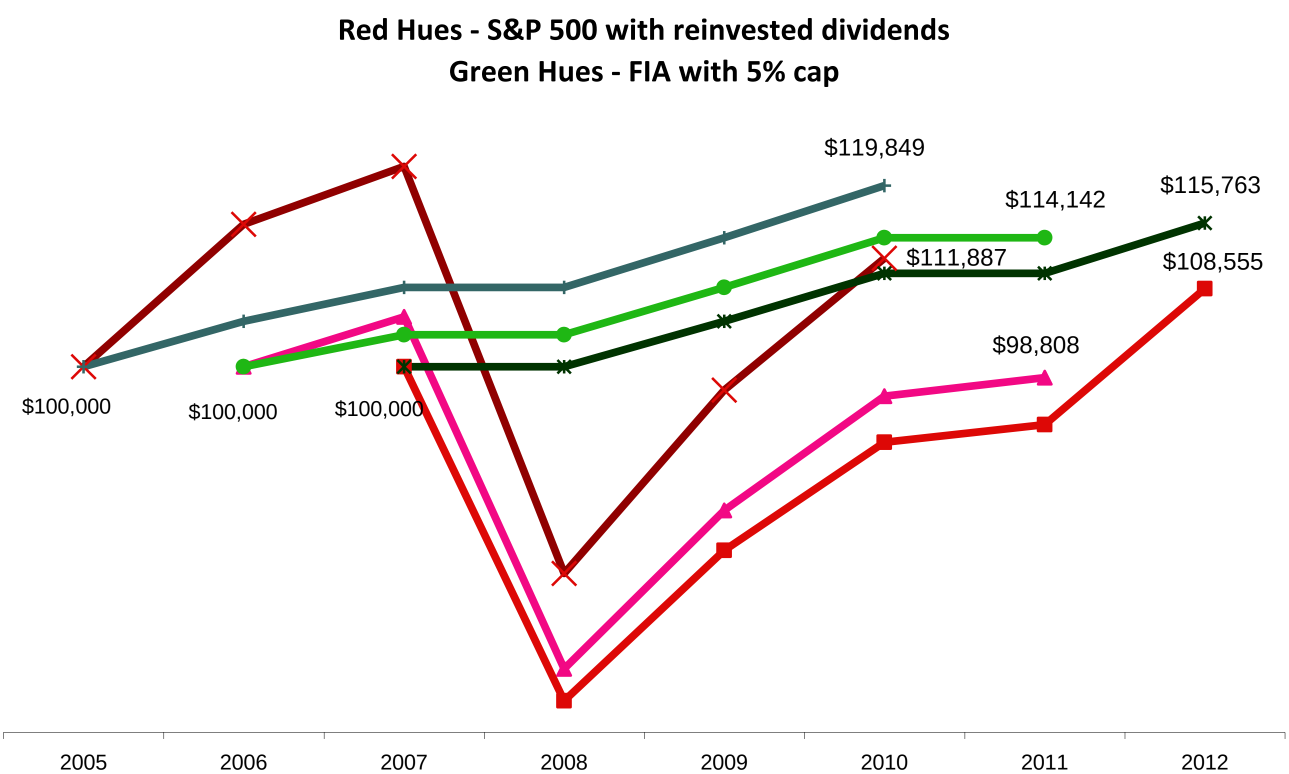
A Little Bear Experiment

Let's do some hypothetical comparisons. On one side we'll place $100,000 in the S&P 500 index with reinvested dividends and no fees of any kind. On the other we'll place $100,000 in a fixed index annuity that credits interest based on gains of the S&P 500 – without reinvested dividends – and we'll place a 5% cap on the annual interest credited. We'll use a five year period because FIAs are available where the money is available without surrender penalties after five years. To make this easy to check the data, we'll use calendar years.

The Crash of ‘08
If your crystal ball was working well, you’d have gotten out of the market at the end of 2007. If you’d stayed in you would have watched your $100,000 drop to $62,576 one year later. However, if you’d stayed the course you watched your investment rebound due to three years of strong double digit returns and wound up with $108,555 by the end of 2012. The FIA didn’t get those big returns since it had a 5% cap, but since it was still worth $100,000 even in the depths of the Crash, the FIA finishes with $115,763. FIA wins.

Let’s say you got out too early and switched to the FIA at the end of 2006. Good call. The $100,000 placed in the FIA is worth $114,142 and the $100,000 in the S&P index with dividends is worth $98,808. FIA wins.

This time you really blew it. You got out at the end of 2005 with two years of the bull market to go. By staying in you gained an extra 21%! You survived the bear market and your $100,000 is worth $111,887 at the end of 2010. However, the $100,000 in the FIA is worth $119,849. FIA wins.



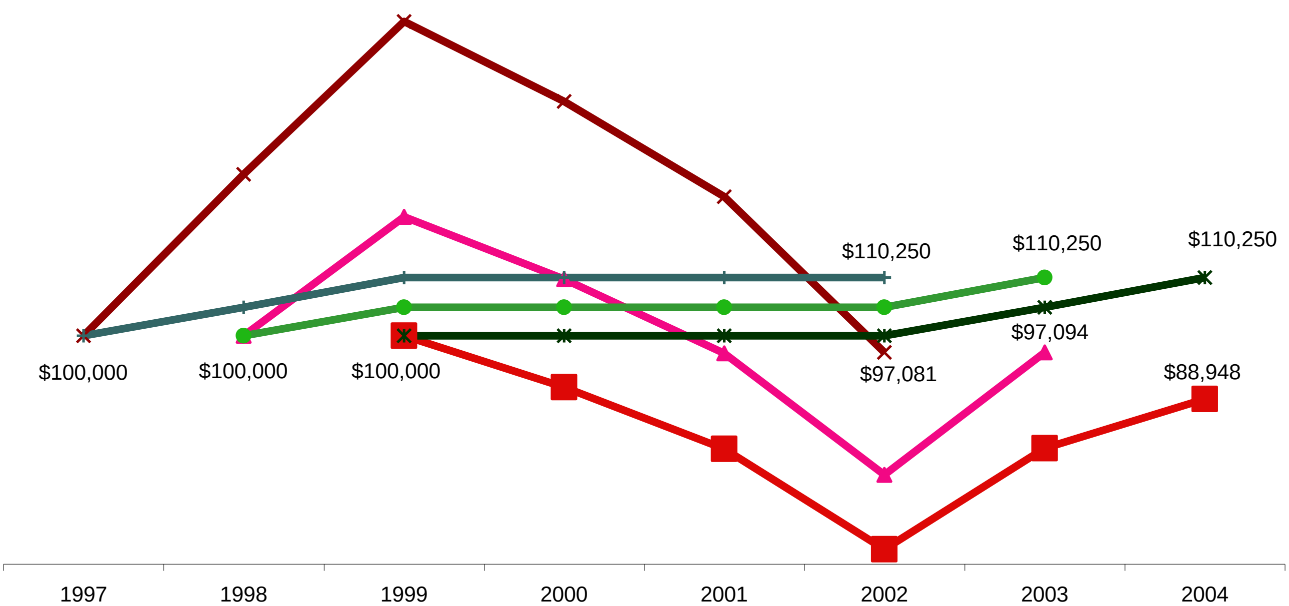
It didn’t matter whether your timing was right on or way early. In every case you still wound up with more money in the fixed index annuity (and missed the emotional gut-wrench of the 2008 crash). Surely, this was a fluke! The FIA couldn’t perform this well in other bear markets – or could it?

<u>The Millennial Bear</u>
You wisely got out of the market at the end of 1999. It's a good thing because you would have watched your $100,000 plummet before finally recovering a bit back to $88,948 by the end of 2004. By contrast, at the end of the same five year period your FIA has an accumulated value of $110,250.
FIA Wins.

You jumped the gun a little and got out at the end of 1998 and moved over to the FIA. Once again, your FIA's value five years later is $110,250, but if you'd stayed in your reinvested dividend index you finished up at $97,094. FIA Wins.

This time you really pulled the cord too early and moved to the FIA at the end of 1997. You're feeling a touch of buyer's remorse as you watch the S&P index with dividends gain 28% in 1998 and 21% in 1999, while your FIA pokes along with a 5% cap. However, at the end of the five years your former investment has given back all of those gains, plus a little more, so your $100,000 winds up at $97,081…and the FIA is worth $110,250. FIA Wins.

Red Hues - S&P 500 with reinvested dividends
Green Hues - FIA with 5% cap



Safeguarding The Future
We don't know when the next bear market will occur nor do we know how severe it will be. These examples show that based on the last two bear markets, protecting what you have was more important than missing out on some late bull market gains. We can't predict the future, but with fixed index annuities we can safeguard the present so that the money is available in the future.

Annuity Myths

There are certain preconceived beliefs about fixed annuities that make some people feel that they will not fit in as a part of their financial plan. Here are the main myths and the truth:

Myth: An Annuity Is Just An Income Stream

A fixed annuity is a savings vehicle that offers minimum guarantees, tax advantages and the ability to receive an income one cannot outlive. It appears that 98% of the fixed annuities purchased are not annuitized, but instead used as a conservative savings instrument offering availability of interest and the ability to pass along assets to a designated beneficiary. And yet the financial media's message is a fixed annuity is an income vehicle, and they tell consumers not to buy one unless they 1) need immediate income and 2) want to lose their principal forever.

The income benefits of a fixed annuity are wonderful, but you are not required to annuitize the annuity (turn the principal into an income stream) and the choice of using the income feature is only one benefit of owning an annuity. For the consumer a fixed deferred annuity is:

- A savings vehicle that guarantees you will earn at least a minimum return regardless of where future interest rates go – only Savings Bonds offered this feature.

- A savings vehicle that gives you a choice of receiving a stated rate of interest or the potential for more interest by receiving stated participation in an external index.

Myth: Most Fixed Annuities Have Fees

Many fixed annuities offer optional benefits such as lifetime income riders; these usually charge a fee (a rider is an additional benefit that is not a part of the basic annuity contract). There are a very few annuities that require a rider and charge a fee. However, I have not seen any fixed annuity charge a management fee or a mortality fee for the basic policy.

Myth: A Fixed Annuity Is Not For Young People

The "too young" slap against annuities is usually based on the IRS rule requiring a 10% income tax penalty on the interest portion of annuity withdrawals when under age 59½. Whether this really is a factor depends on the comparative returns of other vehicles and what the money is intended to do. If the choice is between a certificate of deposit yielding 2% or a fixed annuity crediting 4%, the annuity still pays more even if hit with the IRS penalty. And if the money is earmarked for retirement saying you should not buy an annuity at age 35 is as nonsensical as saying not to fund an IRA at age 35.

Myth: A Fixed Annuity Is Not For Old People

The "too old" criticism usually is based on misunderstanding what an annuity maturity date. Someone will say "an 80 year old should not buy this annuity because they are locked in until age 105." However, the maturity date referred to is the latest the annuity owner can force the insurer to keep the money and not the other way around. Usually simply stating this is sufficient.

Or someone will say "an 80 year old should not buy an annuity with a surrender charge because it ties up their money". The truth in this argument depends on the needs – and not the age – of the annuity owner and the features of the annuity chosen.

If the annuity owner will probably need access to most or all of the money before the annuity's surrender period is over then they should buy a different annuity with a shorter surrender period or put less in the annuity. Other concerns can be met by selecting an annuity with the features needed.

If an annuity owner believes they may need access to more than annual interest down the road, then the annuity selected might offer a cumulative penalty-free withdrawal feature. If an annuity owner wishes to make all of the annuity value immediately available upon death, then the annuity chosen should not have any restrictions on payment of death proceeds. If the annuity owner is concerned about possible nursing home bills if future health fades, then the annuity selected should have a nursing home provision permitting access to funds. You can never be too old for the right annuity.

Not A Myth

Whether a fixed annuity candidate is appropriate is not determined by age, but by needs and risk tolerance. Put simply, a 75 year old with good genes, sufficient resources, and a high tolerance for risk may never be a fixed annuity candidate because they do not want or need the safety features. On the other hand, an age 30 worker with scads of time until retirement may never develop the emotional tolerance for the investment world and would be a good fixed annuity candidate. These are simple truths, not myths.

They Say, You Say

Consumer	Annuity-Meister
"Nobody buys annuities"	Over 1 million of your friends and neighbors bought a fixed annuity in 2019 (Beacon Research)
"I've never heard of a fixed index annuity"	Over half a trillion dollars has been placed in fixed index annuities by people just like you (Beacon)
"I'm not worried about a bear market"	There have been four periods of long bull markets over the last 100 years: the 1920s, the 1960s, the 1990s and now. The first three extended bull markets were followed by prolonged, very nasty bear markets. (Advantage Compendium)
"I'm afraid I'll miss out on the next market upswing if I move out of securities"	Protecting against market loss can work better than trying for a last hurrah. A mild bear market is a 20% loss. Unless that market upswing gained 25% or more, you'd have more money at the end if you moved into a fixed index annuity and missed the last stock market hurrah.

Consumer	Annuity-Meister
"I might need the money and I don't want to pay a surrender charge"	Let's step back and take a bigger look. Imagine a pie representing all of your financial assets. Even if you had to cash in the annuity the surrender charge is only a small sliver of the pie. But first look at your other assets relative to the fixed annuity. You'd have to eat a great deal of your pie before you even touched the annuity slice.
"I like the idea of moving this money from securities to a fixed annuity, but I want to wait until I make back my recent 10% loss"	Let's suppose that this time the 10% loss was only the beginning of the next bear market. And let's suppose it is a year from now and those securities are now down 40%. Would you be happy or sad that you didn't move the money to a fixed annuity today?
"I like the idea of moving this money from securities to a fixed annuity, but I want to wait until I make back my recent 10% loss"	With this 2% MYGA you're guaranteed to make back the loss in five years and from then it is all interest gains compounding!
"What is the minimum premium?"	While the average premium is $62,000, the minimum premium is $25,000.
"I'm afraid I'll miss out on the next market upswing if I move out of securities"	Let's say the market moves up and your $100,000 is worth $120,000. The fixed index annuity has a 4% cap meaning your $100,000 would grow to $104,000. But what if we have a mild bear market and you lose 20% or $20,000 while the annuity avoids the loss. Is it worth risking a loss of $20,000 or more to maybe make an extra $16,000?
"How safe is this fixed annuity?"	Do you know anyone that has ever lost money in a fixed annuity?
"I don't like the surrender charge"	What additional liquidity might you need from this annuity that would not be met by your other assets?
"I could earn more in securities"	Is it important to protect at least some assets from the risk of stock market loss?

Consumer	Annuity-Meister
"I could earn more in securities"	If the choice is earning a bit less or risk losing what you already have, which do you choose?
"I like the certainty of the 1% CD rate because I don't know if the fixed index annuity will hit the 4% interest cap"	If you choose the annuity you may earn 1% less than the CD, but if you choose the CD you will lose the opportunity to earn 3% more interest with the annuity.
"What if the index goes down?"	Annual reset fixed index annuities reset annually. What that means is the following year interest earning period will start at the lower index level – it doesn't need to make back the index loss before it generates interest.

Could A Fixed Index Annuity Yield More Than a 5-Year CD?

Blue Shade: Assumes FIA competing against a 2% rate
Yellow Shade: Assumes FIA competing against a 1.5% rate
"Yes" means the FIA with a 4% cap using S&P 500 resulted in a higher yield over 5 Years

58-62	Yes	Yes	77-81	No	Yes	96-00	Yes	Yes
59-63	Yes	Yes	78-82	Yes	Yes	97-01	Yes	Yes
60-64	Yes	Yes	79-83	Yes	Yes	98-02	No	Yes
61-65	Yes	Yes	80-84	Yes	Yes	99-03	No	Yes
62-66	Yes	Yes	81-85	Yes	Yes	00-04	Yes	Yes
63-67	Yes	Yes	82-86	Yes	Yes	01-05	No	Yes
64-68	Yes	Yes	83-87	Yes	Yes	02-06	Yes	Yes
65-69	Yes	Yes	84-88	Yes	Yes	03-07	Yes	Yes
66-70	No	Yes	85-89	Yes	Yes	04-08	Yes	Yes
67-71	Yes	Yes	86-90	Yes	Yes	05-09	Yes	Yes
68-72	Yes	Yes	87-91	Yes	Yes	06-10	Yes	Yes
69-73	No	Yes	88-92	Yes	Yes	07-11	Yes	Yes
70-74	No	Yes	89-93	Yes	Yes	08-12	Yes	Yes
71-75	Yes	Yes	90-94	Yes	Yes	09-13	Yes	Yes
72-76	Yes	Yes	91-95	Yes	Yes	10-14	Yes	Yes
73-77	No	Yes	92-96	Yes	Yes	11-15	Yes	Yes
74-78	No	Yes	93-97	Yes	Yes	12-16	Yes	Yes
75-79	Yes	Yes	94-98	Yes	Yes	13-17	Yes	Yes
76-80	Yes	Yes	95-99	Yes	Yes	14-18	Yes	Yes

The experiment is a simple one. If we look back at calendar years going back six decades, and apply an annual reset method to the no-dividend S&P 500 index using a 4% cap, does the total gain over a five year period exceed that of a fixed interest competitor earning 2% or 1.5%?

As the graph shows, roughly 85% of the time the annual reset approach produced more than a 2% annualized return, and in every period the annual reset approach created more than a 1.5% return. What it means is, based on history, even an FIA with a 4% cap should reward the owner with more interest than if they buy a five-year year certificate of deposit.

Granted, the bar is low because interest rates are low, but the low interest rate environment is also the reason for the 4% cap. When savings rates go up, FIA index participation is buoyed by the same increase and caps go up. Even in these exceptional times, the FIA story holds true.

Summary

Fixed index annuities have been earning interest for over a quarter century, and in three bear markets no fixed index annuity owner ever lost a dime of their principal or credited interest. For those dollars that need to be protected from possible market loss, fixed index annuities have demonstrated the ability to be a competitive interest earning financial tool.

Advantage Compendium Ltd. **(www.advantagecompendium.com)**
is led by Jack Marrion, providing research and consulting services to financial firms in a variety of areas. He has conducted a broad scope of research ranging from the behavioral economic reasons why consumers buy or don't buy financial products to future industry impact models. He also served as Director of Research for the National Association for Fixed Annuities and as a Research Fellow for Webster University.

His insights on the annuity and retirement income world have appeared in hundreds of publications including *Best's Review*, *Business Week, Kiplinger, The New York Times*, and *The Wall Street Journal*. He has thrice been asked to address the National Association of Insurance Commissioners, most recently about the evaluating volatility control indices and previously on the effects of aging on senior decision-making. *Best's Review* said he was likely to affect the course of the industry.

Prior to forming Advantage Compendium Dr. Marrion was president and owner of an NASD broker/dealer with offices in nine states, and formerly vice president of a life insurance company and previously vice president of an NYSE investment banking firm. He has a BBA from the University of Iowa, an MBA from the University of Missouri and his doctorate from Webster University in the area of cognitive bias in decision-making formed a new paradigm in the marketing and development of retirement income products. Neither Jack Marrion nor Advantage Compendium sell or endorse any financial product.