

UNDERSTANDING FIXED INDEXED ANNUITY INTEREST-CREDITING METHODS

Fixed indexed annuities (FIAs) have generated considerable interest in recent years as tools for helping individuals build retirement savings. This is because FIAs are designed to both protect principal and provide more interest-earning potential than a fixed annuity.

The key to evaluating the various FIA products offered today is to understand how they credit interest. In this white paper, we explain five common interest-crediting methods: annual point-to-point with a cap, performance-triggered, participation rate, annual monthly averaging, and monthly point-to-point. The paper also looks at how each interest-crediting method typically performs under given market conditions and reviews a number of other factors to consider (aside from interest-crediting methods) when choosing among FIA products.

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A LOOK AT TODAY'S MOST COMMON INTEREST-CREDITING METHODS

Index-Linked Interest Crediting

Fixed indexed annuities (FIAs) are retirement savings vehicles designed to help protect principal while offering the potential for growth through interest crediting. FIAs have generated considerable interest in recent years as tools to help clients build retirement savings and provide income for life. One of the keys to understanding FIAs is to understand how they credit interest. Most FIAs offer a fixed option that provides a guaranteed interest rate for a specified term. However, a popular choice with this product in order to potentially earn more interest on the contract is to select an index-linked interest-crediting option. The index-linked option offers a choice of index, time frame for earning interest, and interest-crediting method. The interest-crediting method is how interest is calculated and credited to the contract. This paper explains today's most common FIA interest-crediting methods, though these methods do tend to evolve and change.

It should be noted that there is no simple answer to the question, "Which method is best?" There is no simple answer. It depends on how markets perform. On a short-term basis, different methods may outperform others. Over the long term, each method may level out and credit approximately the same amount of interest, assuming that the **option budget** is the same from one contract to the other.

Since most fixed indexed annuities offer a variety of interest-crediting methods, as well as a selection of indexes (both domestic and foreign), allocating the purchase payment to a variety of interest-crediting methods can hedge against the unpredictability of the markets.

Therefore, it may be less important to try to predict which method will outperform others than to select a highly rated insurance company you can trust, with straightforward interest-crediting methods and products.

Growth through Interest-Crediting Methods

In contract years that see positive index returns, interest may be credited to a contract depending on the amount of the return and the interest-crediting method chosen. In a year in which the index return is flat or negative, no interest is credited; however, the contract value will not decrease due to negative index returns, and there would be no loss. It should be noted that while interest is earned based on the movement of the indexes, they are not available for direct investment. And, because no interest may be credited in certain years, the upside potential when returns are positive can be more than with a fixed annuity.

The interest-crediting methods determine how interest is calculated and credited to the contract. The objective of the insurance company is to design interest-crediting methods that:

- Provide more upside interest-crediting potential than a fixed annuity.
- Impose reasonable limits on that upside potential in order to provide the product's downside protection.

Definition

Option budget: The dollar amount an insurance company allocates to support the interest-earning potential of fixed indexed annuity interest-crediting methods. The budget approximates interest that would have been credited to a contract if it were a traditional fixed annuity.

EXAMPLES OF COMMON INTEREST-CREDITING METHODS

While all FIA interest-crediting methods serve a similar purpose, their mechanics vary. Below is a review of today's most common methods.

The following examples are hypothetical, for illustrative purposes only, and do not represent the performance of an actual index.

Annual Point-to-Point with a Cap

With this method, the insurance company compares the index price at the end of the index term to its price at the beginning of the term, for example, one year. If the price has increased, the interest credited to the contract will equal the percent of the index price increase, up to a **cap**. If the price has decreased, the interest credited is 0% and there would be no loss.

This method will typically perform best when the index posts modest and relatively stable gains each year.

Hypothetical Example of Annual Point-to-Point with a Cap

Index Price Change	Cap	Credited Interest
-4%	5%	0%
3%	5%	3%
6%	5%	5%

Performance-Triggered

With this method, the insurance company compares the index price at the end of the index term to its price at the beginning of the term. A declared, fixed interest rate is credited when triggered by a flat or positive index return over the term. If the index return is negative, no interest is credited, and there would be no loss.

This method typically will perform best when the index posts modest and relatively stable gains each year.

Hypothetical Example of Performance-Triggered

Index Price Change	Declared Interest Rate	Credited Interest
-4%	4%	0%
0%	4%	4%
3%	4%	4%
6%	4%	4%

Note: Dividend reinvestment is not included in most FIA interest-crediting methods. Formulas are typically based on change in the index price, not the total return of the index.

Definition

Cap: The maximum rate of interest that can be credited at the end of an index term.

Participation Rate

This method is also similar to the annual point-to-point with a cap method, in that the insurance company compares the index price at the end of the contract year with the price at the beginning of the term. However, instead of a cap, the contract is credited with a percentage of the total index increase. For example, let's assume a 50% participation rate. At the end of each contract year, the insurance company would calculate that year's percentage increase in the index price. The contract would be credited with 50% of that percentage increase.

In some products, after application of the participation rate, a **spread** also may be deducted. Generally, if a spread is to be applied to a participation rate method, the participation rate may be higher than versions without a spread.

Just as in all interest-crediting methods, if the change in the index price multiplied by the participation rate and minus any applicable spread is 0% or less, 0% is credited to the contract, and there would be no loss.

A participation rate method may result in more interest credited to a contract than other methods when index returns are high. However, in environments with lower index returns, an annual point-to-point with a cap method offering a 100% participation rate may result in more credited interest.

Hypothetical Example of Participation Rate

Index Price Increase	Multiplied by the Participation Rate	Total Credited Interest
12%	50%	6%
6%	50%	3%
2%	50%	1%
-4%	50%	0%

Hypothetical Example of Participation Rate with Spread

Index Price Increase	Multiplied by the Participation Rate	Minus Spread	Total Credited Interest
12%	70%	2%	6.4%
6%	70%	2%	2.2%
2%	70%	2%	0%
-4%	70%	2%	0%

Definition

Spread: A percentage that is deducted from the adjusted index return before interest is credited.

Annual Monthly Averaging

With this method, the insurance company looks at the index price at the end of each month of the contract year, adds them together, then divides by 12 to calculate the average. This average is compared to the index price on day 1 of the contract year. If the comparison shows an increase, that increase, in the form of a percentage, is credited to the contract. Some products place a cap on the increase. If the comparison shows a decrease, interest credited is 0%, and there would be no loss.

The cap on this method will typically be higher than the cap on an annual point-to-point with a cap method. For example, if the annual point-to-point cap is 5%, the annual monthly average cap may be 6%. This method may perform best if the index is volatile or experiences a considerable decline at the end of the contract year.

Hypothetical Example of Annual Monthly Averaging

Index Prices during Contract Year												
Day	End of Month											
1	1	2	3	4	5	6	7	8	9	10	11	12
2,000	2,200	2,300	2,150	2,250	2,400	2,200	2,300	2,150	2,000	2,100	1,950	1,850

Credited Interest $(2,154.17 - 2,000) \div 2,000 = 7.7\%$ **Monthly Average** = 2,154.17
 If the cap is 6%, the contract would be credited with 6%.

Monthly Point-to-Point (a.k.a. Monthly Sum)

With this method, the amount of interest credited at the end of a contract year will equal the sum of the 12 monthly percentage changes during that year. Monthly percentage increases are capped, but decreases are not. If the sum of all the increases and decreases is 0% or less, 0% will be credited to the contract and there would be no loss.

This method will perform best when the index experiences fairly steady growth throughout the contract year, with few or no months with large negative returns.

Hypothetical Example 1: Monthly Point-to-Point (or Monthly Sum)

Index Price Changes Each Month												
	1	2	3	4	5	6	7	8	9	10	11	12
	4%	0%	0%	0.5%	0%	0%	6%	-1%	0.5%	0%	0%	1%
3% Cap	3%	0%	0%	0.5%	0%	0%	3%	-1%	0.5%	0%	0%	1%

Credited Interest (Sum of Above with Cap Applied) Is 7%

As shown below, you can see how just one or two significantly down months could negate the positive months with this method.

Index Price Changes Each Month												
	1	2	3	4	5	6	7	8	9	10	11	12
	4%	0%	0%	0.5%	0%	0%	6%	-1%	0.5%	-6%	0%	1%
3% Cap	3%	0%	0%	0.5%	0%	0%	3%	-1%	0.5%	-6%	0%	1%

Credited Interest (Sum of Above with Cap Applied) Is 1%

INTEREST-CREDITING METHODS ARE NOT THE ONLY CONSIDERATION

Understanding the differences between fixed indexed annuity interest-crediting methods is an important factor in analyzing various FIA products. It is not, however, the only consideration. For example, contracts vary in the specific indexes upon which interest-crediting is based. Since index performance is a key factor in interest credited to a FIA, you may want to consider contracts with recognizable indexes. Also consider how transparent the indexes are, and if they include equities, bonds, commodities, and/or cash that may affect performance.

Contracts also have a variety of minimum fixed interest rates, caps, and participation rates. Contracts with spread method options may vary regarding the maximum spread they can impose on index returns.

Other contract factors also will have an impact on the amount of income received from the contract. All should be considered carefully, and include:

- Choice of annuity income options.
- Choice of withdrawal charge periods.
- Withdrawal provisions and withdrawal charge waivers.
- Choice of optional living and death benefits, available for an additional cost.

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