PACIFIC LIFE

WHY PURCHASE A DEFERRED FIXED ANNUITY IN A RISING INTEREST-RATE ENVIRONMENT?

A Summary of the White Paper by Wade D. Pfau, Ph.D., CFA

Introduction

The United States has experienced historically low interest rates in recent years, resulting in lower returns for fixed-income assets. As a result, many individuals who are close to retirement and thinking about options for generating fixed income may avoid purchasing a deferred fixed annuity.

Is this a sound strategy?

As an alternative to a deferred fixed annuity, near-retirees could consider bonds. However, while long-term bonds may offer higher yields than deferred fixed annuities, they will experience capital losses when rates rise if they are not held to maturity. Similarly, while short-term bonds may not experience losses with rising interest rates, their lower yields may not be as competitive as today's deferred fixed annuities. Therefore, as shown in this white paper, even in a low interest-rate environment, deferred fixed annuities can be an attractive option for near-retirees seeking fixed income.

Understanding Bonds

- Bonds (generally considered less risky than stocks) are issued by both governments and private corporations as contractual obligations to make a series of specific payments on specific dates, and return the bonds' face values when they are held to maturity.
- Bond interest rates are determined by the interaction with supply and demand for bonds as they continue to be traded.
- Rising interest-rate environments will lower prices for existing bonds.
- Decreasing interest-rate environments will increase prices for existing bonds.

Today's Interest-Rate Environment

- 10-year Treasuries have fallen to the 2% range in recent years, which has not occurred since the early 1940s.
- A low interest-rate environment is risky for investors, especially those approaching retirement, because the price of bonds will decrease as interest rates rise. As a result, bond funds and individual bonds may experience losses when sold before maturity.
- Those waiting for a rate increase to purchase an annuity may find that capital losses on their bond funds will be greater than any potential gain experienced from higher annuity interest rates.

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Sequence-of-Returns Risk

- Sequence-of-returns risk is the idea that the order of market returns matters, not just the average market return over the long term.
  - Simply put, as assets are accumulated through contributions, later market returns impact more years of contributions and larger asset levels, so near-retirees' financial plans that are dependent on bond funds may be steered off course by a rise in interest rates if they need to sell the bonds before maturity.

What to know about Fixed Annuities and Bonds for Retirement Income

Given that sequence of returns risk is high during the period leading up to retirement, one may want to consider adding a fixed income strategy to an overall retirement plan. The white paper discusses the advantages and disadvantages of fixed annuities and bonds as a source of income during retirement.

Deferred Fixed Annuity	Bond
Contract value is not affected by market volatility and interest-rate changes	Value will fluctuate with changes in interest rates
Assets may grow faster through tax deferral	Taxed as ordinary income in the year interest is earned
Potentially less credit risk (the risk an issuer may be unable or unwilling to meet its financial obligations, risking default)	Subject to the risk that the bond issuer will default on their payments of interest and principal
Has tax penalties or withdrawal charges if distributions are taken prior to the end of the withdrawal charge period	Flexibility to sell the bond before the maturity date, although may be subject to capital losses if interest rates rise

Conclusion

Contrary to what one might expect, a deferred fixed annuity may offer higher after-tax returns than bonds, even if purchased in a low interest-rate environment. This can better set the stage for retirement and creating lifetime income.

A complete copy of this white paper can be found on Annuities.PacificLife.com.

Pacific Life Insurance Company commissioned The American College of Financial Services to write the report, *Why Purchase a Deferred Fixed Annuity in a Rising Interest-Rate Environment?* Wade Pfau is not an employee of, nor affiliated with, Pacific Life Insurance Company.

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