



FIXED INDEXED ANNUITIES AS A FIXED INCOME ALTERNATIVE FOR NEAR-RETIREEES

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

Introduction

Although fixed indexed annuities (FIAs) have been sold for more than 20 years, they are still not widely understood. This white paper examines the ways a FIA can help retirees protect wealth and achieve their retirement savings goals, while also providing a degree of upside potential in the pivotal years leading up to retirement. The white paper provides insight on how insurance companies manage the downside risk and support the interest-earning opportunities provided by a FIA. Wade D. Pfau, Ph.D., CFA, performs this analysis by comparing the hypothetical performance of a FIA against the historical data of other asset classes, including bond funds and stocks, for historical rolling seven-year periods dating back to January 1962.

Managing Downside Risk

An important difference between FIAs and bonds or other fixed-income alternatives, which can lose value when interest rates rise, is that the contract value of a FIA is protected from downside risk because the principal is protected. For clients targeting a specific retirement savings goal, the ability to control downside risk, along with the tax-deferred nature of a FIA, may help ensure that their retirement savings goals will be met. FIAs eliminate a client's downside risk through the use of an options budget, purchasing call options to obtain exposure to market upside. If the value of the market index is below the index value at the beginning of the option term, the option expires without value, but the insurance company has protected the principal.

Methodology

Modeling the performance for FIAs is more complex than modeling returns for traditional asset classes such as stocks and bonds due to the limited time FIAs have been available for sale. A FIA model was created to better compare the returns of stocks and bonds to interest credited to a FIA. Dr. Pfau describes the steps taken to provide a historical analysis of FIA interest earnings compared with historical returns of equities and fixed-income investments. The paper describes the methodology in detail, including the period of analysis, steps taken to determine the historical options budgets, and determination of historical call option prices, which lead to simulated historical FIA participation rates. These data points lead to the historical cumulative returns of stocks, bonds, and the interest earned for FIAs over rolling seven-year periods. He analyzes the return characteristics for stocks and bonds during these rolling seven-year periods in both taxable and nontaxable accounts and compares those characteristics to the interest earned by the FIA model during the same rolling seven-year periods.

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Conclusion

The paper concludes that the anticipated interest credited in a FIA is more like bonds than stocks. However, a FIA's unique method for earning interest while providing downside protection make them unlike stocks and unlike bonds. Principal is protected for FIAs, while bonds can experience capital losses when interest rates rise. With the use of a participation rate, FIAs may have more volatile interest credited than bonds, but that volatility is based more on upside than downside. FIAs can provide another option for fixed-income assets that protects principal and has the potential to outperform bonds when considered net of taxes and fees. Despite results showing that the interest credited to a FIA has the potential to be competitive with stocks net of taxes and fees while experiencing less volatility, owners should not think about FIAs as an alternative to owning stocks. The unique interest-crediting structure of FIAs led Dr. Pfau to conclude that they may have a role to play in preretirement accumulation portfolios and are worth a careful consideration by those preparing for retirement.

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Pacific Life Insurance Company commissioned Wade Pfau, Professor of Retirement Income at The American College, to write this report, *Fixed Indexed Annuities as a Fixed Income Alternative for Near-Retirees*. Wade Pfau is not an employee of, nor affiliated with, Pacific Life Insurance Company.

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