SIMON from iCapital

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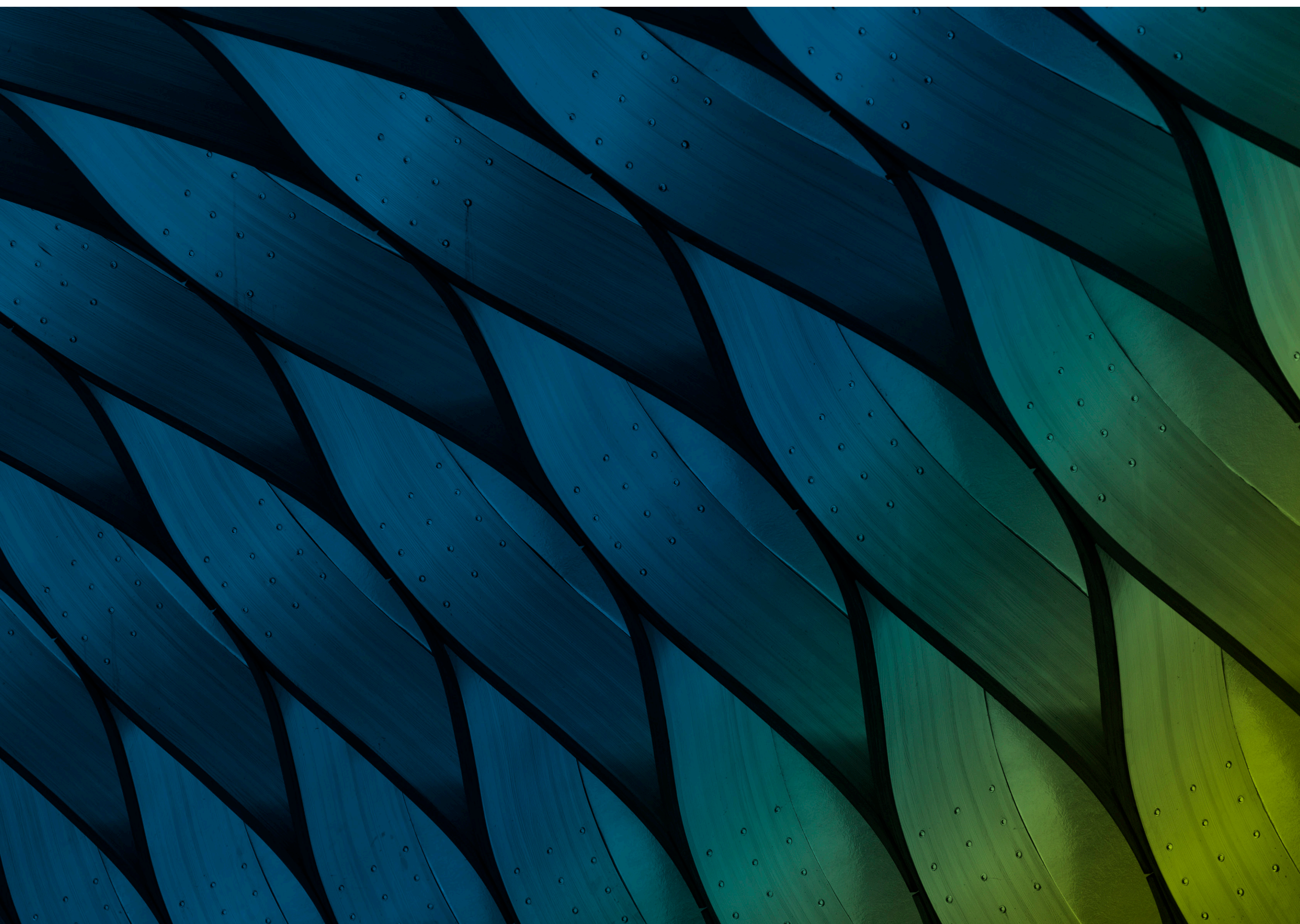
Confessions of an Indexed Annuity Purist

March 2023



When I began to urge advisors to consider incorporating fixed indexed annuities into their practice back in 2006, I highlighted the importance of keeping the story simple. Specifically, I stressed the need to be able to answer the question: "How did the insurance company calculate the interest they credited to my policy?" To answer this question, I offered a simple solution – stick with one-year cap strategies on the S&P 500 (SPX). Why needlessly complicate things?

Increasingly, advisors are exploring other options within the indexed annuity space. According to Wink's Sales and Market Report, in the third quarter of 2022, only 44% of fixed indexed annuity sales were in a cap rate strategy tied to the S&P 500 Index.[1] In other words, more than half of all sales were tied to indices other than the S&P 500.

In addition, the Life Insurance Marketing and Research Association (LIMRA) noted in its 2021 Fixed Indexed Annuity Sales and Assets report that only 16% of total sales were allocated solely to a cap rate strategy, while participation rate strategies captured 39%. Another 22% of total sales were allocated to a combination of participation and cap rate strategies.[2]

Obviously, there are a lot of advisors today who are not following my 2006 guidance. Is it time for me to follow their lead? Let's take a look at a sample of fixed indexed annuities on the market and see.

Since its inception in 1957, the S&P 500 has an average annual return of 10.67%.[3] If an indexed annuity policyholder had a 11% cap rate on the S&P 500 for every possible one-year period, the average return over time would have been 6.64%. In a world where protection is a primary goal for many investors, it's easy to understand the attraction of an expected 6.64% return with full protection of principal. No one should be surprised, therefore, that LIMRA reported that indexed annuity sales hit record levels in the third quarter of last year, and then broke that record in the fourth quarter.[4]

Despite these expected results, I have to admit that it's time for me to join those advisors who have already moved beyond the simple one-year point-to-point

Exhibit 1: Fixed Indexed Annuity Example

One-year Point-to-Point Strategy with 11% Cap Rate on SPX

Past Performance Statistics 04/18/57 – 03/10/23	
Performance	**Indexed Terms**
Best	11%
Average	6.64%
Worst	0%

Frequency of Returns	Indexed Terms
Positive	72.31%
Zero	27.69%
Negative	0%

Using SIMON from iCapital's Annuities Platform, we can view the hypothetical performance metrics across one-year indexed terms between April 18, 1957 and March 10, 2023. The best return in any of those one-year indexed terms would have been 11%, or the cap. Since a fixed indexed annuity without a fee cannot have a negative return, the worst return would have been 0%. The average return across all of the observed one-year indexed terms would have been 6.64%. It is also worth noting that 72.31% of the observed one-year indexed terms would have resulted in a positive return, while 27.69% would have resulted in a 0% return.

Source: SIMON from iCapital, as of March 10, 2023. Assumes a 10-year surrender charge period and a minimum initial premium of $5,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

strategies on the S&P 500. My message today is if you have not considered some volatility-controlled indices, the time to do so is now. The rapid increase in interest rates over the course of 2022 has led to a corresponding increase in the general accounts of insurance companies, enabling them allocate more funds to the "options budget" of the indexed annuity and offer more attractive rates across the board.[5]

Volatility-controlled indices also have another important advantage. Since these indices are designed to manage volatility within the index, hedging is much less costly than hedging the S&P 500, according to Barclays' Index Pricing Model.[6] In other words, the insurance company can buy more options with less money, given the lower cost of the options. To better understand this concept, compare the cost of buying options on a relatively stable stock, like IBM, compared with a highly volatile stock, such as Tesla – as volatility increases, the prices of options tend to rise.

Participation rates on these indices have become very competitive relative to cap rates. As an example, consider an indexed annuity from Forethought Life Insurance Company, a Global Atlantic Company. It offers a 195% participation rate on a one-year point-to-point on the PIMCO Balanced Index (PIMBAL). While this particular index doesn't have as much history as the S&P 500, we can observe returns that would have been generated by a 195% participation rate back to the beginning of the century. The results are in Exhibit 2 below.

Historically, the current pricing on this strategy would have provided an average annual return of 9.28%, much higher than the 6.64% generated from the S&P 500 strategy with the 11% cap.[7] In addition, this strategy would have provided significantly more positive one-year returns.

Some carriers now offer the option of paying an annual fee of 1.0–1.5% in order to add to the options budget and,

Exhibit 2: ForeAccumulation II Fixed Indexed Annuity

One-year Point-to-Point Strategy with 195% Participation Rate on PIMBAL

Past Performance Statistics 12/31/01 – 03/10/23	
Performance	**Indexed Terms**
Best	35.33%
Average	9.28%
Worst	0%

Frequency of Returns	Indexed Terms
Positive	85.07%
Zero	14.93%
Negative	0%

Using SIMON from iCapital's Annuities Platform, we can view the hypothetical performance metrics across one-year indexed terms between December 31, 2001 and March 10, 2023. The best return in any of those one-year indexed terms would have been 35.33%. Since a fixed indexed annuity without a fee cannot have a negative return, the worst return would have been 0%. The average return across all of the observed one-year indexed terms would have been 9.28%. It is also worth noting that 85.07% of the observed one-year indexed terms would have resulted in a positive return, while 14.93% would have resulted in a 0% return.

Source: SIMON from iCapital, as of March 10, 2023. Assumes a 7-year surrender charge period and a minimum initial premium of $100,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. The calculated results are based on SIMON from iCapital's past performance model and have certain inherent limitations, including but not limited to results being generated through the retroactive application of certain contract parameters and assumptions with the benefit of hindsight. The model may be changed from time to time and the effect on performance results could be either favorable or unfavorable. The values displayed do not include any rider fees, product level fees, or adjustments that may apply at the product level which, if included, would lower the values shown. Product terms are established by Forethought Life Insurance Company, a Global Atlantic Company.

therefore, increase the participation rate even further. For example, consider a fixed indexed annuity from Eagle Life Insurance Company offering 140% participation rate on a one-year point-to-point strategy on the Invesco Dynamic Growth Index (IIDGROW). In exchange for paying a 1.25% annual fee, the participation rate goes up to 220%. Advisors should keep in mind that this is a true fee, therefore, if the index does not increase in price by at least 1.25% during the year, the policyholder would get a negative return of up to … 1.25%. "Zero will no longer be your hero."

How would these options stack up? Let's review the data from SIMON from iCapital's Annuities Platform.

In reviewing the performance metrics, we can observe that paying the annual 1.25% fee would have led to over a 4% greater annual average return per year. However, the trade-off is that in 12.5% of the observed one-year indexed terms, the policyholder would have suffered a 1.25% loss. Is it worth the trade-off? The answer will depend on the individual client's investment objectives and risk profile. However, it is definitely worth considering.

SIMON from iCapital gives you the data you need to weigh the pros and cons of each option.

Regardless, of whether you stick with the simple S&P strategy or venture into one of the many volatility-controlled reference indices, the current interest rate environment provides an opportunity for investors to lock in attractive fixed indexed annuity rates while managing downside risk.

Exhibit 3: Eagle Select Focus 7 Fixed Indexed Annuity

One-year Point-to-Point Strategy with 140% Participation Rate on IIDGROW

Past Performance Statistics 01/10/08 – 03/10/23	
Performance	**Indexed Terms**
Best	26.87%
Average	9.77%
Worst	0%

Frequency of Returns	Indexed Terms
Positive	87.77%
Zero	12.23%
Negative	0%

Source: SIMON from iCapital, as of March 10, 2023. Assumes a 7-year surrender charge period and a minimum initial premium of $5,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. The calculated results are based on SIMON from iCapital's past performance model and have certain inherent limitations, including but not limited to results being generated through the retroactive application of certain contract parameters and assumptions with the benefit of hindsight. The model may be changed from time to time and the effect on performance results could be either favorable or unfavorable. The values displayed do not include any rider fees, product level fees, or adjustments that may apply at the product level which, if included, would lower the values shown. Product terms are established by Eagle Life Insurance Company.

Exhibit 4: Eagle Select Focus 7 Fixed Indexed Annuity

One-year Point-to-Point Strategy with 220% Participation Rate on IIDGROW and 1.25% Annual Fee

Past Performance Statistics 01/10/08 – 03/10/23	
Performance	**Indexed Terms**
Best	40.97%
Average	14.1%
Worst	-1.25%

Frequency of Returns	Indexed Terms
Positive	86.75%
Zero	0%
Negative	13.25%

Source: SIMON from iCapital, as of March 10, 2023. Assumes a 7-year surrender charge period and a minimum initial premium of $5,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed. The calculated results are based on SIMON from iCapital's past performance model and have certain inherent limitations, including but not limited to results being generated through the retroactive application of certain contract parameters and assumptions with the benefit of hindsight. The model may be changed from time to time and the effect on performance results could be either favorable or unfavorable. The values displayed do not include any rider fees, product level fees, or adjustments that may apply at the product level which, if included, would lower the values shown. Product terms are established by Eagle Life Insurance Company.

END NOTES

1. Source: Wink's Sales & Market Report Q3 2022, as of Nov. 22, 2022.
2. Source: LIMRA, "A Deeper Dive: 2021 Fixed Indexed Annuity Sales and Assets," 2022.
3. Source: Seeking Alpha, as of Jan. 2, 2023.
4. Source: LIMRA, "2022 U.S. Retail Annuity Sales Shatter Annual Sales Records Set in 2008," Jan. 26, 2023.
5. Source: Financial Advisor, Ben Mattlin, "How Rising Interest Rates Affect Annuities," March 1, 2022.
6. Source: Barclays' Index Pricing Model, as of Jan. 2023.
7. Source: SIMON from iCapital, as of March 10, 2023.

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