Is it Worth it to Pay a Fee to Get a Higher Rate on an Indexed Annuity?

September 2024

When you consider a fixed indexed annuity (FIA), you face a multitude of decisions regarding the appropriate strategy within the FIA.

You have to choose between several indexes and crediting terms lengths, and from an increasing number of products that offer the option of paying a fee for a higher participation cap or trigger rate. This option is found most often on a crediting strategy with a volatility-controlled index, but can also be on more common indexes such as the S&P 500. For example, as of June 24, 2024, one FIA offers a one-year point-to-point strategy on the S&P 500 with a 9.25% cap rate with no fee vs. 12.75% cap rate with a 1.25% fee.

To quantify whether it's worth paying 1.25% per year for potentially 2.25% more return (3.5% cap rate difference minus the 1.25% fee), you need to know both how often the price of the S&P 500 index will increase by more than 9.25%, and by how much, because you only get the full 2.25% differential if the index price increases by 12.75% or more. If it's up just 10%, then the contract will credit only 8.75% net of the fee.

Let's look at how a one-year point-to-point strategy on the S&P 500 with a 9.25% cap rate with no fee vs. 12.75% cap rate with a 1.25% fee would have compared historically.

The below tables (Exhibit 1) show two cap rates on the S&P 500 for every one-year period ended since December 1964. Since the first strategy can't yield a return of more than the 9.25% cap in any given year, the average annualized return would have been 5.91% with 100% protection against any negative annual return. More important, historically, the strategy would have had a positive return in almost 3 out of every 4 one-year periods.

The best possible return on the fee option is 11.5% (the 12.75% cap less the 1.25% fee). The average annualized return would have been 6.26%, or 0.35% more per year than the strategy without the fee. But because the fee is still deducted anytime the price of the index falls, all of the annual results that would have created a 0% return for the year now create a loss anytime the price does not increase by at least 1.25%. That 1.25% hurdle also shows a slight drop in the percentage of times the strategy creates a positive return.

Is the possible additional 0.35% return per year worth the chance that the client could incur a slight loss about one in every four-year annual period? That depends upon the risk profile of your client and your willingness to back off of recommending a strategy with 100% downside protection.

Exhibit 1: Fixed Indexed Annuity Example

One-Year Point-to-Point with 9.25% Cap Rate on SPX

Performance Statistics One-Year Indexed Term 12/31/64 - 06/21/24	
Performance	**Indexed Terms**
Best	9.25%
Average	5.91%
Worst	0%
Frequency of Returns	**Indexed Terms**
Positive	73.84%
Zero	26.16%
Negative	0%

Source: iCapital annuities platform, as of June 24, 2024. Assumes ten-year surrender charge period and minimum initial premium of $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

One-Year Point-to-Point with 12.75% Cap Rate on SPX with 1.25% Annual Fee

Performance Statistics One-Year Indexed Term 12/31/64 - 06/21/24	
Performance	**Indexed Terms**
Best	11.5%
Average	6.26%
Worst	-1.25%
Frequency of Returns	**Indexed Terms**
Positive	71.8%
Zero	0%
Negative	28.2%

Source: iCapital annuities platform, as of June 24, 2024. Assumes ten-year surrender charge period and minimum initial premium of $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Now let's look at a trigger rate example (Exhibit 2). **This same product also offered a 6.5% trigger rate with no fee vs. 8.25% trigger rate with a 1.25% fee.**

Since this strategy pays a specific return as long as the index price does not fall, we see the non-fee version always pays 6.5% if interest is credited, while the fee version always pays 7.0% (8.25% less the 1.25% fee). Given these rates, the most benefit in any one year is 0.5%. In addition, since the 7.0% net of the fee is credited anytime the index is higher, unlike our previous example, this strategy will not generate a negative return when the index is up between 0.0% and 1.25%. The trigger rate version will only generate a negative return if the index goes down in price. Just how much extra return would your client get on average by paying a fee to get a 7.0% trigger rate net of that fee? In the example below, as of June 25, 2024, an FIA offers a one-year point-to-point strategy on the S&P 500 with a 6.5% trigger rate with no fee vs. 8.25% trigger rate with a 1.25% fee.

It's unlikely that an advisor armed with the above information would recommend the higher trigger rate with the fee, given the limited additional return net of 1.25%. They would not likely choose to turn the 26.14% of the 0% occurrences to slightly negative return occurrences. However, the advisor might reconsider if the gap between the trigger rate with the fee and the trigger rate without the fee widens. These variables make it vital to check historical data to weigh the trade-offs anytime the insurance company changes its rates.

OTHER CONSIDERATIONS

While the data that technology can deliver is a powerful tool for making better recommendations, advisors should also factor in:

1. The data is based on historical average returns. While this context can help inform your decisions, the actual future returns will most likely differ.

2. The initial cap and trigger rates are not guaranteed in subsequent years. A change in differential between the cap or trigger rates without the fee vs. the rates with the fees will alter the actual results. A widening of the rate differential will help the rate with the fee, while the opposite will occur if the rate differential is reduced.

3. Most FIAs have a surrender charge period of seven years or longer and are typically suitable only if the client has an expected holding period of at least the length of the surrender charge period.

Exhibit 2: Fixed Indexed Annuity Example

One-Year Point-to-Point with 6.5% Trigger Rate on SPX

Performance Statistics One-Year Indexed Term 12/31/64 - 06/21/24	
Performance	**Indexed Terms**
Best	6.5%
Average	4.8%
Worst	0%
Frequency of Returns	**Indexed Terms**
Positive	73.86%
Zero	26.14%
Negative	0%

Source: iCapital annuities platform, as of June 25, 2024. Assumes ten-year surrender charge period and minimum initial premium of $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

One-Year Point-to-Point with 8.25% Trigger Rate on SPX with 1.25% Annual Fee

Performance Statistics One-Year Indexed Term 12/31/64 - 06/21/24	
Performance	**Indexed Terms**
Best	7.0%
Average	4.84%
Worst	-1.25%
Frequency of Returns	**Indexed Terms**
Positive	73.86%
Zero	0%
Negative	26.14%

Source: iCapital annuities platform, as of June 25, 2024. Assumes ten-year surrender charge period and minimum initial premium of $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

CONCLUSIONS

Much of the appeal of FIAs comes from the comfort clients find in 100% downside protection. Anytime an advisor chooses to recommend a strategy with a fee, the client discussion must change from "you can't lose" during any strategy period, to "you can only lose (the size of the fee)." Some clients will accept that trade-off if the expected return is sufficiently greater. For those that are willing to occasionally incur a minor loss, the decision becomes about how much additional return they expect to get in return for this trade-off. The good news is that the data exists to measure this trade-off. But remember, your conclusions can change every time rates change. Sometimes paying the fee will make sense. And other times it will not.

iCapital®

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

www.icapital.com

North America
New York City
Princeton
Greenwich
Boston
Boca Raton
Toronto

Europe
Zurich
London
Lisbon

Asia
Hong Kong
Singapore
Tokyo