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Your Client Wants Protection: Fixed Annuity or Fixed Indexed Annuity?

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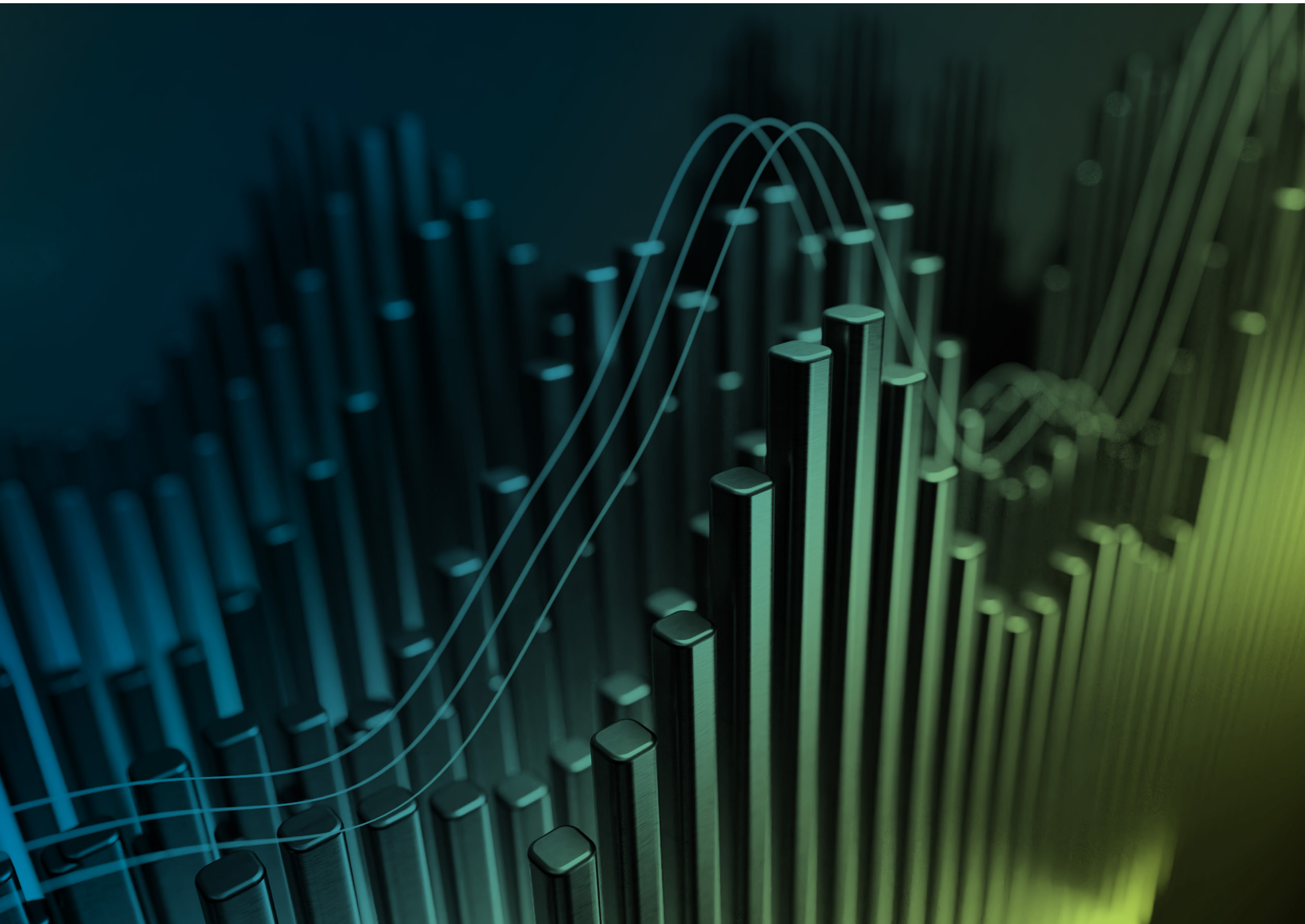

Earlier in the year, LIMRA reported that both fixed and fixed indexed annuity (FIA) sales hit record levels in 2023. Combined, these two types of annuities totaled $286.2 billion, or almost 75% of all annuity sales.[1] More recently, LIMRA reported that the surge in these two annuity types remains unabated. Fixed annuity sales were $48 billion in the first quarter of 2024, up 16% over the previous year, while FIA sales set a record of $29.3 billion for the first quarter.[2] Just ten years ago, the total sales in these two annuity types was 30% of the annuity market.[3]

As the baby boomers have marched into retirement, their desire to seek out investment options that provide downside protection has only grown. Combine this need with interest rates that are still near decade-long highs, and you have all the ingredients to push fixed and FIA sales to yet another record in 2024.

But this also means that advisors have a choice to make. Do they keep it simple and minimize uncertainty by recommending a fixed annuity guaranteeing 5% annually for five years, or do they add a bit of both complexity and uncertainty and recommend an FIA with a 10% one-year cap rate strategy on the S&P 500? To answer this question, an advisor must better understand the trade-offs.

For the FIA, capturing all of the positive price changes of the S&P 500 over a one-year period up to the 10% cap certainly sounds like an attractive alternative to a 5% flat rate offered by the fixed annuity. But as you can see from Exhibit 1 below, the price of the S&P 500 drops on average one of every four 12-month periods. In those years, the client will earn 0% from the FIA. And in some years the market will be up, but by less than the 10% cap. So, what type of return can one expect from a 10% cap? Or put another way, how high of a cap would lead one to choose an FIA with a higher, but unknown return, over the known and certain 5% annual return provided by a fixed annuity?

Fortunately, if you have a history of all of the S&P 500 (SPX) one-year returns, this becomes just a math problem. As an example, let's view the hypothetical performance metrics across one-year indexed terms for an FIA with a 10% cap rate on SPX using iCapital's platform for annuities.

Using the iCapital platform for annuities, a user can view the hypothetical performance metrics across one-year indexed terms between December 31, 1964 and May 14, 2024. The best return in any of those one-year indexed terms would have been 10%, 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 6.28%. It is also worth noting that 73.8% of the observed one-year indexed terms would have resulted in a positive return, while 26.2% would have resulted in a 0% return. Of course, this information is only helpful if a particular product has a 10% cap. Scanning through the nearly 115 FIAs on the iCapital platform for annuities, a user can find one-year point-to-point strategies on SPX with cap rates as low as 5% and as high as 11% – and pretty much every rate in between.[4]

Let's compare the average rate of return across one-year point-to-point strategies on SPX for cap rates from 5% to 11%. As shown in Exhibit 2, a cap rate of 8% or more is required to provide an average rate of return of more than the 5% that can be earned on a fixed annuity.

Exhibit 1: Fixed Indexed Annuity Example

One-Year Point-to-Point Strategy with 10% Cap Rate on SPX

Past Performance Statistics 12/31/1964 – 5/14/2024	
Performance	**Indexed Terms**
Best	10.0%
Average	6.28%
Worst	0%
Frequency of Returns	**Indexed Terms**
Positive	73.8%
Zero	26.2%
Negative	0%

Source: iCapital, as of May 14, 2024. Assumes a five-year surrender charge period and a minimum initial premium of $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

Exhibit 2: FIA Average Rate of Return by Cap Rate

One-Year Point-to-Point Strategies with 5%-12% Cap Rates on SPX

Past Performance Statistics 12/31/1964 – 5/14/2024	
Cap Rate	**Average Rate of Return**
5.0%	3.45%
6.0%	4.08%
7.0%	4.67%
8.0%	5.24%
9.0%	5.78%
10.0%	6.28%
11.0%	6.75%

Source: iCapital, as of May 29, 2024. Assumes a surrender charge period of at least five years and a minimum initial premium of at least $10,000. For illustrative purposes only. Past performance is not indicative of future results. Future results are not guaranteed.

1. LIMRA, Record-High 2023 Annuity Sales Driven by Extraordinary Growth in Independent Distribution, March 12, 2024.
2. LIMRA, U.S. Annuity Sales Surge to Strongest First Quarter Ever, April 25, 2024.
3. Saltzman Associates, Annuity for Banks, Regionals & Wires Roundtable, May 2024.
4. iCapital, as of May 29, 2024.

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Considerations

The final question for an advisor becomes, how much of an expected return differential does an investor need to choose an FIA over the fixed annuity. Mostly, this will depend upon the risk profile of the investor. While both products provide 100% downside protection, the fixed annuity has the advantage of knowing the return will be a flat rate per year, regardless of market conditions. Some investors highly value this certainty. However, less conservative investors would likely be willing to accept some uncertainty for the opportunity to earn a higher return. Advisors should also factor in the following when evaluating an FIA:

1. The historical average return will most likely differ from the actual return.
2. The initial cap rate is not guaranteed in subsequent years. A reduction in the cap rate upon renewal can lead to significantly lower returns than modeled above.
3. Most FIAs have a surrender charge period of seven years or longer, which can be a longer holding period than a fixed annuity.

Summary

One can think of the return on a fixed annuity as the annuity world's "risk-free" rate of return. Therefore, an advisor should consider an FIA over a fixed annuity only if the expected return is sufficiently above this rate to adequately compensate the investor for the added risk and uncertainty that comes with the FIA. But, choosing between these options becomes difficult, if not impossible, without the means to properly analyze the data. In the past, advisors had limited tools to properly analyze this trade-off. However, with the iCapital platform for annuities, advisors now have access to the tools and the data they need to assess the pros and cons of each option.

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