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# A New Perspective on Fixed Indexed Annuities and Lifetime Income

INDEPENDENT THINKING...MEANINGFUL RESULTS

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The combination of extremely low interest rates, increased market volatility and the growing need for lifetime income strategies has positioned Fixed Indexed Annuities (FIAs) as a growing player in the retirement plan toolbox. These market forces are leading astute plan sponsors and their advisors to include FIAs in their retirement plan offerings.

FIAs have long been available in the non-ERISA 403(b) and 457(b) plan markets, and leading plan sponsors and other managers of these retirement programs are re-evaluating these insurance tools to help their plan participants address the two main challenges faced by participant directed plans – not having enough money to retire and running out of money during retirement.

Based on a thorough analysis of FIAs and their performance over the last 10 to 20 years, Verity Asset Management[1] concluded that FIA's warrant significant consideration for inclusion in a non-ERISA retirement plan. Policy specific provisions, riders, costs, investment horizon, and structure of a specific product will be highly influential in the selection process.

With 403(b) and 457(b) plan assets above $2 trillion and growing as of 12/31/2018[2], FIA's are quickly becoming an important holding in the retirement plan toolbox of the future.

These structured insurance contracts address both the accumulation and distribution phases of a retirement plan. This dual nature makes FIAs an effective solution to address key retirement plan risks and as a tool to combat the extremely low interest rate environment while retaining the characteristics of a capital preservation instrument.

## The Role of Fixed Index Annuities in 403(b) and 457(b) Plans

Typically, 403(b) and 457(b) plans offer plan participants a menu of investment options and investment providers, and plan participants select the specific investments that best suit their needs.

Two key benefits of FIAs are their use to mitigate downside risk during the accumulation phase and to guarantee lifetime income in the distribution phase. These benefits directly address the two greatest risks to retirement investors over time – Sequencing Risk and Longevity Risk.

A Fixed Indexed Annuity (FIA) can be described as an insurance contract whose contributions and interest earned will be guaranteed by the issuing insurance company. An FIA has an intermediate to long-term time horizon that provides principal protection in a down market and opportunity for growth. FIAs generally provide more growth potential than a fixed annuity or stable value fund along with more volatility than these short-term fixed income instruments. Note that the annual credited interest may be 0% when the index declines in value over the year.

FIA returns are based primarily on the performance of an underlying index, such as the S&P 500® Composite Stock Price Index and are intended to provide an opportunity for increased returns in periods of positive index movement. While an FIA's benchmark index does follow a market index, **a plan participant's money is never directly invested in or exposed to the market(s) represented by the index.**

FIAs are often misunderstood and inappropriately categorized. This is due to a lack of knowledge regarding the workings of an FIA. Generalized concerns on high fees indiscriminately cast all annuities in a negative light. Most importantly, standardized methods for evaluating FIAs from a fiduciary perspective exist but are generally lacking.

1 Verity Asset Management is an SEC Registered Investment Advisor located in Durham, NC. Verity Financial Group, through subsidiaries Verity Asset Management and Verity Investments, Inc., has been providing servic es including investment management and advice to 403(b) and 457(b) plans and participants since 1996.

2 Statista 2020

## Trends 2020

People want financial security and the concepts of lifetime income as well as guaranteed returns that can participate in market movements without any downside are gaining in popularity.

- 77% of those who currently are enrolled in employer-sponsored plans would consider adding an option that offers guaranteed lifetime income. 59% indicated they would specifically consider adding an annuity.[3]
- As many as 95% of consumers are very or somewhat interested in guaranteed lifetime income in an annuity, the Insured Retirement Institute found. The most important traits consumers want in an annuity are "guaranteed income each month" and "will not lose principal."[4]
- 61% of Americans age 55-75 place a high value on having guaranteed lifetime income to supplement their Social Security income."[5] As a result of these trends, plan sponsors are searching for broad portfolio management solutions that include the accumulation and distributions phases of retirement "in-plan."

## Shifting Risks and Increased Participant Responsibility

Managing both the accumulation and distribution phases of retirement also presents new challenges for participants in these retirement programs. This puts the individual in the position of being an expert investment manager which is problematic. Evaluation tools and technologies are becoming a necessity for plan participants to help them make good decisions that amplify their retirement readiness. In addition, the responsibility has increased the need for excellent communication, education, guidance, and advice programs, which are now further complicated by overlapping sets of regulatory constructs governing distribution of financial products and services. The complexity can be overwhelming even for industry professionals.

> The responsibility for managing both accumulation and distribution phases of the financial lifecycle has largely shifted to private individuals.

The complex standard of care and disclosure requirements that apply to insurance agents, registered representatives and investment adviser representatives are continually evolving. Frequently, a financial professional may wear "more than one hat," potentially addressing conflicts of interest and making recommendations to participants. This is particularly a factor in many governmental plans that commonly have multiple investment product providers operating in the same plan under different service and distribution models.

## Key Considerations and Risks

The process of evaluating any guaranteed insurance product or guaranteed income benefit is profoundly different than the more common and well-defined analytic methodologies used for evaluating performance, fees, and expenses of traditional investment options. An alternate methodology was developed to focus on evaluating the financial benefits provided under an annuity contract construct, net of all fees and expenses.

In this approach, Verity Asset Management has applied a combination of *internal rate of return*[6] and *net present value*[7] calculations as an ongoing metric for measuring value and comparing relative value of outcomes from one specific contract to other contracts as a benchmarking exercise. Verity Asset Management has built a process and methodology to evaluate fixed indexed annuities. It focuses on a set of outcomes-based measurement techniques to create a mathematical understanding of an FIAs effectiveness in the accumulation and distribution phases.

3 https://www.allianzlife.com/about/newsroom/2020-press-releases/employer-sponsored-plan-participants-showing-interest-in-guaranteed-income
4 https://www.fa-mag.com/news/iri-study--most-consumers-want-guaranteed-lifetime-income-54272.html 5 https://www.investmentnews.com/study-finds-most-retirees-want-guaranteed-lifetime-income-70806
5 https://www.investmentnews.com/study-finds-most-retirees-want-guaranteed-lifetime-income-70806

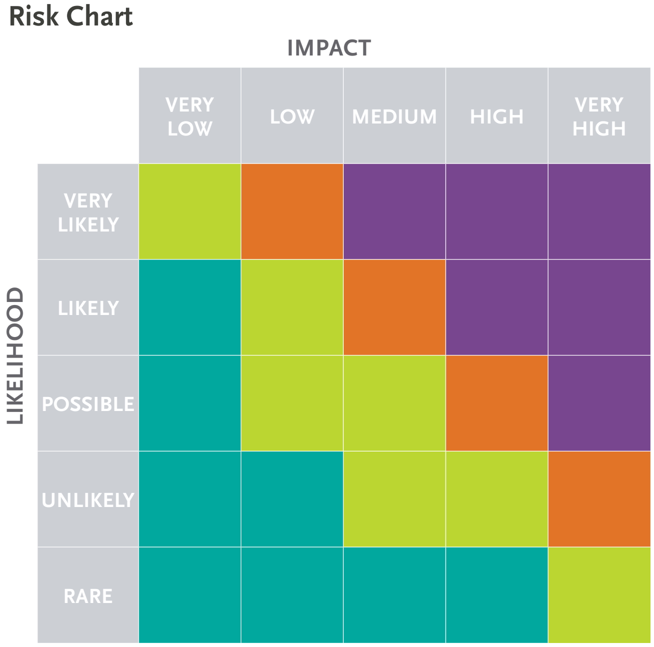
These methodologies can be added to an *Investment Policy Statement* and become part of the governance and investment management of a defined contribution retirement plan, providing plan sponsors with the fiduciary metric needed to evaluate FIAs and other guaranteed income options.

## Risk in General

One way to look at risk is to measure it in reference to both the impact of the risk and likelihood of an occurrence. For example, the likelihood of a hurricane impacting a community that is hundreds of miles inland is low. But, as we learned with Hurricane Michael hitting the coast of Florida and then moving inland in 2018, when it does occur, the impact can be very severe. This type of analysis can be very valuable when designing a portfolio to support excellent outcomes and retirement dignity.

Sequencing risk is the possibility that the timing of withdrawals from a person's retirement account may have an increased negative impact on the overall withdrawal rate available to the investor during a period of market decline. The amount of income that can be delivered from a retirement account is often a function of the total balance in an account.

**Risk Chart**




It is important to understand that a 25% loss in capital value requires a greater percent gain to recoup the losses. If someone has $100,000 and their portfolio drops 25%, they now have $75,000. Their $75,000 must earn 33% to return to the $100,000 level.

When an account balance drops significantly just prior to or just after the retirement start date, it can have a devastating impact on the income available from a lifetime of investing. In the market drop of 2008, numerous individuals had to postpone retirement or had to go back to work because their retirement account was no longer able to support their lifestyle. To slow retirement savings losses during this time, more than 55% of workers aged 50 to 64 expected to be working full time when they reached age 65[8].

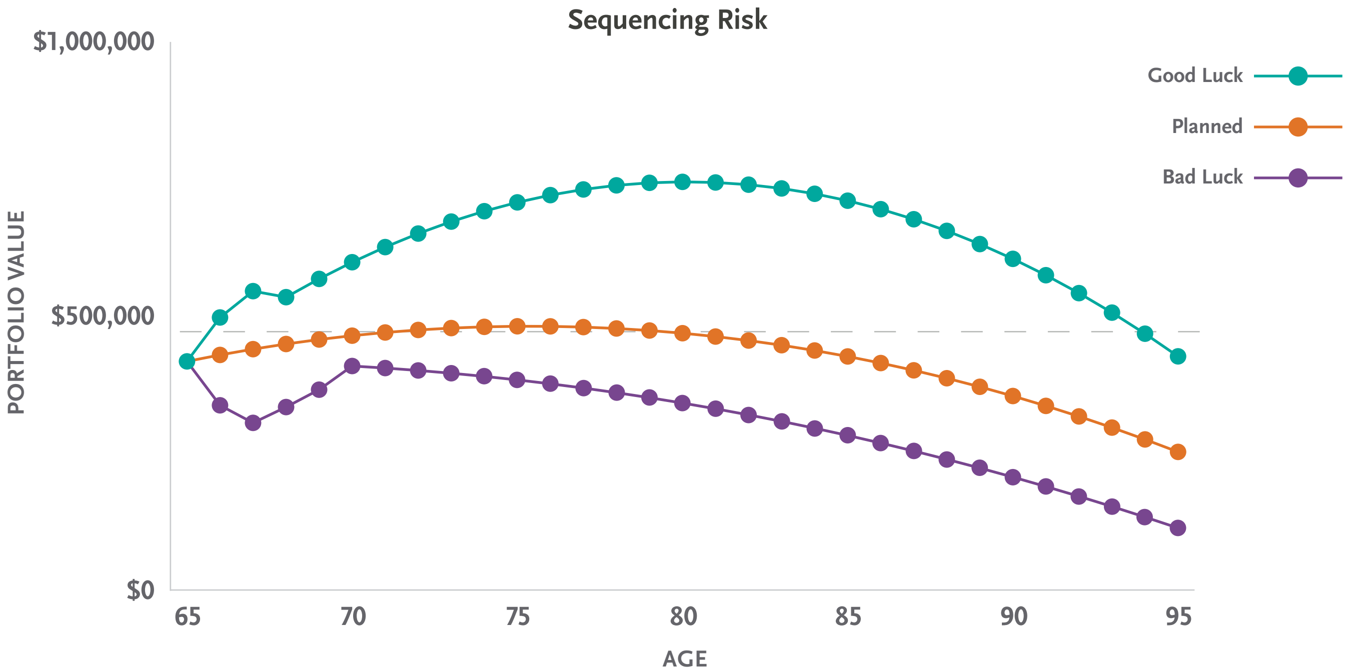
Sequencing risk may also be called sequence-of-returns risk, or for the lay person, the "luck of the draw." Sequencing risk is highly correlated to the volatility of an investment portfolio. Therefore, it is generally wise to increase the use of lower volatility investments as one approaches retirement. Sequencing risk is more likely in investments with greater short-term potential for volatility including stocks, gold, and real estate.

For example, in 2008, the stock market experienced a significant downturn. Individuals nearing retirement who were invested in equities (whether diversified or concentrated) experienced the negative impact of sequencing risk on their portfolios, and many were literally forced to postpone retirement in the hopes of regaining some of their losses. Market volatility experienced in 2020 could have a similar impact on those needing to take distributions from market-based investments.

6 The internal rate of return (IRR) is a metric used in capital budgeting to estimate the profitability of potential investments. The internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero. IRR calculations rely on the same formula as NPV does.

7 Net Present Value (NPV) is the value of all future cash flows (positive and negative) over the entire life of an investment discounted to the present.

8 Population Reference Bureau | *Today's Research on Aging* | No. 32 | November 2015




This **sequencing risk chart** illustrates the impact of market movement at or near retirement. The blue line represents a lucky market and the purple line represents an unlucky market move. The end results are dramatically different. *For illustration purposes only.*

Capital preservation assets in a portfolio provide a mechanism to reduce portfolio volatility during the accumulation phase. Similarly, when a lifetime income component is added to the investment, then the impact of sequencing risk can be greatly reduced during the distribution phase. These attributes are those of a fixed indexed annuity and this is why the appropriate use of FIAs can be so important in creating positive retirement outcomes.

## Longevity Risk

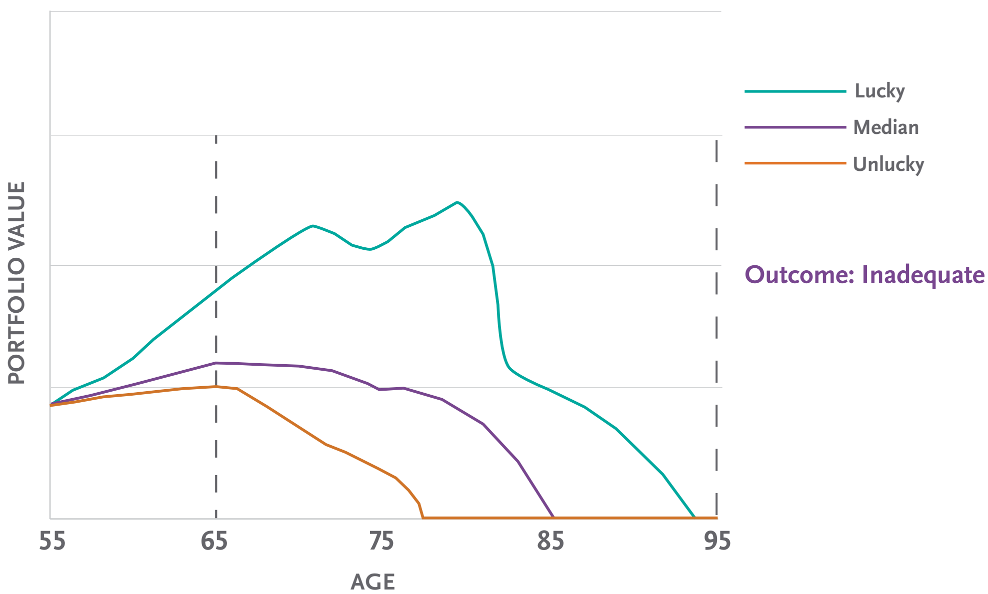
Longevity risk is a significant consideration in providing distribution options available to participants in qualified retirement plans. Over the last 50 years, life expectancy in the U.S. has increased from age 70.8 (1970) to age 78.9 (2020)[9]. Now, new medical technologies and other forces are further increasing likelihood of life expectancy. As a result, plan participants and retirees are faced with increasing challenges to stretch their retirement income accordingly. Many studies indicate that increasing life expectancy is adding to the burden that retirement plan participants face. These individuals need the same innovation and improving results to be found in the investment world – just as they have in the medical industry.

Guaranteed income provisions represent a material advantage to helping participants manage this type of risk. An in-depth analysis of current factors impacting longevity risk yields a clear conclusion that guaranteed income contracts reduce longevity risks. The key lies in how to measure these contracts.

Traditional distribution models of sustainable drawdown do not allow individual participants to pool their longevity risk with other individuals. A guaranteed income benefit contract provides increased economic efficiency for individual participants to purchase future benefits at lower cost. So, judging by the idea that great measurements can lead to better outcomes, it is important to measure the effectiveness of these lifetime income contracts. The chart on the next page compares the **Net Present Value (NVP)** of projected income from a guaranteed income rider to other capital preservation instruments over a 59-year period. The assumption is a $100,000 deposit at age 40 and then maximum lifetime income beginning at age 67. The chart below illustrates that the annuities with guaranteed income riders significantly out perform Stable Value funds during the income phase of retirement. Analysis shows the same to be true of other capital preservation assets like money market funds, CD's, and other fixed annuities.

9 https://www.macrotrends.net/countries/USA/united-states/life-expectancy

## Analysis of Sustainable Distributions in Retirement




**PROBABILITY OF ASSET DEPLETION**

| Age | Probability |
|---|---|
| 65 | 0% |
| 70 | 0% |
| 75 | 0% |
| 80 | 20% |
| 85 | 53% |
| 90 | 86% |
| 95 | 93% |

**PROBABILITY OF FULL INCOME**

| | |
|---|---|
| 84 | 45% |
| 94 | 7% |

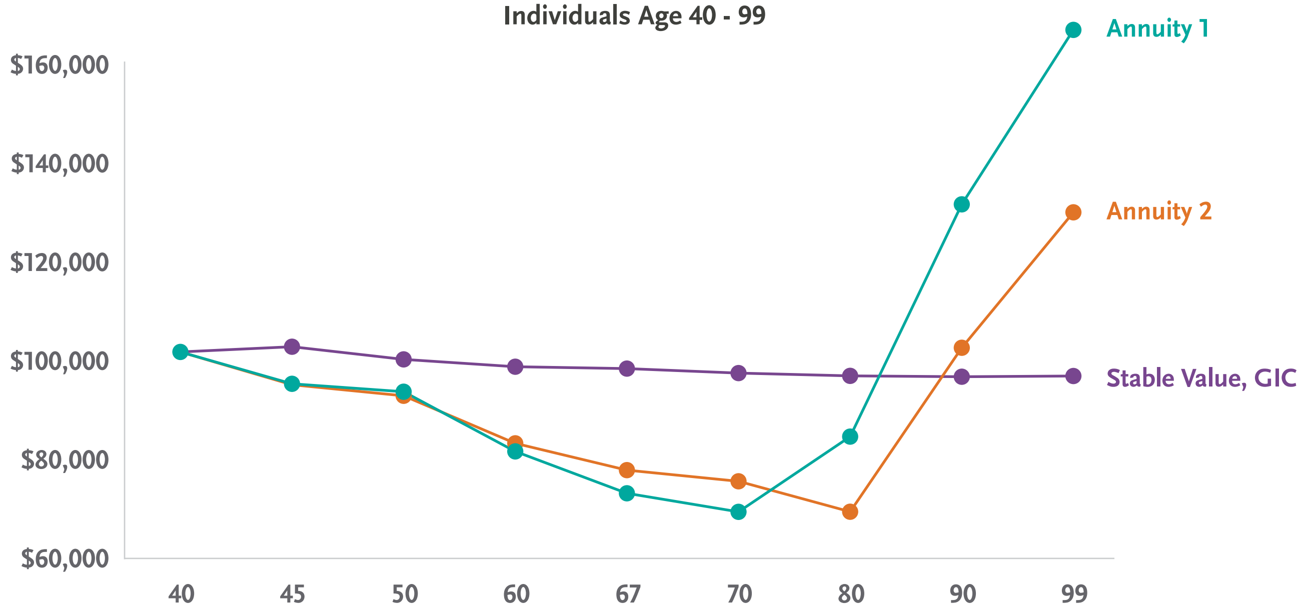
Source: Otar & Associates

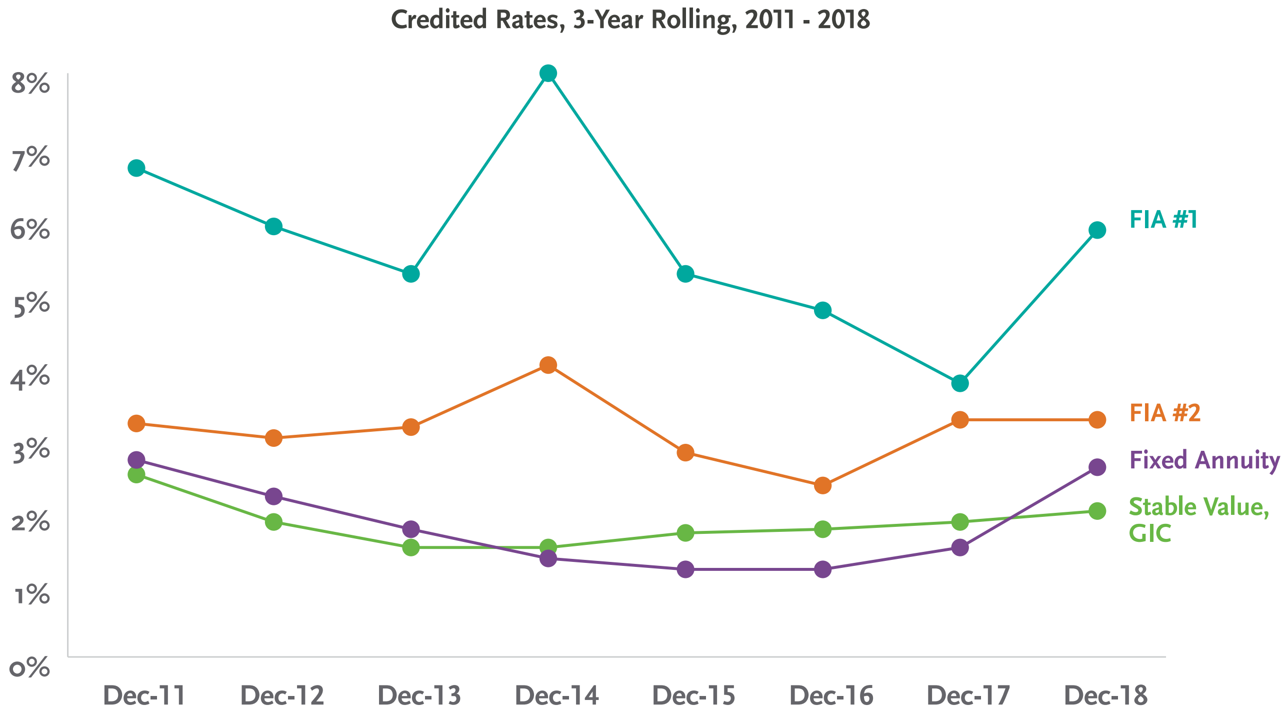
To understand this chart, one must look at the NPV of a set of contracts based on a fixed set of illustration assumptions. The higher the value, the more effective the contract is over a lifetime. In addition, the higher the slope of the NPV line, the more efficient the contract is in providing lifetime income. One can conclude from this chart that the lifetime income annuity options are far more efficient at providing lifetime income than a stable value fund.

## The SECURE Act of 2019

The SECURE Act of 2019 provides a fiduciary safe harbor for selecting providers that offer guaranteed lifetime income products in qualified retirement plans. The full text of the SECURE Act is available online at www.congress.gov/bill/116th-congress/house-bill/1994/text. There is now opportunity for plan decision makers to seriously consider the use of lifetime income products in retirement plans.

### Net Present Value (NPV) of Projected Lifetime Income Contracts, Individuals Age 40 - 99






The SECURE Act also addresses a number of other key items, including a fiduciary requirement to consider fee reasonableness, and defines a new eligible distribution event that would allow a participant to roll over the balance in a guaranteed income product to an IRA if that product is deselected by the plan, under certain circumstances. This new legislation resolves some of the barriers created by the 2008 Advisory Council Report on Spend Down of Defined Contribution Assets at Retirement that caused concerns for many plan sponsors otherwise looking to include guaranteed income options in their plans.

## Conclusion

Fixed Indexed Annuities warrant significant consideration for inclusion in a non-ERISA retirement plan. FIA accumulation options and guaranteed income options address and help to minimize the two key risks that retiree's face – sequencing risk and longevity risk. The use of FIAs will be an area of increased focus, and scrutiny in the future. The industry is likely to see significant product solution innovations and new frameworks to evaluate and regulate these benefits. Most importantly, proactive plan sponsors will turn to established partners to explore the use of FIAs in their plans.

**About the Author, Al J. Otto, AIFA™**
Well-respected and a seasoned professional, Mr. Otto is the Director of Employer Plans at Verity Asset Management, headquartered in Durham, North Carolina and on the Board of Directors for the Center for Board Certified Fiduciaries and a certified Analyst at the Center for Fiduciary Excellence (CEFEX). He has been working in the financial services industry for more than 35 years, holding executive roles with Veriphy Analytics™, Shepherd Kaplan LLC, and OneFiduciary Group. In addition to authoring a wide array of articles and publications focused on retirement plan administration and legislation for various journals and professional associations, he is the co-author of the book *You Can't Serve Two Masters – The Ethics of Investment Fiduciary Governance*. He has also been a featured speaker at industry conferences and organizations across the United States. Most notably, Mr. Otto has been called as an expert witness in more than twenty local and federal court cases, reporting on fiduciary and financial matters within the field of retirement planning, fiduciary responsibility and financial planning. He holds a Bachelor of Science degree from Virginia Tech and attended the Georgia Institute of Technology for additional graduate work.

## Key Considerations for Plan Sponsors Considering FIAs

There are seven key steps for plan sponsors to consider when designing the inclusion of FIAs into the 403(b) and 457(b) market. The primary challenges include providing sufficient liquidity for investors and valuing investments on a periodic basis.

A 7-Step System to drive better decisions at the plan level for committees to evaluate products:

1. Evaluate contract benefits being offered relative to economic value and other alternatives.
2. Ensure product disclosures are comprehensible, allowing buyers to make informed decisions.
3. Review contract provisions ensuring product features are reasonable, and not likely to disadvantage a participant relative to the available benefit.
4. Review provider policy for implementing a vendor deselection decision made by a Committee with respect to potential impact on individual participants/contract holders.
5. Review IRA rollover provisions and portability features available under the SECURE Act that support benefit continuity for individuals.
6. Review participant/individual contract rights ensuring contract provisions align with plan provisions and contract operations are consistent with operational requirements.
7. Ensure sufficiency of ongoing information available from provider to effectively monitor contract performance over time.

**Liquidity:** As is the case for substantially all investment options available in 403(b) and 457(b ) plans, there is a need to allow for contributions and withdrawals at the plan participant level. FIAs with a retail construct should be considered as intermediate to long-term capital preservation assets because of their surrender fee construct. As group unallocated contracts come into the mainstream, FIAs will likely become more benefit responsive and can be used for shorter term investment horizons. In the retail construct, liquidity is limited to 10% of the FIA balance per year through a predetermined surrender charge period.

**Valuation:** While some in the industry want to make it complex, the valuation of an FIA is wonderfully simple. Asset values and credited interest are guaranteed (generally annually) and cannot go down in value. As mentioned above, however, a surrender charges and rider expense may reduce contract values.

**Fee Structure:** Determining the fees of an insurance product requires a specific approach that is very different from that of a mutual fund or collective trust product. The structure of these products does not involve an expense ratio as typical investments like mutual funds, money market funds, and collective trust arrangements.

In general, fixed insurance product manufacturers earn revenue through a spread differential between the interest paid to the contract holder and investment returns earned by the insurance company. Since fees are not expressed as an expense ratio, a different approach is required to determine if the benefits provided are reasonable, with respect to the premiums paid. Rather than look at fees, a more appropriate strategy is to evaluate outcomes over a common time-period. This methodology for determining the value provided by a guaranteed income option requires an analysis to compare projected outcomes based on risk and return on an ongoing basis, rather than simply measuring or benchmarking fees. It was Ben Graham (author of *The Intelligent Investor*), Warren Buffet's mentor, that coined the phrase, "Price is what you pay, value is what you receive."

Measuring actual outcomes – net of fees – is a superior method for determining the reasonableness of fixed insurance product fees. Just because the price of a product is low, does not mean that the product represents a good value. In fact, the U.S. Department of Labor clearly states that a fiduciary does not need to choose the lowest cost provider to meet the standard of prudence. This Crediting Rates chart above clearly shows that during the period from 2011 – 2018 FIAs significantly outperformed other capital preservation instruments. Note that money market funds were not included on the chart because their actual performance was *de minimis* compared to those illustrated.