CLARITY
INSURANCE MARKETING

FIXED INDEXED ANNUITIES

UNDERSTANDING THE PRODUCT MECHANICS &
HOW THEY CAN BE USED IN A CLIENT'S BEST INTEREST

FIXED INDEXED ANNUITIES

Fixed indexed annuities have had explosive growth over the past decade. Academics, financial institutions, financial planners, and investment advisors have expanded the application of these products, which were once just seen as something "sold by insurance salespeople", to become a valuable tool within a holistic financial plan. Even economist Roger Ibbotson, a 10-time recipient of the Graham and Dodd Award for financial research excellence and professor emeritus at the Yale School of Management, unveiled recent research analyzing the emerging potential of fixed index annuities as a bond alternative in retirement portfolios. However, the ability to objectively evaluate these products has been a challenge.

THE MECHANICS OF FIXED INDEXED ANNUITIES: INTEREST RATES & OPTION COSTS

To understand how to evaluate these products, we must first understand the mechanics of how these products are designed. For every dollar of indexed annuity premium, the majority is used to support the product's minimum interest guarantee. This minimum guarantee is the anchor that helps classify the product as a fixed annuity and supports one of the main reasons that clients purchase these products, and that is safety. The minimum guaranteed interest rate is established by the NAIC, the National Association of Insurance Commissioners. They have the ability to increase or decrease the rate, and carriers have to adjust accordingly.

The current economic environment we're facing has been challenging for all fixed-income investments, and annuities are certainly not immune. If we remain in a very low-interest-rate environment like we are in right now, the NAIC might lower the minimum guaranteed interest rate. For an indexed annuity, this would potentially allow the insurance company to lower the MGIR on their products, ultimately freeing up more of the insurance company's portfolio yield to help cover expenses and potentially allocate more money to the options budget. The more money allocated to the options budget, the more options they can buy. The more options they can buy, the higher the caps and the rates to your client.

Now, as with any fixed annuity, the funds used to back these guarantees are invested in bonds and other long-term instruments to generate a yield. The funds are part of the insurance company's general account, and the policy owner does not have any interest in the underlying investments. This is a big reason that these products are fixed insurance products and not securities.

A portion of that yield is allocated toward covering the minimum guaranteed interest rate set by the NAIC. The remaining yield is going to be used to pay expenses of the insurance company itself. Expenses could be things like compensation to the agent, the cost of overhead and staff, printing brochures, picking up the phone, and servicing all of the agents and clients. Another expense is the options budget used to purchase call options in certain market indices, which enables the client to potentially earn a more favorable interest rate. These options are the mechanism that allow the insurance company to credit additional interest tied to the index gains. If the index goes up, the client earns a favorable interest rate. If the index goes down, the client simply earns a zero.

The lower the yield on the insurance company's general account portfolio, the lower the budget available for options, and ultimately, the lower the cap in the product. Yields on fixed income have decreased dramatically over the last 12 months. For example, the 10-year Treasury is a good benchmark for the interest rates that impact insurance companies. On August 1, 2019, the 10-year Treasury had a yield of 2.018%. Fast forward 30 days later, August 31, 2019, the 10-year Treasury yield fell to 1.499%. That's a 25% change in just one month—that is a huge!

The 10-year Treasury peaked at about 3.23% in October of 2018. Leading up to October of 2018, we were feeling the positivity of higher caps and rates in these products. We saw insurance companies over the last few years gradually increase the caps and participation rates on their products. That was mostly a direct result of interest rates and yields rising. A rising tide lifts all ships. If the 10-year Treasury is rising in terms of the yield, then riskier fixed-income yields, like corporate bond yields, should rise as well. That's going to trickle down all the way through most fixed-income options.

From its peak of about 3.23% in October of 2018 to about 1.47% yield at the beginning of September 2019, the 10-year Treasury has seen a 55% decrease in 11 months. That means 55% of the yield has been lost.

Insurance companies rely on the yield to covers the guaranteed minimum interest rate for the policy itself; it also covers their overhead and expenses and their options budget. As you could imagine, a 55% decrease in yield is going to have a ripple effect back to the policies. However, it is important to note that this decrease in the Treasury is not just impacting fixed annuities, it's impacting fixed income and interest for our clients across the board. It will have an impact on retiree's income at some level or another.

It's also important to note that indexed options are not all purchased upfront to support credited interest gains over the life of the policy. Think about it, if you sell a 10-year policy, they're not buying all the index options upfront for those 10 years. Therefore, the caps offered on most indexed annuities are guaranteed one year at a time. It's a concept called an annual reset design. Now, we've recently seen some carriers move to multiyear options, such as two-, three- and even five-year point-to-point index options.

Advisors need to be aware of the potential tradeoffs of these longer-term indexing options. While the options cost is cheaper for the insurance company, allowing them to buy more options, (i.e., higher caps,) one bad year might wipe out all the good years in that period. These multiyear strategies are similar to a monthly cap strategy where there is no downside limit on the negative months, but there's a cap on the positive. In that type of strategy, sometimes one big negative month can wipe out 11 good months. In a multiyear strategy, one big negative year like 2008 could potentially wipe out two, three or even four positive years. So again, it is important to address

these tradeoffs while educating your clients.

While there are multiyear crediting methods available, the bread and butter of the indexed annuity marketplace is the one-year strategy with the concept of an annual reset. Each year the insurance company must purchase new options that may result in interest gains credited to the policy over the coming year.

Advisors will sometimes ask why the insurance company doesn't purchase all of the options upfront and guarantee the caps or the spreads for the term of the policy? Why does the insurance company have the ability to change the rate each year?

The primary reason is that in today's environment, the tradeoff between having guaranteed caps and the cost of guaranteeing those caps would not be an attractive offering to prospective clients. Let's face it, guarantees come at a cost, so if you're familiar with options trading, the longer you try to guarantee something, the more you're going to pay for it.

Think about life insurance; a term policy for 20 years is going to cost less than a permanent policy for life. If the guarantees are offered for a longer period, the guarantee would need to be offered at a lower rate. Based on today's environment, it's just not favorable.

> "If the price of options are higher in a given renewal year, then it was assumed that in that renewal year, fewer options can be purchased compared to the policy issue year. With the price of the option being higher and the options budget being the same, the insurance company can buy fewer options. **The end result in that scenario is the renewal cap on the policy will have to be lowered as fewer options purchased translates into a lower cap.** Conversely, if options cost is lower at policy renewal, then the result could be higher caps because the cost of the option goes down and the insurance company has more money to buy more options. More options mean higher caps."

Other than the insurance company's ability to earn their yield on fixed income, the other driver that impacts these products are options costs. We are seeing this driver impact product pricing today based on current market conditions.

If the price of options is higher in a given renewal year, then it was assumed that in that renewal year, fewer options could be purchased compared to the policy issue year. With the price of the option being higher and the options budget being the same, the insurance company can buy fewer options. The end result in that scenario is the renewal cap on the policy would have to be lowered as fewer options purchased translates into a lower cap. Conversely, if options costs are lower at policy renewal, then the result could be higher caps because as the cost of the option goes down, and the insurance company has more money to buy more options. More options mean higher caps.

TWO VARIABLES IMPACTING THE COST OF OPTIONS

What are the primary drivers of options costs? Well, there are two major variables that affect the cost of options that insurance companies purchase: the risk-free rate of return and the volatility of the equities market.

So, let's start with the risk-free rate of return.

An increase in the risk-free rate of return will generally cause the cost of options to increase. Conversely, a drop in the risk-free rate of return will cause the cost of options to decrease. The risk-free rate of return is typically represented by the return of one-year government-issued Treasuries; there's virtually no risk associated with investments backed by the government, specifically a one-year Treasury. Options cost more when the risk-free rate is higher because not only does a risk-free rate investment cost more when it's providing a higher yield, but so does an investment that has additional risk and uncertainty, such as a call option, which offers the potential for higher returns.

Call options are the main option that insurance companies are buying. When most companies issue an indexed annuity policy, an assumption is made as to what the risk-free rate will average over the life of the contract. If we look at risk-free rates over the past several years, the change is astounding. We've seen an increase of almost 1,400% since 2014. In 2014, the one-year Treasury had a yield of 0.13%. A few years later, in 2017, the one-year Treasury raised to 0.89%, and as of October 2019, the one-year Treasury is at about 1.72%.

So, as the risk-free rate rises, so does the cost of options. The higher the cost of options, the less the insurance company can buy for our clients. Again, remember we went from 0.13% in 2014 all the way up to 1.72% in 2019. In today's market, we are hearing about economic concerns regarding an inverted yield curve. With the one-year Treasury at about 1.72%, the 10-year Treasury at 1.45%, and the 30-year Treasuries at 1.95%, we can see that the 1-year and the 30-year yields are not that far apart. The one year is higher than the 10-year, which is known as an inverted yield curve.

To put that into perspective, in 2014, the one-year Treasury was at 0.13%, the 10-year was at 3%, and the 30 year was at almost 4%. Many economists view that as a healthier-looking yield curve. So, the moral of the story is, this change in the risk-free rate has greatly increased the cost of options.

The second factor to options cost is market volatility. We all know the performance of equity markets at times can fluctuate up and down significantly in a short period. Movements in any given stock index are used to predict the standard deviation of the market index for the following year, which again, is a main determinant of the cost of the option. Over the last several months, the volatility in US markets has risen significantly. The VIX is looking like an EKG machine since July. We're having Chinese trade war issues coming up, we're about to go into the presidential election season over the next year, and the reality of it is, it's anyone's guess as to what's going to happen next. If you look at the VIX chart, you will see that it was steady up until July, then became very volatile. The volatility of the market affects the likelihood of whether or not an option will pay off and what return it will provide, which of course, helps to determine the cost of the option itself. So, at the time an indexed annuity policy is issued, an average market volatility level is assumed for the life of the contract, just like the risk-free rate is assumed for the life of the contract.

When current volatility is at the level of the pricing assumption, each option type will have options costs identical to the budget that's been set for the products at issue, assuming a constant risk-free rate of return. This means the company is going to be able to maintain the caps and rates that they set at policy issue. They wouldn't need to lower or raise renewals rates. If, however, current volatility is below the pricing assumption, most options costs will be lower than assumed, allowing the insurance company to buy more options, resulting in higher caps and rates for our clients. If current volatility is above pricing assumptions, most options cost will be higher than assumed, allowing less options to be purchased. Again, less options equals lower caps. As introduced earlier, the combined effect of changes in the risk-free rate and market volatility determine the cost of options that will be purchased each year for an indexed annuity policy. If the net effect is a higher options cost, fewer options are purchased, and one can expect lower caps and rates. If the option cost is lower, the fixed option budget will allow for more options to be purchased, resulting in higher caps and rates.

COMPARING FIXED ANNUITY PRODUCTS TO ALTERNATIVE FIXED-INCOME VEHICLES

Although we're in a pretty constrained environment right now, the bottom line of all of this is fixed annuity products still have attractive offerings compared to similar alternatives and can be a great option for our clients. Let's look at similar alternatives:

- CDs could be similar alternatives.
- A one-year CD has an interest rate of about 2.4%
- A three-year CD is at about 2.45%
- A five-year CD is at about 2.5%

Investment-grade corporate bonds could also be looked at as a similar asset class.

- A seven-year duration investment grade corporate bond fund has a yield of about 2.68%.

Many could also make the argument that a well-rated insurance company's annuity product could be viewed as a safer investment vehicle than investment-grade corporate fixed income.

Now that we have a comparative yield basis let's look at some of the annuities rates that exist today.

If we start with the shortest duration, we have a one-year multiyear guaranteed product that pays 2.25% interest. Compared to the one-year CD, it's a slightly lower interest rate, but the CD is taxed at your client's highest marginal tax rate while the annuity allows you to defer that interest and tax. So, we recommend you look at it from a holistic perspective. A rate of 2.25% tax-deferred might be better than

2.4% taxable if the client's in a high tax bracket.

When we get to a three-year multiyear guarantee, we have products that guarantee 2.9% for three years. A three-year CD is 2.45%, so the annuity is more favorable than the three-year CD. In fact, the three-year multiyear guarantee annuity is even more favorable than a seven-year investment-grade corporate bond yield right now.

If you wanted the opportunity for even more upside potential, there is currently a three-year fixed indexed annuity in which you help your client take advantage of the short end of the yield curve. With this product, your client can earn a 2.1% fixed interest rate if you elect that option, or you could elect the annual-point-to-point with a cap is between 4% to 5%, depending on the premium amount. Essentially you have the upside potential to earn almost double what a three-year CD would yield based on going into the index allocation.

Now, on a five-year time horizon, a CD is paying about 2.5%. A five-year multiyear guarantee annuity is currently at 4%. There are also indexed options that allow your client to participate in up to 41% of the S&P 500 on an annual point-to-point basis, while locking in their gains each year. For conservative clients, they may really appreciate the opportunity to earn up to 41% of the S&P performance over a 1-year period, with none of the downside.

> “While today's current market conditions along with the fact that people are living longer than ever may cause lifetime income rates to go down, we all need to be aware that many of our clients desire the guarantee that only an annuity can provide. If interest rates stay low and mortality increases, insurance companies may reprice products, meaning the same dollars will buy you less guaranteed income. Now is a phenomenal time to learn how utilizing lifetime guaranteed income products can enhance your client's retirement plan. “

If we go out to a seven-year time horizon, we could offer our clients a seven-year multiyear guaranteed annuity at 4.1%. Outside of a MYGA, we have indexed options based on the S&P 500 dividend aristocrat index in which your client can earn up to a 95% participation rate in that index.

Many annuities offered today are built on a 10-year time horizon. A multiyear guaranteed annuity with a 10 year time horizon will provide your client with about 4.2% guaranteed interest for 10 years. Although that may be a strong 10-year rate for fixed income, many advisors gravitate towards an indexed annuity allocation for the potential to increase interest credits.

Even in today's challenging interest rate and economic environment, a fixed indexed annuity could be a tremendous alternative to bonds or CDs that can provide your client the opportunity for higher interest.

USING ANNUITIES FOR RELIABLE INCOME

In addition to their competitive yields, one of the biggest benefits of having an annuity in a financial plan is to produce predictable and reliable income. There are only three sources of guaranteed income for our clients today. You can guarantee income at the bank via laddered CDs, you can guarantee income through the federal government by laddering government bonds, or you can guarantee income through insurance company using an annuity.

While today's current market conditions along with the fact that people are living longer than ever may cause lifetime income rates to go down, we all need to be aware that many of our clients desire the guarantee that only an annuity can provide. If interest rates stay low and mortality increases, insurance companies may reprice products, meaning the same dollars will buy you less guaranteed income. Now is a phenomenal time to learn how utilizing lifetime guaranteed income products can enhance your client's retirement plan.

But, when it comes to guaranteeing income, you don't just have to use fixed or indexed annuities for lifetime income payouts. These products can be used as an incredible source of funds for the drawdown method of income by simply accessing penalty-free withdrawals. This methodology allows you and your client to hold less of their net worth in the annuity (compared to lifetime income options), while still protecting against sequence of returns risk, providing reliable income for a period of time, and helping ensure your clients can weather any short-term market volatility to stay the course with their long-term growth accounts.

HOW TO USE FIAS IN THE BEST INTEREST OF YOUR CLIENTS

As advisors, we not only have an opportunity to help the 10,000 baby boomers turning 65 and easing into retirement every single day, but we have the obligation to inform them of how they can insure to protect their wealth and not outlive their income. We have access to lifetime guaranteed income options that allow investors the peace of mind of having a pension. We have draw-down options that give investors the ability to eliminate sequence of returns risk and the confidence to stay the course with their growth assets. It is up to us to ensure we are educating our clients on all their options and helping them select the appropriate solutions that will meet their individual needs.

The Wall Street Journal shared a survey several years ago concluding that retirees live longer and happier lives if they are surrounded by friend and family and have a guaranteed income—a critical attribute that annuities can provide. We are going to continue to see a lot of changes in the insurance industry, and we are in a uncertain interest rate environment, but we should all stay positive on the products and the carriers that we're partnering with to provide these solutions to our clients because if we compare them side-by-side the other fixed alternatives, such as CDs or bonds, the insurance companies are providing us with a strong solution to help meet our clients goals. That is why Clarity Insurance Marketing created our Best Interest Annuity Screening Process.

The goal of creating the Best Interest Screening Process was to help strip away singular factors, including commissions and incentives, to provide a thorough, analytical way to help identify an insurance product in the best interest of the client.

The award-winning process was designed to help both insurance agents improve upon their existing abilities for proper product selection as well as to open new opportunities for securities advisors to integrate fixed-indexed annuities into their financial plans with confidence.

The insurance distribution (IMO and FMO) industry is a highly competitive space, and we see the Best Interest Screening Process as a key differentiator for us and for our advisors. We have invested a significant amount of resources into building tools that can help advisors offer an insurance component in a holistic financial plan. We're proud to be acknowledged for this mission and accomplishment.

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Dave Alison is an accomplished financial planner, tax advisor, speaker, and mentor with a passion to help individuals achieve financial freedom. As a founding partner of C2P Enterprises, Dave has helped bring the leadership team together and shape the vision to simplify financial planning for financial advisors and their clients.

To validate his commitment to furthering his education and competency in the advice he provides, Dave has earned the CERTIFIED FINANCIAL PLANNER™ designation, Enrolled Agent and Certified Financial Fiduciary® designation.

Dave's professional capabilities to coordinate tax, financial, insurance and estate planning needs are what led him to found Alison Wealth Management as a boutique tax, financial planning & investment management firm bringing household CFO services to affluent families & high-income professionals across the United States.

Dave is the creator of The Tax Management Journey® and currently serves as a mentor and trainer to hundreds of financial planners, CPAs and estate planning attorneys as well as a frequent speaker at industry conferences through the United States. One of his recent innovations includes the development of the award-winning Best Interest Annuity Screening, recognized as the winner of 2019 WealthManagement.com Industry Award for Insurance Services. He is regularly called upon as a public speaker and by the media to share his knowledge on holistic financial planning, including Bloomberg, MarketWatch, Forbes Investor's Business Daily, US News and World Report, Financial Planning and more. Dave is an active member of The Financial Planning Association, The FPA of Silicon Valley, The National Association of Enrolled Agents, The National Ethics Association, and The Forum 400.

About Clarity Insurance Marketing

Clarity Insurance Marketing is a fiduciary-friendly insurance marketing organization (IMO) that facilitates advanced product screening, selection and support for all lines of fixed insurance products, such as fixed and indexed annuities, single premium and traditional life insurance, and asset based long-term care products. It works to create efficient back-office support and quality service standards to help advisors issue new business quickly, accurately, and effectively.

Clarity Insurance Marketing is dedicated to the implementation of best interest practices for the use of its insurance products—effectively mitigating risk for institutions, their advisors, and ultimately American families nationwide through sophisticated case design, product selection, and implementation of insurance solutions as financial planning tools. The firm was recognized as the winner of 2019 WealthManagement.com Industry Award for Insurance Services for its innovation of the Best Interest Annuity Screening Process. To learn more, call (844) 381-4115 or visit www.clarityinsurancemarketing.com.