Fixed Index Annuities Protect Investors From Market Herd Behavior

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Herd behavior (or herd mentality) is a term used to describe how individuals in a group can act together without planned direction. In humans herd behavior is seen during street demonstrations, sporting events and mob violence. Herd behavior among humans is also prevalent during stock market bubbles and crashes. Large stock market trends often begin and end with periods of frenzied buying driven by greed (bubbles) or hysterical selling fuelled by fear (crashes).

As a stock market bubble bursts and the stock value drops significantly, investors attempt to get out of the market at the same time to avoid incurring more losses. Panic selling eventually turns a declining market into a market crash and often followed by an economic depression.

The U.S. market has had it share of bubbles and crashes. The Florida Real Estate Craze (1926), The Market Crash of 1987, The Dot Com Bubble (2000 to 2002), and the mother of all crashes that gave birth to The Great Depression of 1929.

The subprime mortgage crisis of 2007 only proves that herd behavior among investors is alive and well. Some are currently pointing at bio-diesel production as a bubble in the making. In the era of global economy even market crashes that take place overseas, such as the Asian Financial Meltdown in 1989 and the Shanghai Bubble that popped early this year, are expected to exert some impact on the U.S. economy and investors.

Also it appears that bubbles and crashes are occurring more frequently. The time between crashes appears to have been shortened from centuries to merely a matter of years.

Does this mean investors have no choice but to bear the brunt of market crashes? If an investor is not suited to handle the emotional roller coaster of the investment should he or she get out of the market game altogether? Some financial experts are saying that this is not necessarily the case.

While information is good and financial experts do encourage investors to educate themselves and do their homework, there is such a thing as too much information. Some studies have shown that decision-making can actually suffer when the brain experiences information overload. Excess information can trigger irrational greed and panic, which in turn trigger overreaction. Overreaction translates to buying high and selling low.

What a good financial advisor may do is initiate an arrangement with his or her clients where the investors agree to read only information provided by the advisor. Meanwhile, the advisor carefully filters all information and presents them in a manner that encourages thoughtful and rational thinking rather than emotional knee-jerk reaction. This could be particularly useful for new or uneducated investors who are easily manipulated into buying sprees and selling frenzy.

But such an agreement may be hard to enforce because information, reliable or not, are practically impossible to avoid. The Internet, for instance, is said to have the power to deliver almost 300 billion pieces of financial information.

A better option is to pick the right investment tools that offer protection from the effects of market bubbles and the fallout of market crashes. These include treasury bonds, bank certificates of deposit (CDs) and fixed index annuities (FIAs).

In terms of safety, treasury bonds are considered "risk-free" making them ideal for capital preservation. While bonds can outperform stocks during recession stocks will outperform bonds in the long run because bond interest rates are regulated by law and relatively low.

CDs are a special type of deposit account with a bank or thrift institution that carry higher interest rates than regular savings account. However, like treasury bonds, the inherent safety and short-term nature of a CD investment makes their interest yields lower than other higher risk investments.

FIAs also provide the safety of CDs and treasury bonds but generate more earnings. Based on historical data from 1997 to 2007, returns on FIAs were up to 50% higher than the average yield of CDs and savings bonds. Another study showed that FIAs returns were higher than 63% to 75% of all mutual funds from March 31, 1998, to March 31, 2003.

Although that is not enough to outperform stock market investments, FIAs do offer investors something that stocks do not. During market crashes FIAs may earn no new index-linked interest but investors do not lose the money they already have. Some advisors say this feature effectively curbs the urge to commit panic selling in the event of a market crisis.

What about good market years? Investors will not be able to gain from all of the upside because the contracts enforce a cap on the amount of indexed interest credited to the FIA and a participation rate that determines the amount of indexed interest to be credited to a contract.

In the end, FIAs embody the philosophy of “it’s not what you make, it’s what you keep.” Since FIAs are virtually immune to stock market losses, investors are able to get a competitive return even with limited participation. Besides FIAs, CDs and bonds are meant to serve to counter balance the greater risk associated with higher earning investment vehicles in a portfolio.