USING FIXED INDEX ANNUITIES FOR RETIREMENT INCOME

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As advisors and clients continue to search for reliable retirement income alternatives, one bright star has emerged among the many contenders: the fixed indexed annuity (FIA). The FIA's assent is, at least in part, due to the fact that many of the historical objections to fixed annuity products have been overcome by the development of a new set of indexed annuity features that, when combined with modern market forces, provide a powerful fixed income alternative.

In fact, today's FIAs often offer features, such as annual interest crediting to lock in gains each year, that have generated returns in excess of traditional "safe" investment products (think corporate bonds) while still providing for 100% principal protection. The end result is undeniable–FIAs have been established as major players in the fixed income world, and it's time for a second look.

MODERN FIAS: INTEREST CREDITING FEATURES

In general, FIAs base the performance of the annuity upon a major index or indices (usually a stock index, such as the S&P 500). Unlike directly investing in the equity markets, the fixed indexed annuity product itself generally offers principal protection in exchange for limitations on the potential for investment gains.

When purchasing the FIA, the client is able to choose among a variety of product features, one of the most important of which is the way interest is credited to his or her account value. The annual reset (or ratchet) method has become popular because it can eliminate the risk of a mid-year decline in the index's value, and locks in gains on an annual basis.

Essentially, this method compares the change in the index from the beginning of the year to the end of the year, calculates the percentage change in the index and ignores any mid-year changes. If the ending value is higher than the starting value, the account is credited with the change (taking into account any applicable participation rates or caps; see below). If the ending value is lower, no interest is credited, but the client's principal account value is still protected.

The annual reset method has gained in popularity because it locks in the value of any increase in the index each year. Conversely, other crediting methods (such as the high water mark method or point-to-point method) often do not credit interest until the end of the investment term. If this is the case, a decline in value near the end of the term can cause a loss of earlier increases in value.

The high water mark and point-to-point methods can also prove problematic for clients who surrender their contracts early–because interest gains are not locked in each year, depending upon the timing of surrender, those gains could be lost. The now widely available annual reset method can provide clients with a consistently available way to measure investment growth throughout the contract's lifetime. FIA Caps and Participation

Though the annual reset method may be the most attractive for clients looking for stable growth, clients should be aware that, in many cases, lower cap and participation rates can apply. A cap, as the name suggests, places a cap on the maximum interest rate that can be credited to the client's account in any given period (e.g., an 8% cap means that the account will be credited with 8% interest even if the index value increases by 10%).

A participation rate limits the value of the index increase that can be used to calculate the contract's interest earnings (for example, if the FIA had a participation rate of 75% and the index rose by 10% the contract would be credited with 7.5% interest).

Despite this, for clients looking to FIAs as a means for ensuring consistent growth over the long haul, these lower caps and participation rates can provide worthwhile as risk is managed through annual interest crediting.

CONCLUSION

The surge in FIA popularity is no accident–recent trends in FIA product development have come together to offer options that are undeniably attractive. Importantly, flexible options now ensure that FIAs can function as an important part of a client's fixed income portfolio to provide secure retirement income.