FIAs & DIAs

Understanding The Difference

Does a Fixed Indexed Annuity or a Deferred Income Annuity make more sense for you?

FIAs & DIAs

Introduction

The annuity market is constantly evolving to create new "multi-tasking" products, and along with them, confusion. Historically, the word **annuity** meant one thing: an exchange of money today for a stream of steady payments in the future. There was some room for customization, such as choosing when payments would start (now or later), and how long they would continue (set period or for life).

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The primary function that these annuities served – and the reason why an insurance company was the one issuing them – was to protect against longevity risk, or the possibility of running out of money late in life. By promising to continue payments until death, income annuities still offer this classic, simple, and crucial protection today.

The primary function of an annuity is to protect against longevity risk, or the possibility of running out of money late in life.

What's the catch? Effectively providing this type of protection means losing control of the assets you convert to an annuity. Income annuities are illiquid, meaning the only access you have to your money is through the scheduled income payments. From the insurer's perspective, limiting access allows them to provide coverage at lower rates. But, some consumers find this discomforting.

Enter new, "multi-tasking" products, such as Variable Annuities (VAs) and Fixed Indexed Annuities (FIAs), which claim to offer upside potential with no downside risk, liquidity, and longevity protection all in one. What's the catch? They don't do any of these things well.

FIAs & DIAs

Fixed Indexed Annuities (FIAs)

Fixed Indexed Annuities (FIAs) are often pitched as products with upside potential, no downside, liquidity, and the option of guaranteed income for life. But how exactly do these products provide you with all of these promises?

Upside Potential

When you choose to purchase a FIA your premium is invested in different funds that track a stock market index (often the S&P 500). The growth of your accumulation value (i.e. your cash balance) is based on the underlying indexes that you choose. However, your upside is limited through features called participation rates, caps, and spreads.

Participation Rate

This is the percentage to which you participate in the upside of the index. For example if your participation rate was 80% and the index was up 10% that year, your accumulation value would only have access to 8% of that growth.

Cap

A cap sets the maximum amount of growth you can get for any increase in the index. For example if there is a 5% cap and the index was up 10% that year, you would only get the benefit of 5%.

Spread

A spread is the fee applied to any growth in the index. For example if there is a 1% spread and the index was up 10% that year, you would only get the benefit of 9%.

One additional complication is that each index your money is invested in can have more than one of these features. Meaning you could be subject to participation rates, caps and spreads at the same time. The effect is a dramatic reduction in your upside potential.

Downside Protection

If the market takes a tumble, most FIA products promise that you won't lose money. Generally that is the case but if you have any additional riders added to the policy (like a guaranteed income rider) your account is still charged that annual fee.

Guaranteed Income Rider

FIAs generally have the option of adding a Guaranteed Income Rider that promises to pay you a fixed amount for as long as you live. The payments you receive are determined by multiplying a payout percentage (fixed at the outset of your policy for specific ages) by the guaranteed benefit amount in your policy. Often these products will have guaranteed growth rates that will be applied to your policy for the purpose of determining your benefit. However, there are a few important factors to keep in mind:

1. **There is a fee associated with this rider.** Depending on the insurance carrier, the fee to have this option can be as high as 1.5%, charged annually as a deduction to your account value.

2. **The income may not last your entire life.** If you ever take a distribution above the allowed amounts from your policy or decide you want to access the accumulation value once income has started, your payments are no longer guaranteed for life. That means that you can only access market-based growth in your policy by sacrificing your lifetime income stream.

3. **The income reduces your accumulation value over time.** Once your policy begins paying you guaranteed lifetime income, the accumulation value (i.e. how much cash you could access) reduces over time. Once your accumulation value has reached zero, assuming you have not made any extra withdrawals, your income would continue but you would have no other value in the policy.

Liquidity

The lack of access to the money you invest in an income annuity is the biggest detractor for most people. So, the FIA attempted to address it by providing access to the contract's accumulation value. But, accessing your money winds up being a bad idea for two reasons:

1. **During the early years, you'll pay a surrender charge.** Depending on the carrier and the year of your withdraw/surrender, you could be charged somewhere around 10% of your account value.

2. **Withdrawals erode the Income Rider benefit.** If you've added an income rider, it will never be financially advantageous to take withdrawals beyond the stipulated income amount. Doing so reduces your income benefit (which you're paying for via an annual fee) and could mean that the income would no longer continue for life.

Understanding Your Options

So how do you compare a Fixed Indexed Annuity to other options available? The best way is to look at an example that compares these options over a historical period.

To start off with, let's talk about the two options available if you're interested in guaranteed lifetime income, as well growth through market upside:

Option 1

Purchase a Fixed Indexed Annuity with a Guaranteed Income Rider.

Option 2

Purchase a Deferred Income Annuity with less money, and leave the rest of your money in the market.

To compare these two options, let's use Adam as an example. Adam, 45-years-old, is considering investing $100,000 in a Fixed Indexed Annuity. His goals are to (1) create a guaranteed income stream starting at age 60, and (2) grow his funds by participating in the market.

Option 1: Buy a $100,000 Fixed Indexed Annuity with a Guaranteed Lifetime Income Rider starting at age 60. This rider will produce an income benefit of $7,000 per year.

Option 2: Spend $76,000 to buy a Deferred Income Annuity that produces an identical income stream, and leaves the rest of his money in the market.

For this analysis, Option 1 will be based on the Voya Quest 7 with the Voya myIncome Withdrawal Benefit (Guaranteed Income Rider) with rates as of 11/16/2016. Option 2 uses the Mutual of Omaha Deferred Income Protector with Cash Refund with rates as of 11/16/2016, along with the Vanguard 500 Funds which tracks the S&P 500 and charges a 0.05% annual fee. For both scenarios, the first 15 years will be based on historical S&P 500 performance between 2002-2016, after a conservative assumption of 4% growth is used.

So how did each of these strategies do over time?

Income Benefit

First, let's compare the income benefit available. The guaranteed income generated by each of these two strategies is exactly the same: $7,000 per year starting at age 60 and continuing for as long as he's alive.

For the Deferred Income Annuity in Option 2, there is absolutely nothing he can do to risk or lose this benefit. But, for the Fixed Indexed Annuity in Option 1, any withdrawals made above the allowable amount will substantially reduce the guarantee income benefit and cancel the guarantee that it continues for life.

For the Fixed Indexed Annuity in Option 1, there is also an opportunity for the income benefit to increase if the accumulation value grows to be greater than the guaranteed withdrawal base. If this is the case on a policy anniversary, the guaranteed withdrawal base would "ratchet" up to meet the accumulation value. This would also mean a higher income benefit. This is extremely unlikely to happen.

Understanding the Guaranteed Withdrawal Base

Fixed Indexed Annuities with Income Riders have two account values: the Accumulation Value and the Guaranteed Withdrawal Base

Accumulation Value

This is similar to an investment's account balance. It is invested in the market (but limited by participation rates and caps), charged fees and spreads, and available to be withdrawn (subject to surrender charges). This is what we've been discussing so far.

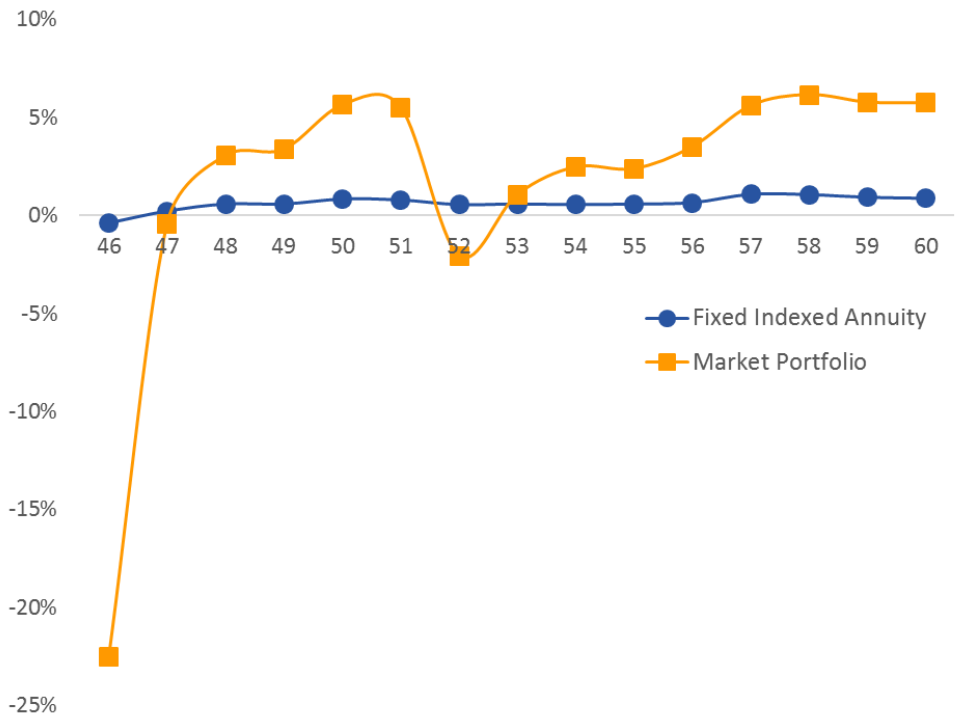
Guaranteed Withdrawal Base

Alongside the Accumulation Value is another account which determines the guaranteed income benefit available. It's "phantom" in that its value can't be accessed directly. Typically, it grows at a fixed, pre-determined, rollup rate for a set period of time and then remains constant but could increase to the level of the Accumulation Value if it is ever higher. For this to happen, the market performance would have to be extraordinary such that the Accumulation Value growth, after participation rates, caps, spreads, and fees are applied, exceeds the rollup rate. It is extremely unlikely.

Market Upside

Next, let's look at the growth of the assets. For Option 1, this is the same $100,000 that's invested in the Fixed Indexed Annuity, which is supposed to provide access to market upside and produce a guaranteed income stream. For Option 2, this is the $24,000 leftover from the Deferred Income Annuity purchase that can be invested directly in the market.

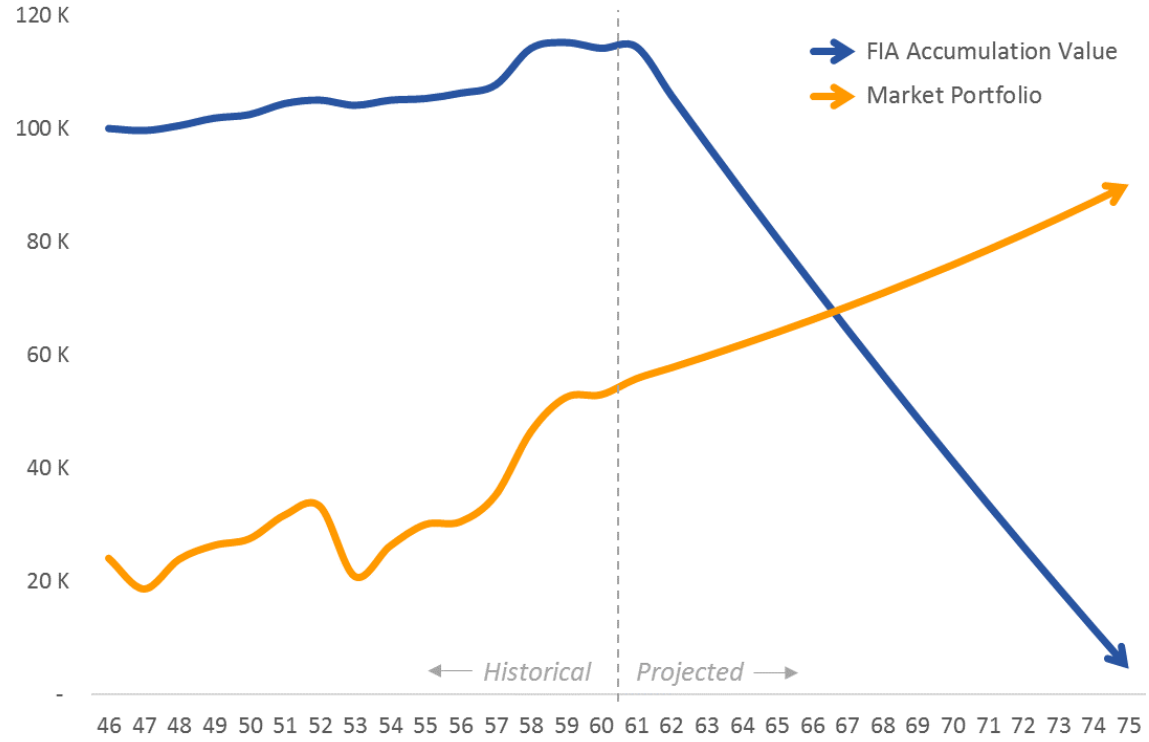
The following chart shows the annual growth in the funds invested from ages 45 to 60, using historical S&P performance from 2002 to 2016.



The performance of the S&P index was strong, while volatile, averaging a 6.3% return each year. In comparison, the Fixed Indexed Annuity accumulation value grew only an average of 0.9% per year during this period. The vast majority of growth was not captured by the FIA due to the mixture of participation rates, caps, spreads, and fees. While the FIA did not experience any decline in value during bad years, a significant amount of growth was lost over the 15-year period.

Value & Liquidity

And lastly, let's take a look at how the FIA accumulation value compares to the market portfolio. The chart below compares the two accounts using historical returns for the first 15 years (accumulation phase of the FIA), and projected returns thereafter (withdrawal phase for the FIA).



The market portfolio more than doubled in the first 15 years, benefiting fully from the index's growth (offset only by a minimal 0.05% investment fee). In comparison, the FIA accumulation value, which was invested in the same underlying index, experienced growth of only 14% after applying the participation rates, caps, spreads, and fees.

The market portfolio continues to grow indefinitely, whereas the FIA accumulation value begins to decline once income benefits begin at age 60. From that point forward, there's no potential for growth, and instead just charges against the account for each withdrawal and for rider fees. In this example, all of the FIA accumulation value is depleted by age 75.

Choosing An Approach

So what's the right approach?

In every category above, Option 1 underperforms Option 2, that is the FIA provides an inferior outcome to using an income annuity and a market based portfolio.

In fact, no matter what the goal, Fixed Indexed Annuities are typically an inferior solution.

1. **Generating Income** For the same investment, FIAs generate less income than a pure income annuity.

2. **Market Upside** FIAs limit your gains through participation rates, fees, and caps. In comparison, investing directly in an S&P index costs as little as 0.05% per year.

3. **Maintaining Some Liquidity** FIAs limit your access to funds in early years, and all withdrawals won't make sense because you'd substantially reduce, or even eliminate, your income benefit.

If you are looking for an income stream and market upside, in the long-run you're better off purchasing an income annuity and leaving the rest in a low cost market portfolio.

In trying to cover three objectives into one product, the Fixed Indexed Annuity winds up being costly, complicated and suboptimal.

At Abaris, we only sell annuities for their guarantees, never for their potential. So stick with low-cost diversified funds for market upside and income annuities for a guaranteed paycheck for life.