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Fixed Index Annuities As A Bond Alternative



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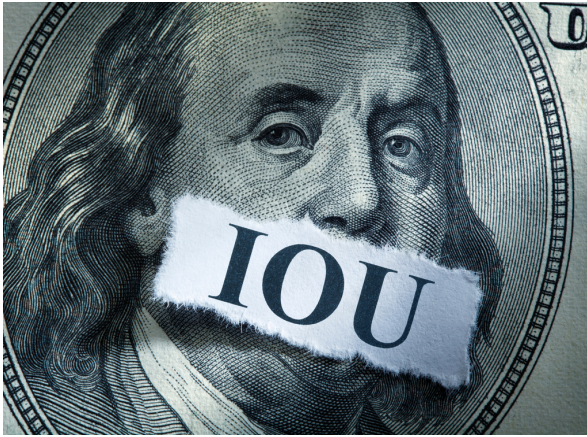


Introduction

There are many challenges involved in retirement planning, but one challenge takes precedence over all others. And what is that challenge? It is making sure that our clients' money does not end up dying before they do. I could ask 1,000 retirees what their goals were in retirement and I would get 1,000 different responses. That diversity in goals makes sense, in that everyone's vision of what they want their future to look like is unique to them. There is, however, one retirement goal that will be common to almost everyone: the goal that their retirement dollars last as long as their retirement years.

Everything we do as retirement planners should be focused on helping our clients achieve that goal, even if that means rethinking old paradigms of planning. I have heard it said that sacred cows make great hamburgers...well, allow me to kill a sacred cow by stating that there may be a better alternative to the way bonds have been used in retirement portfolios. Specifically, I want to suggest that a fixed index annuity (FIA) can, for the right client, be a compelling alternative for the space in their portfolio that has been historically filled with bonds.

What is a bond?



A bond is essentially an IOU, whereby you effectively “loan” your money to a bond issuer and they in return promise to pay you back your principal with interest over a stipulated period of time. The bond issuer may be a corporation, a municipality or even the federal government. A bond could be purchased from a U.S.-based entity or internationally.

Historically, bonds have been used to be both a stable counterweight to the volatility of stocks, as well as a way to generate interest income that could either be reinvested or taken to supplement retirement income. The two key questions that we will consider momentarily are:

Can a fixed indexed annuity (FIA) better serve both the role of lowering volatility and the role of providing income?

Can this be accomplished with as little or even less risk than with bonds?

First of all, let’s look at the issue of risk. There are two primary risks associated with bonds: the risk of default and interest rate risk. Let’s take a look at both.

Default Risk

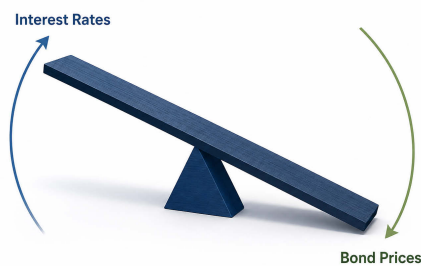
It has been my observation over the years that when a client tells their broker that they want to be more conservative, the broker simply increases the bond allocation without the client always fully understanding that they can indeed lose money if the bond issuer were to default. A bond does carry with it the promise of principal repayment with interest, but that promise is only as good as the ability of the bond issuer to keep it. On numerous occasions over the years I have had prospective clients show me their present portfolios and express to me that with such a large bond allocation they were comfortable that their risk level was very low. Sometimes their perception does not square with the reality of the risks they are carrying in their bond allocations.

The bottom line is that all bonds are not alike. A bond that is paying an unusually high interest rate is typically doing so because their financial strength is shaky enough that they need to offer a high rate in order to attract investors. Using analytical tools such as Morningstar, we have the ability to “X-ray” our client’s bond portfolios and give them an honest appraisal of the quality of their bond holdings and the risks they may unknowingly have.

The chart shows the various rating agencies’ grade charts for bonds. As you can see, there are plenty of opportunities for people to own poorly-rated bonds. When we are recommending annuities from well-rated insurance companies, we can offer a genuine alternative to the default risk that exists for the client who owns lower quality bonds.



Interest Rate Risk



There is an inverse relationship between interest rates and bond values. Think of it like a teeter-totter. Generally speaking, when interest rates go down, bond values rise, but when interest rates go up, bond values tend to fall. Because most bonds are not bought on the primary market directly

from the bond issuer but rather are bought in the secondary market from people who have previously bought them, there is the risk that if you bought a bond and wanted to sell it, a rising interest rate environment since you purchased it might mean that you will have to sell it at a loss. It’s really not that complicated. If, hypothetically, you bought a 10-year bond paying

4 percent interest three years ago and you now wanted to sell it, you would need, through your brokerage firm, to look for a buyer. Well, if in the past three years, interest rates have risen so that a new bond comparable to the one you have is paying 6%, you are going to have trouble selling the bond you own for the same amount you paid for it. This is interest rate risk, and it is commonly not understood by bond owners. When interest rates rise, it is common for bond holders to see the value of their bond holdings decline. With an indexed annuity, there is a known early surrender penalty for a stipulated number of years, but unless there is an MVA on the annuity, the client is protected from interest rate risk.

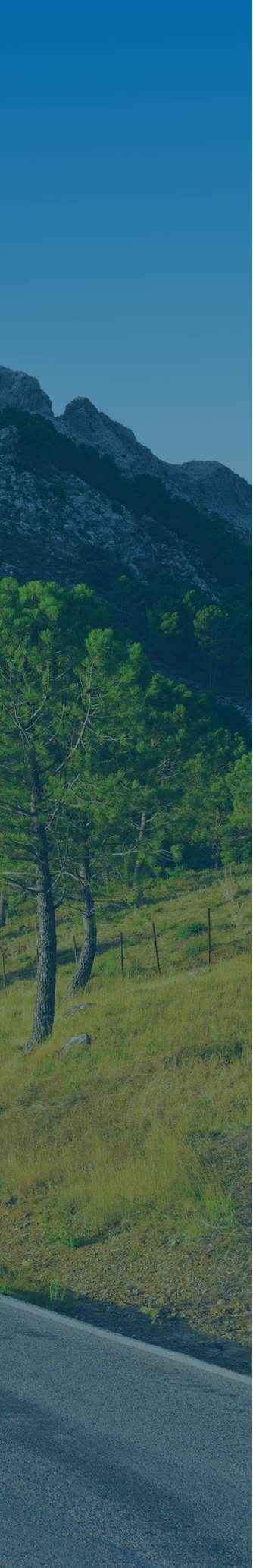
How could a fixed indexed annuity serve as an alternative for a bond allocation?

I have often said that an annuity is nothing more than life insurance in reverse. We buy life insurance when we are young in case we die too soon. We buy annuities when we are older in case we live too long. The wonderful thing about fixed indexed annuities is that they can so effectively help clients bring more stability to their retirement, while at the same time generating income that cannot be outlived - income that can help them to fully embrace all of the wonder and the adventures of retirement, to live their lives aggressively and joyfully, and to avoid looking back in regret at an unfulfilled bucket list. I believe that in many cases an annuity can help them achieve those goals much more effectively than bonds. There are three primary reasons why: Safety, Growth and Income. Let's look at each.



Safety

It is somewhat ironic that as I am suggesting that fixed indexed annuities can serve as attractive alternatives to bonds the reality is that the investment portfolios of the insurance companies that issue these annuities are made up mostly of...bonds. The difference is that with a fixed annuity the bond risk is assumed not by the contract holder but by the insurer. With an indexed annuity, the insurer will take a small percentage of the premium (typically around 5%) and purchase an option on an index, such as the S&P 500. If the index goes up in a given year, the insurer exercises the option and any interest




earned for the contract holder (up to any caps or participation rates) is credited to the annuity. If the index goes down, the client is protected against market loss. It is what I call “when zero becomes a hero.” All of the interest rate risk and default risk associated with bonds is taken on by the insurer and kept from the annuity contract owner.

Growth Potential

Not only do bonds have risks of which investors are not always fully aware, they can have a pretty low upside potential, especially in today’s low interest environment. In an important white paper published in 2018, entitled “Fixed Indexed Annuities: Consider the Alternative,” highly regarded economist Roger Ibbotson suggests bond returns in today’s historically low interest rate environment may be insufficient in meeting the anticipated retirement needs of U.S. investors, potentially placing many at risk of outliving their retirement savings. Ibbotson says, “Conventional wisdom has most investors de-risking their portfolios by allocating more heavily to bonds as they approach retirement. However, investors should consider other alternatives such as Fixed Index Annuities. In this low interest rate environment, complacency can be a danger to our clients’ futures.”

Backing up his assertion, Ibbotson conducted a study where he looked at the performance of bonds versus uncapped fixed indexed annuities (those with participation rates but no caps). What he found is that uncapped FIAs would have outperformed bonds on an annualized basis for the past 90 years. Past performance may indeed be no guarantee of future results, but that is some pretty impressive past performance! Additionally, he maintains that it is highly unlikely bond investors will realize as high a return from capital gains in the coming 10 years as they have realized in the past 10 years. In fact, if interest rates rise, Ibbotson says that movement in the values of bonds in the future will be negative (capital losses).



This is where FIAs can ride to the rescue, offering more upside potential, minus some of the risks associated with owning bonds.

Income

Ultimately annuities are about the generation of income. An aging population creates the challenge of finding ways to make sure that retirees do not outlive their income even as they live longer. Annuities are unique in the financial world in that they can guarantee an income for life. Traditional 'life-only' annuities have always had the uncomfortable tradeoff of the insurance company keeping your premium at the time of your death. In other words, if someone chose a life annuity it would be a great deal if they lived a really long time, but if they were hit by a bus as they left the bank after cashing their first monthly check...well, it was not such a great deal. With the income riders on fixed indexed annuities that concern is set aside. The client can still have an income for life that will continue even if the account value has been spent down, but whatever is in the account value at the time of their deaths will go to their specified beneficiary.

Can a bond do that? If the need arose to spend down a bond portfolio, would that income continue even if the account had been depleted? Of course not! The day the last dollar is spent in the portfolio is the day the monthly checks would stop. And when you factor in the additional income that can come from many annuities if the client is confined in a long-term care facility or in some cases simply unable to perform 2 out of 6 activities of daily living...well, there is considerable value there. And what of the fees? With many income riders, the annual fee is around 1%, and some carriers offer no-fee riders as well. While this is certainly a consideration in purchasing the rider, the fact that many actively managed mutual funds have expense ratios that can exceed 1%, and yet have no underlying guarantees that protect against market loss or provide a lifetime income, should put that annuity fee into its proper perspective.

Summary

In today's low interest rate environment, there is a need for reliable, income-based products in a retirement portfolio. When you consider the risks of bond ownership on the one hand, and the safety, growth potential, and income guarantee of annuities on the other hand, there is a compelling rationale for financial advisors to consider FIAs as an alternative to some of the space in a retirement portfolio that has historically been filled with bonds.

Get Started

To learn more about how we help hundreds of independent advisors across the U.S. implement fixed index annuity and life insurance solutions for their clients' retirement needs, visit our website or call our office.

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