Indexed Annuities With Rate Cap, Participation Rate Beat Others in Cannex Study

by Tamiko Toland PUBLISHED MAY 2, 2018

How does the performance of fixed-indexed annuities (FIAs) compare to that of traditional fixed annuities (multi-year guaranteed annuities, or MYGAs)? Both are fixed annuities, but their yields are based on completely different criteria. MYGAs are simple, as they use a declared rate. However, FIAs are linked to equity or hybrid indexes, which determine the magnitude of gains.

Cannex set about answering this question of relative performance by studying 14 products from six companies. We looked specifically at accumulation value, not income, though living benefits play a key role in product selection for many FIA buyers.

Our results showed:

- FIAs can increase potential yield but there's a risk of performing below the MYGA rate
- FIAs that limit participation but don't cap rates performed the best in our model
- Beliefs about future market performance can drive strategy selection
- Lower volatility indexes can improve FIA performance
- FIAs are still fixed annuities (really)

To provide a fair comparison, we used Cannex FIA Analysis, which allows us to run a large number of market simulations in order to test the performance of these products under realistic conditions over the span of a surrender period. This analysis generates histograms that represent the frequency of results within bands. We also compared this distribution to the same company's MYGA. The discussion here excludes the FIAs that use a monthly strategy.

Overall, the average performance of the FIAs we looked at didn't significantly differ from the MYGA rates for seven-year products from the same companies: 3.26% versus 3.08%. After all, despite the association with an index, FIAs are still fixed annuities. The link to equities provides a premium that may be more limited than expected.

Nevertheless, there are significant variations in performance by strategy. Not surprisingly, the drivers are also the two primary factors that limit the contribution of the index: the rate cap and the index participation rate. Strategies can use one or both. Under our modeling conditions, the best performance came from three annuities with no rate cap but a participation rate. In these cases, average returns ranged from 4.38% to 5.10%, notably better than the average for the group as a whole.

While the participation rate takes a chunk out of every year's gains, it also leverages outlier years with very high performance. The three best-performing strategies out of the 14 in this study had participation rates between 40% and 50%. Even these sometimes yielded less than the related MYGA, though they generally returned more.

Rate Cap Inflection Point

For FIAs with rate caps and full index participation, we see a shift in performance based on the size of the rate cap. Those with a cap of 5.85% and above fared better than those at 4.5% and below. This makes sense, as the caps at the lower end are not much higher than the comparative MYGA rates. Even with stellar performance in each year, the annuity cannot exceed the cap over the total period.

Market Conviction and Volatility

Though FIAs are not equity products, their relationship with equities means that a perspective on future equity performance can play a role in strategy selection. We assumed a Standard & Poor's 500 yearly average return of 8% and a volatility of 16%. While our study demonstrated that products with rate caps perform better, different assumptions about future market performance and volatility could justify a strategy that doesn't perform as well within our study.

To this point, we tested what would happen if the product was linked to a theoretical index that has both lower volatility and average returns. Many custom and dynamic indexes have similar goals, though our assumptions didn't reflect any particular design. We found that under a 6.0% rate cap, the lower volatility index shifted results markedly higher. This certainly suggests that proprietary indices may be useful and work especially well with specific strategies, as we see here. However, because of their proprietary nature, including factors that may not be disclosed or accessible, it is a challenge to compare them directly against each other.

Performance Transparency Benefits FIAs

In practice, MYGA and FIA buyers have different aims, with the former typically investing over a shorter period and looking for something to beat rates on bank certificates of deposit. FIA purchasers lean towards products with longer surrender charge periods and often elect living benefits. Thus, the direct comparison of the two does not necessarily reflect the buying process or decision making. Nevertheless, it is still reasonable to compare them because they both generally fall within the same class of product.

Regulators have long expressed concern about the potential misrepresentation of FIAs as equity products. Certainly, the industry is aware of the potential pitfalls and has taken steps to better clarify the value proposition of the FIA. However, the introduction of more proprietary indices may increase scrutiny from regulators if advisors find themselves advocating the volatility and return characteristics of one proprietary index versus another.

FIAs occupy a distinct place in the market but still risk being misunderstood, so elucidating performance in a histogram provides helpful transparency to better understand how they function under real market conditions. Furthermore, adding living benefits, a factor not included in the current study, further enhances the value of these products and expands their utility beyond pure accumulation.

ABOUT TAMIKO TOLAND

Tamiko Toland is Head of Annuity Research for Toronto-based CANNEX. Her focus is the U.S. annuity market, where CANNEX recently launched CANNEX VA Analysis℠ and CANNEX FIA Analysis℠, innovative annuity benchmarking tools. She is responsible for product development and strategy as well as thought leadership on the annuity space. She has more than 15 years of experience tracking trends and key issues on retirement income, synthesizing commentary and analysis for broad audiences and specific clients. She is known for her dynamic presentations with a unique perspective on the industry and the forces that are shaping it.