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De-Risking With Bonds Can Be Risky: Accumulation Index Annuities Could Be An Answer

By Roger Ibbotson

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Increased volatility in equity markets has many people — especially those entering or in retirement — reconsidering their options. Conventional wisdom has been to increase allocations to bonds as retirement nears. However, I'm concerned that if interest rates were to rise, traditional fixed-income returns might underperform in the coming years, and people may be setting themselves up for disappointment in retirement. Our latest research suggests there may be an alternative to traditional fixed income that can reduce a variety of risks and may provide for more income in retirement.

The hidden risk of rising interest rates

In retirement research and planning, there are two distinct phases: The "accumulation" phase is the period leading up to retirement where we are saving, building financial capital, and managing risk. The "retirement" phase is the period when we are drawing from our financial capital to generate income.

Rising interest rates are a double-edged sword. In the retirement phase, higher interest rates could be beneficial to retirees (assuming the rise keeps up with inflation). However, for those investors in the accumulation phase, a rise in interest rates may erode the future returns on their fixed-income investments and the value of their portfolios. That is the hidden risk that we are most focused on and concerned with today.

Given the current low-yield environment, bond total returns for the next several years will likely be primarily based on today's low yield. Although the lower risk (volatility) of bonds may be appropriate as we age, returns may disappoint or be insufficient to maintain necessary income in retirement.

Bond buyers beware: Past performance is no guarantee of future results.

Bonds have done very well over the past 10 years (2007-2016), almost matching large-cap stock returns (6.48% for bonds vs. 6.95% for stocks). Are bonds likely to outperform stocks over the next 10 years? Unlikely. To develop a simple forecast for bond returns, we can look in more detail at what has happened in the past. Specifically, we can decompose bond returns into capital change (gains or losses) and yield.

Over the past 10 years, almost half of the total return for bonds was attributable to capital gains. This is because rates have been falling (and prices rising). In contrast, over the long term, total returns for bonds are dominated by yield with almost no capital gain. Today, yields are near historical lows.

At the end of 2017, the U.S. 30-year government bond yield was 2.74%, the 10-year yield was 2.41%, and the 5-year yield was 2.21%. For bonds to continue to enjoy capital gains going forward, yields would have to decline significantly. On the other hand, if rates were to rise, capital gains in the future would be negative (capital losses). For these reasons, we expect a more "normal" spread or relationship between equity returns and bond returns in the future.

Accumulation index annuities may be an alternative (when properly understood and used).
Annuities have existed for thousands of years, dating back to ancient Rome. Social Security and pensions are forms of annuities. They serve an important purpose: Annuities are contracts purchased from an insurance company that mitigate longevity risk. We do not know how long we will live, and there is a risk we may outlive our assets. Annuities are a tool to help manage this risk.

Over time, the insurance industry has developed many different variants of annuities in an effort to tailor products to individual needs, including immediate annuities, deferred annuities, variable annuities, fixed annuities, and indexed annuities. Many annuities today serve two purposes: They are a savings vehicle in accumulation and also a potential source of guaranteed income in retirement. But, with financial innovation and tailoring comes complexity, confusion, and a lack of transparency. For these reasons, annuities have a mixed reputation. More education is needed because at their core, annuities serve an important purpose and can be a valuable tool in retirement planning.

Our latest research focuses on an uncapped fixed indexed annuity (FIA), which if structured properly, can help control financial market risk, mitigate longevity risk, and may outperform bonds over time. An FIA is a contract issued and guaranteed by an insurance company. It is a growth and accumulation vehicle leading up to retirement, with an option to convert to a payout annuity in retirement or take systematic withdrawals.

In the accumulation phase, growth potential is based upon the positive changes of, typically, an equity index (e.g., S&P 500® Price Return Index) and grows tax-deferred, subject to floors and participation rates. Regardless of index performance, indexed annuity contract values are not impacted by negative index returns over specified intervals.

A major advantage of an FIA is the ability of the insurance provider to "transform" equity returns into a more "tailored" return/risk profile (eliminating downside risk and providing an opportunity for interest earnings based upon exposure to equity returns). During accumulation, growth of a generic, uncapped FIA is based upon an index. For example, over a three-year period, the FIA might use the S&P 500® Price Index subject to a 0% floor and a participation rate of 60% of any positive index changes. In a period where the S&P 500® Price Index gained 10%, the FIA would credit interest at 6%. In a period where the S&P 500® Price Index declined -10%, the FIA would not lose money subject to the 0% floor. The principal is protected.

This downside protection is very powerful and attractive to many individuals planning for retirement. In exchange for giving up some growth potential (the participation rate), the insurance company bears the risk of the price index falling below 0%. The floor is one way for an investor to mitigate financial market risk and also gain exposure to potentially higher-equity performance than traditional fixed-income investments. In today's extremely low-interest-rate environment, the prospects of capital-gain appreciation for fixed-income investments is lower. As a result, the ability to gain exposure to equity-like returns through an insurance product may be an attractive alternative, particularly if we expect equities to outperform bonds.

Simulated FIA performance in accumulation
We simulated the net growth of an FIA with a large-cap equity index from 1927 to 2016 (90 years) based upon 30

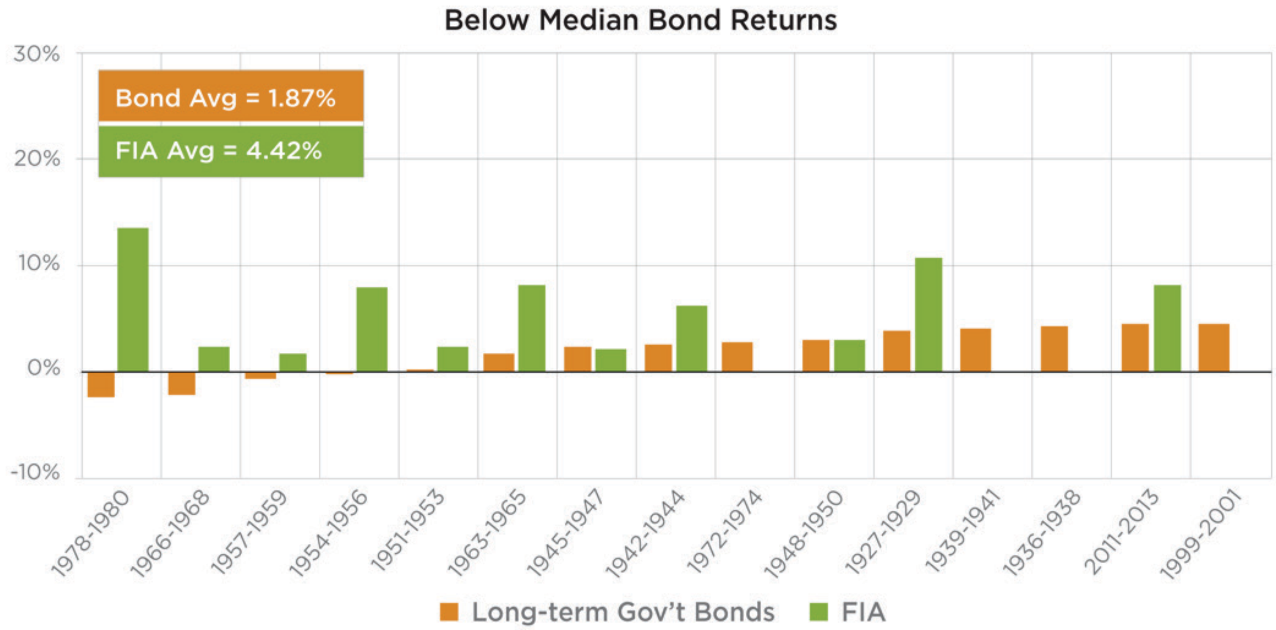
three-year holding periods, the price return of a large-cap equity index, a minimum three-year net return floor of not less than 0.00%, and uncapped dynamic participation rates.

The table below shows the annualized performance for the period 1927-2016, net of assumed fees for large-cap stocks, long-term government bonds, and the simulated FIA. The simulated FIA slightly outperformed bonds with better downside protection.

	Large Cap Stocks	Long Term Gov't Bonds	FIA
Annualized Return	9.92%	5.32%	5.81%
Minimum Annualized 3-Year Return	-27.00%	-2.32%	0.00%
Maximum Annualized 3-Year Return	30.76%	23.30%	27.56%

Source: 2017 SBBI Yearbook, Roger G. Ibbotson, Duff & Phelps; Zebra Capital; AnnGen Development, LLC

Since we are concerned with rising interest rates in accumulation, we isolated the 15 three-year periods when bonds performed below the median. The chart below shows the average three-year annualized performance for bonds during the worst 15 three-year periods was 1.87%. During those same periods, the FIA averaged an annualized return of 4.42%. In simulation, when bonds performed poorly, the FIA performed relatively well.



Source: 2017 SBBI Yearbook, Roger G. Ibbotson, Duff & Phelps; Zebra Capital; AnnGen Development, LLC

An alternative to consider

Annuities have for a long time deserved a place in retirement portfolios, and the evolution of the industry has made these vehicles more flexible and attractive. That said, annuities can be complicated products, and more education is needed. Working with a trusted advisor or provider, understanding the pros and cons, and doing your own due diligence is key.

In general, FIAs have many attractive features for accumulation with principal protection and as a potential source of income in retirement. To be clear, I am not saying FIAs are for everyone. FIAs should be viewed as long-term investments and in the context of thoughtful retirement planning and asset allocation. That said, it is our opinion, considering today's low-interest-rate environment and our modest expectations for bond returns in the coming future, FIAs are a valid alternative to consider.

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