Retirement: Pros and cons of fixed-index annuities

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Forget stocks, bonds, ETFs and non-traded real estate investment trusts. The new flavor of the month these days for those hawking retirement products is something called a fixed index annuity or FIA.

Consider: Sales of FIAs rose 14% to $38.7 billion in 2013 and another 24% to $48 billion in 2014, or about 21% of all annuity sales, according to a survey out last month by the Insured Retirement Institute, a Washington, D.C.-based lobbying group for annuities.

"Fixed index annuities are the current flavor and will remain so while consumers perceive the market indexes potentially rising," says William Byrnes, an associate dean at Texas A&M University School of Law in Fort Worth.

What gives? Here's what experts say about yet another acronym in the alphabet soup of retirement products.

What are FIAs? An FIA is a fixed annuity that, according to the Insured Retirement Institute's report, credits a minimum guaranteed rate of interest over a fixed number of years, plus additional interest that may be credited based on the percentage change in the value of a broad market index.

The interest, according to the IRI, is calculated using a formula that determines how much of that percentage change applies to the account value of the FIA. Insurers use participation rates, caps and spreads to limit the amount of interest that can be credited based on the change in value of the underlying stock market index, which is typically the Standard & Poor's 500-stock index.

So, for example, if an FIA has a participation rate of 50% of the change in the value of the S&P 500 index, and the index returns 10% in a policy year, 5% is credited to the account, according to the IRI.

By limiting the upside, the IRI says the insurance company is able to purchase index options with the portion of the premium that is not invested at interest to support the minimum guaranteed interest rate. What's more, FIAs now offer guaranteed lifetime withdrawal benefits which, the IRI says, makes them useful for saving for retirement as well as for income in retirement.

But even though FIAs provide buyers with upside potential, these products are not securities, says Stan Haithcock, an adviser in Ponte Verde Beach.Fla., and the author of *The Annuity Stanifesto.* FIAs are an insurance product. 'The unregulated sales pitch that is too often used is 'market upside with no downside.' Only half of that is true," he says. "There is no downside, because it is a fixed annuity."

According to Haithcock, FIA buyers are told they will participate in the upside. But that upside can be limited because of the participation rates, caps and the like. "There is a call option on an index, with very limited gains locked in on the contract anniversary date," he says.

Worse yet, the issuing carrier, in most cases, gets to change the rules of the FIA contract at their discretion on how gains are credited. "That's a key fact that is never disclosed," says Haithcock.

Haithcock also says that most FIAs today are sold with what's called an attached income rider, which is a separate calculation that can only be used for income. "You can't peel off the interest, transfer or get to the lump sum of the income rider total," he says. "This is where the 'agent games' are played. Too many people think that they own a 7% or 8% annuity. They don't. What they own is an income rider that can only be used for a lifetime income stream."

That's OK if the FIA buyer's goal is target-date income, says Haithcock. "But the sales lines are blurred with uninformed or uneducated annuity buyers to falsely believe they are getting real yield," he says.

The pros of FIAs. Of course, that doesn't mean there aren't some good points to FIAs. According to Haithcock, the pros are: full protection of principal; index gains are permanently locked in when the index option expires; can potentially provide better rates than COs; with attached income riders, FIAs are an efficient way to contractually plan for future income needs; and some income riders also offer confinement-care type benefits, which can be used as a supplement to traditional long-term care coverage.

The cons of FIAs. Still, there's plenty wrong with FIAs, too. Haithcock says buyers won't get stock market returns, because FIAs were never designed to do that; income rider growth percentages don't generate yields and act more like "Monopoly money" unless used for income; most FIAs have long- term surrender charge time periods; and upfront bonuses to buyers are pitched as free money, which they are not. "Buying an FIA for the upfront bonus is like buying a car for the stereo system," says Haithcock.

And if all that weren't bad enough, the compensation that insurance salesmen receive for selling FIAs might be excessive. "In my opinion, commissions are way too high on these products," says Haithcock. "Which is why advisers are moving from high-commission variable annuities to high-commission FIAs." An adviser might receive $6,000 to $9,000 plus another $1,000 to $2,000 in "soft" money when someone buys a $100,000 FIA with a 10-year surrender charge, says Haithcock.

The fees associated with FIAs can be high, too. "The more administration and management any product requires, the greater that product's built-in fees," says Byrnes. "Thus, because an FIA has more 'moving pieces' than a standard interest-based annuity, the internal fees of an FIA are more. If the market they are indexed to does not keep growing in value, then after fees, the minimum interest return may be nil, depending on the product's contractual terms of course."

Who should consider using them? All that considered, Haithcock says investors who want to protect their principal and who are OK with CD-type returns should consider FIAs. "FIAs are also an efficient delivery system for income rider guarantees for future income needs," he says.

For his part, Byrnes says investors should ask themselves a behavioral finance question before deciding to buy an FIA. "Is (your) risk averseness to losing a portion of the underlying capital of an investment, over time, worth more than the potential return of purchasing an index product without the capital protection wrapper of this brand of annuity product?"

The purpose FIAs serve in a retirement-income plan. FIAs with attached income riders are a flexible way to contractually plan for future income needs, says Haithcock. "By contrast, FIAs without income riders are a CD-type of product from a return standpoint, and allow you to annuitize that asset at the exact time you need income," he says.

"The bottom line is that FIAs are good products, but not too good to be true," says Haithcock.

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