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Fixed Indexed Annuities: Upside Gains With Downside Protection

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This article is the 3rd in a series on annuities. The Fixed Indexed Annuity (FIA) concept bridges the difference between fixed annuities (bank CD-like interest rates but no risk of principal loss) and variable annuities (your principal goes up and down with the stock market).

How it works: Your interest rate varies with a market index and the most commonly used index is the S&P 500 index (measures the stock market performance of 500 U.S. stocks). One typically gets part of the upside if the market index increases. One participates with limits based on a participation rate (such as 65% of the market index increase) or a cap (such as 100% of the upside but limited to 6.5% interest credited to your account in any given year).

Downside protection: If the market index goes down, your principal suffers no loss (and is credited no interest earnings that year). This contrasts to those in the stock market, who have suffered major losses of 50% or more twice in the last decade (the 2000-2002 Dot Com Bust and the 2007-2009 Wall Street Meltdown).

How the FIA concept compares to being in the stock market over the last 10 years: After adjusting for fees, an investor with an FIA typically has 50-100% more money in his account than if he had invested in the stock market. This is because any FIA annual gains are locked in annually, but no losses occur. This annual reset function is very different than investing in stock mutual funds or variable annuities, where any gains must overcome previous losses.

E.g. If your stock portfolio started at $100,000 and lost 50% in one year, you would have $50,000. If it earned 10% the next year, you would have $55,000. This ignores commissions, fees, taxes, and Wall Street fraud. In contrast, the FIA account would still have $100,000 at the end of year 1 and $106,500 at the end of year 2 (assuming that your FIA shares 100% of the upside with a 6.5% annual cap on gains).

Lifetime Income Rider: Certain FIA contracts allow you to increase your annual cash flow by 5-8% for every year you defer taking income. Certain FIA contracts allow you to get double the income by waiting 10 years.

E.g. If you deposited $100,000 in a FIA account today (at age 60) with a 7.2%/year income rider, you could get $12,000+ of annual income at age 70. If, instead, you deposited that $100,000 in a CD today that paid 3%/year and that rate did not change for 10 years, you would only receive $3,000/year of retirement income at age 70. Even more important, this $12,000 annual income would be guaranteed for the rest of your life. If your share of the market index gains exceeded 7.2% a year for the 10 years, your income would be based on the higher earnings.

What's the biggest difference between a FIA and old-fashioned fixed annuity? You get higher interest earnings and annual retirement income, but you do not have to give up control of the principal. In the history of fixed annuities, you had to "annuitize" to receive a lifetime stream of income. Once you died, the insurance company kept all your principal. With FIA and a lifetime income rider, you can now receive lifetime income without losing all control of the principal. This protects your spouse and kids, who typically are your heirs.

Wall Street Investments vs. a FIA: Certain personalities like unlimited risk and reward. They are willing to risk 20-60% loss of their life savings in exchange for the hope of high returns. In contrast, the FIA concept is for investors who want low risk, but want to earn higher than bank CD rates.

Warning: Many of the FIA contracts are hard to fully understand and you should get the advice of a professional who can explain the terms in plain English. You must be very clear on how your interest income is credited each year and whether you want the security of an increasing lifetime income rider.

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