Three Annuity Cures for Sequence Risk

By Kerry Pechter *Thu, May 16, 2019*

New York Life and Fidelity have introduced a variable annuity with principal-protection over 10 years. Similar protection could be obtained with an indexed annuity or with a combination of a fixed rate annuity and an S&P500 index fund.

The Dow Jones Industrial Average fell by about 600 points on Monday, as investors reacted to fresh tremors in the US-China trade relationship. Although the Dow regained 100 points on Tuesday, the jittery sell-off was a reminder that financial instability is never more than a presidential tweet away.

To provide near-retirement investors with a safe haven for at least part of their money, Fidelity Investments and New York Life have partnered to offer a deferred variable annuity with a guaranteed minimum accumulation rider (VA/GMAB) that guarantees no loss of principal over a 10-year holding period. The only underlying investment is the Fidelity VIP FundsManager 60, which targets a 50% to 70% equity allocation.

The New York Life Premier Variable Annuity—P Series, with Investment Preservation Rider, as the product is called, is billed as “simple and easy to understand, while also providing confidence during market volatility,” according to Fidelity’s press release. The product is designed for people who want principal protection during the years around the retirement date when “sequence of returns” risk—the risk of having to liquidate depressed assets for current income—is highest.

The product joins a variety of other annuity products on the market that are designed to insure near-retirees and retirees from the worst effects of a market storm (which everyone seems to expect after a 10-year bull market) while still allowing them to capture at least some upside if the predictions of doom prove false.

Insurance products in this category include fixed indexed annuities (FIAs), deferred fixed annuities, index-linked “buffer” annuities, as well as variable annuities with lifetime withdrawal riders. They’re designed for investors who want more protection than they can get simply by reducing their equity allocation to 50%.

Indexed annuities

For instance, a fixed indexed annuity could also be used to solve the problem that the New York Life VA/GMAB is built to solve. A few weeks ago, *RIJ* **published** a side-by-side comparison of New York Life's new deferred variable annuity with minimum accumulation benefit rider with a 10-year fixed indexed annuity. The analysis was conducted by Cannex, the annuity data shop, and sponsored by New York Life.

An exact comparison between the two types of products–one of which invests directly in equities and bonds and one that only holds bonds and equity options–was difficult. But Cannex concluded that the FIA would have to have an extraordinary performance cap of 8.25% to compete on average with the VA/GMAB, for which Cannex assumed an average return of 4.99%, net of fees. FIAs with a participation rate of 42.3% over 10 years start to outperform the VA/GMAB. The FIA returns were more clustered, the VA returns were potentially much higher. Both offered limited liquidity.

In the Cannex study, the VA had higher potential returns, while the FIA had more predictable returns, and was more likely to produce a positive return than the VA, Cannex determined. The two products were difficult to compare cleanly. FIAs lock in gains each year, while the New York Life VA/GMAB locks in gains at the end of 10 years (unless the client chooses to lock in gains on an anniversary).

Equities plus a MYGA

There's a third way to solve a client's sequence risk problem, by relying on two cheap, transparent products instead of one complex all-in-one product. This third strategy would involve much lower costs, would allow upside unimpeded by caps or participation rates or high marketing fees or dilution with bonds, and wouldn't rely on luck (the coincidence of a high water account value with a contract anniversary).

This strategy calls for the purchase of a fixed multi-year guaranteed rate annuity with enough of the $100,000 investment to ensure that it would grow to about $100,000 in 10 years, with the remainder invested in the S&P500 index fund. A 10-year MYGA from an insurer with an A rating or better ranges from 2.6% (for a New York Life product) to about 3.3% at current rates. To produce a sure $100,000 after 10 years, the client would have to invest between $77,400 and $72,400.

The client would invest the remaining $22,600 or $27,600 in the equity index. Using an ultra-cheap S&P500 with an assumed growth rate was 11% (the average return of

Vanguard's S&P500 since August 1976), those amounts would hypothetically grow to $64,170 or $78,370 over 10 years. Combined, the two products would be worth more than $164,000 or more than $178,000.

Even with a recurrence of the worst 10-year performance in the modern history of the S&P500 (-3%, for the decade ending in February 2009), the client would still have at least $120,000 at the end of 10 years.

The client can personalize his risk level with precision. One client might apply $80,000 to the 2.6% MYGA and only $20,000 to the S&P500, with an average result of about $103,400 for the MYGA and $56,790 and a worst case of $122,800. Another client might put $60,000 in the MYGA and $40,000 in the S&P500 fund 113575, with an average expected return of about $167,000 and a worst case of about $116,000.

While the New York Life/Fidelity product's account value could in theory reach $200,000 or more, it also has a 14% chance of having a final balance of just $100,000. Its main drawback is fee drag. There's a 1.20% mortality and expense (M&E) risk charge (1% per year after the seven-year surrender charge period), a 0.70% fee for the principal preservation rider, and a 0.74% annual investment fee.

In the two product strategy, the client would not have to sell his S&P500 fund if its value were depressed at the end of ten years. He could hold it in expectation of a big rebound. In addition, the amount invested in the S&P500 Index would be fully liquid during the 10-year holding period, with harvestable gains. Withdrawals from the more complex all-in-one products may entail surrender fees, market-value adjustments or reductions in the guarantee.

In the real world, however, few clients would see all three solutions. Most advisors develop a comfort zone or follow a business model that favors one risk management strategy over another. But advisors who consider themselves fiduciaries, and who want to give clients a chance to decide among multiple options, should arguably have several annuity arrows in their quiver.