RETIREONE® WHITE PAPER

The Benefits of Balancing Growth and Protection in a Diversified Portfolio

by Michelle Richter, MBA

As interest rates remain historically low, investors and their advisors are seeking fixed income alternatives. Here's how a next-gen fee-based advisory FIA may fit the bill. Introducing IndexMax ADV℠: a first-in-kind commission-free fixed index annuity (FIA) offering layered crediting strategies designed for maximizing accumulation by adding: (1) A no-loss floor to (2) Annual Performance Credits during years of index growth, along with (3) one-time Term Participation Credits that stack atop cumulative annual accumulations.

Introduction

Efficient diversification is a linchpin of modern investing and is one of the central tenets of the most commonly-used asset allocation framework in the US: **Modern portfolio theory (MPT)**. MPT, the mathematical investment framework for which Harry Markowitz won the 1952 Nobel Prize, proves that a portfolio's investment returns over the long term can be maximized by selecting high quality securities that are diversified across asset classes which perform differently from one another in a variety of market environments.

Efficient implementation of MPT is baked into financial planning and other advisory software, such that it, behind the scenes, forms a critical element of how savvy advisors can make use of their tech stack to provide clients with valuable portfolio construction advice.

"...it [MPT] gives us little indication for what securities to select when our 60 year-old client is about to retire into the lowest rate environment in modern history."

While MPT provides us with a well-supported intellectual baseline from which to start constructing a long-term diversified investment strategy, it gives us little indication for what securities to select when our 60 year-old client is about to retire into the lowest rate environment in modern history, with little reason to expect a rise in rates any time soon. At its September 2020 meeting, the Federal Reserve's Open Market Committee indicated its intention to keep the short-term benchmark rate at current rock-bottom levels until inflation reaches 2% for the long term. The Fed doesn't expect this to happen until 2023 or later.[1] It is therefore reasonable to assume low interest rates are likely to persist for at least several more years.

In today's low-for-long rate environment, finding high-quality, medium- to long-duration, attractive fixed income assets has proven challenging for institutional and retail investors alike. Opportunities for RIAs to diversify a pre-retirement portfolio, while minimizing interest rate and inflation risk, are becoming increasingly challenging to find.

This environment is leading to a wave of product development changes in annuities and other structured products. Insurance companies are developing advisory solutions to help RIAs close this gap around fixed investing opportunities. These deferred annuities and structured products have traditionally included up front sales charges, which has historically limited their use by fee-only RIAs.

Prior to the growing popularity of the fee-for-ongoing-advice model used by RIAs, these charges were built into the products, often sold as a singular transaction rather than as part of comprehensive ongoing portfolio construction and rebalancing, to compensate financial professionals for the time it takes to learn and then explain their features and benefits to consumers. The recent creation of advisory class annuity products makes these products available to advisors and their clients, and in so doing creates a unique diversification opportunity, as does adding any additional minimally-correlated asset class to the MPT efficient frontier.

MPT guides us to diversify across asset classes. The Fed says expect rates to stay low for long. So…How do I keep my client's assets shielded from downward volatility, and invested in fixed income for a 5-7 year bucket, while maximizing their growth potential in a low-rate environment in their pre-retirement years?

An Alternative to Fixed Income

Academics including Wade Pfau[2] have long touted the role that indexed annuities can play as a suitable replacement for traditional fixed income with a low correlation to the stock market within an accumulation portfolio. Traditional indexed annuities offer downside protection with a 0% floor on returns, while allowing some market upside participation that is capped based on the terms of the contract. In today's low-rate environment, indexed annuities, when substituted for traditional fixed income into an MPT-backed asset allocation, can help protect from losses if rates do rise, and also offer tax deferral during the accumulation period. But traditional indexed annuity capped crediting methods limit upside exposure in the event of a strong bull market, which can result in delayed retirements, or lower-than-desired income once retirement income is needed.

Introducing IndexMax ADV℠ from Midland National® Life Insurance Company. It offers both a 5- and 7-year term.[3] With a layered crediting strategy, IndexMax ADV offers both Term Participation Credits and Annual Performance Credits that are designed in combination to maximize accumulation opportunities. Unlike traditional indexed annuities, IndexMax ADV is offered through RIAs, which means it does not pay a commission to a salesperson delivering it.

Figure 1: Historical 10-Year Treasury Yield (source: Yahoo! Finance)

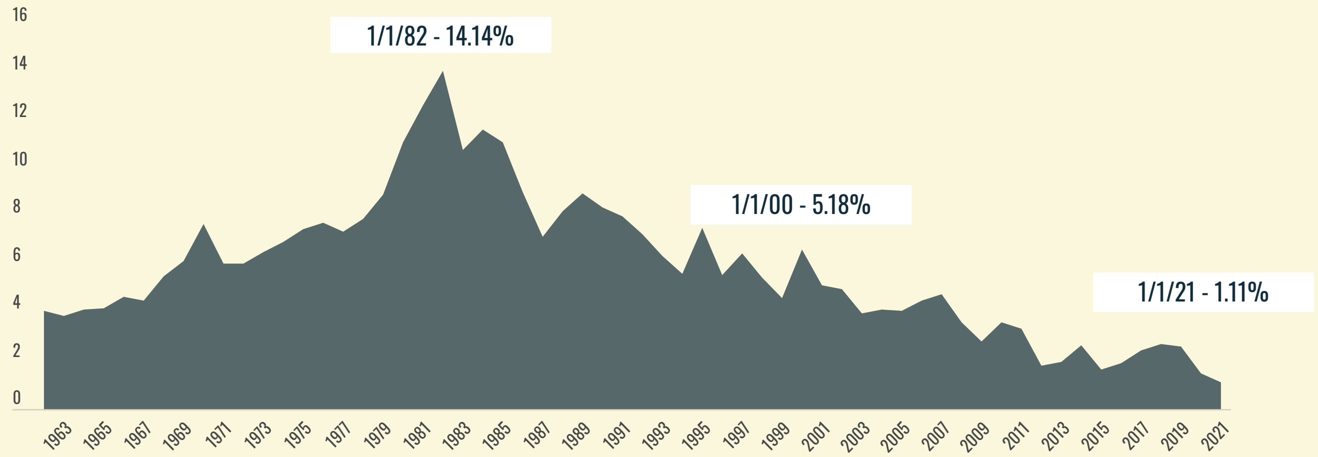
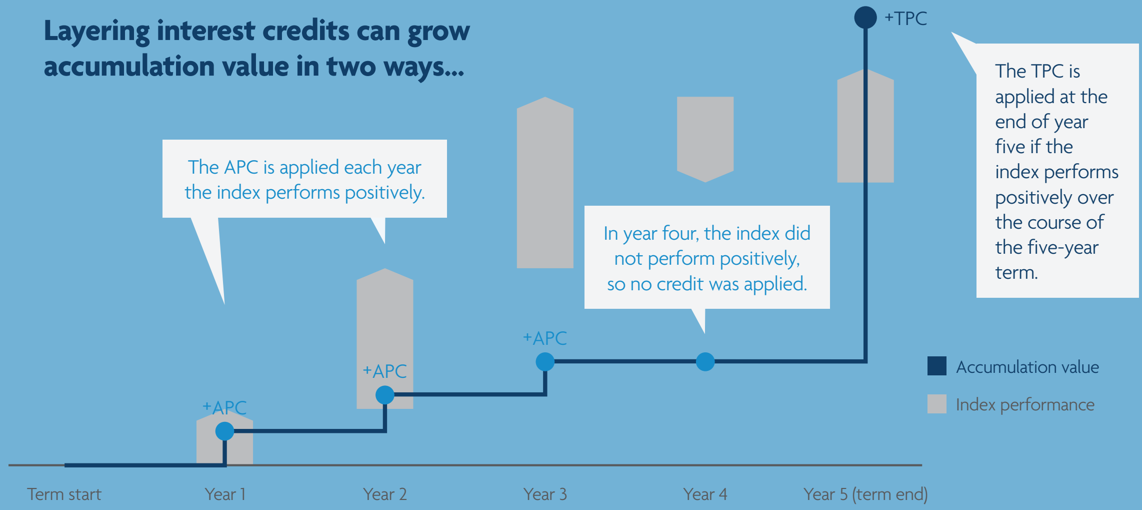


Figure 2: How the Layered Crediting Strategy[4] Works



Hypothetical examples are for illustrative and educational purposes only and not intended to predict future performance. The use of alternate assumptions could produce significantly different results.

IndexMax ADV, in fact, was specifically designed for RIAs allowing an attractive combination of benefits: 1) advisory fees can be taken while not impacting the upside potential of the product and 2) layered interest credits. These layered interest credits allow the investor the opportunity to capture additional participation credits that accrue above each annual performance credit at the end of the term if the index change is positive.

How Does it Work?

The layered crediting strategy allows the investor to potentially grow accumulation value in two ways: via an Annual Performance Credit (APC) and a Term Participation Credit. IndexMax ADV's Annual Performance Credit (APC) is credited annually when the underlying index change is positive and a TPC is not available.

The Term Participation Credit (TPC) is credited at the end of the 5- or 7-year term, when an underlying index change is positive over the course of that term. The index change is calculated by looking at the change between the average monthly index value for the final year of the term compared to the initial index value of the term. The Credit received is equal to 100% of that change. See figure 2 above.

While all indexed annuities offer protection against loss, as well as participation in the upside associated with one or more market indices, many of the traditional crediting methods cap upside participation on a periodic basis, often annually. In the event of a bull market environment, purchasers of these products will experience account value accumulation subject to these annual caps, which cumulatively, over years, may prevent them from enjoying contract value accumulation that keeps pace with the returns of the underlying index. By offering a layered crediting strategy that includes a Term Participation Credit (TPC) in addition to the APC, IndexMax ADV is uniquely positioned among FIAs to provide both downside protection as well as full upside index participation.

For Example

Using the Advisory Annuity Impact Calculator developed by InStream, the following examples were produced to demonstrate outcome ranges in both a recessionary environment and a bull market. The scenarios were run for a pre-retirement investor deciding among a traditional 60% equity/40% fixed portfolio, a representative traditional FIA filling the fixed income sleeve (40%) of a 60/40 allocation with 60% of the portfolio invested in traditional equities, and the same approach substituting IndexMax ADV for the fixed income sleeve (40%) of a 60/40 allocation.

The Advisory Annuity Impact Calculator illustrates how the unprotected portfolio is both volatile and experiences limited upside, in part due to the projection of continued low fixed income rates. The portfolio including IndexMax ADV, along with our substitution out of traditional fixed income for the corresponding portion of the portfolio, when evaluated in the same market environments as the other compared portfolios, offers less volatility because of the downside protections. The results also include generally higher accumulation values in both favorable and unfavorable market environments for the IndexMax ADV portfolio. This is due to the the combination of TPC + APC on the protected portion of the portfolio.

Table 1: Bull Market Simulation (portfolio including traditional FIA is with index cap crediting method).

	Bull Market- Account Values at End of Year 5				
	Unprotected Portfolio (60/40)	Portfolio Including Traditional FIA	Portfolio Including IndexMax ADV SM	IndexMax ADV % Increase over Unprotected Portfolio	IndexMax ADV % Increase over Portfolio Including Traditional FIA
90%	$ 1,105,466	$ 1,205,798	$ 1,305,250	18%	8%
Annual Growth Rate in 90th%ile	*17%*	*19%*	*21%*		
Median	$ 847,011	$ 851,747	$ 916,643	8%	8%
Annual Growth Rate at Median	*11%*	*11%*	*13%*		
10%	$ 639,195	$ 575,922	$ 618,656	-3%	7%
Annual Growth Rate in 10th%ile	*5%*	*3%*	*4%*		

Table 2: Recession Simulation (portfolio including traditional FIA is with index cap crediting method)

	Recession- Account Values at End of Year 5				
	Unprotected Portfolio (60/40)	Portfolio Including Traditional FIA	Portfolio Including IndexMax ADV SM	IndexMax ADV % Increase over Unprotected Portfolio	IndexMax ADV % Increase over Portfolio Including Traditional FIA
90%	$ 882,243	$ 912,318	$ 960,121	9%	5%
Annual Growth Rate in 90th%ile	12%	13%	14%		
Median	$ 674,534	$ 676,652	$ 721,713	7%	7%
Annual Growth Rate at Median	6%	6%	8%		
10%	$ 506,101	$ 502,250	$ 540,820	7%	8%
Annual Growth Rate in 10th%ile	0%	0%	2%		

Conclusion

Stock valuations have soared to historic levels over the course of this unprecedented ten-year bull market run. The market's current CAPE ratio of 34 has been exceeded only once in history when valuations peaked at 44[5] at the height of the dotcom bubble in 1999. These extraordinary market valuations coupled with historically-low bond yields have painted the task of traditional portfolio construction into a corner.

RIAs and fee-based advisors working to protect their clients from the risk of recession have few places to turn for de-risking portfolios. Their clients in the "fragile decade"—those in their last five working years through their first five years of retirement—are especially vulnerable to sequence of returns risk as they begin to draw down their retirement savings.

By providing a bulwark against losses in down markets with greater upside potential than fixed income currently offers, FIAs of all stripes can deliver material protection against this risk of recession in any client portfolio. IndexMax ADV's layered crediting strategy provides both the protection that FIAs offer with the opportunity for additional upside capture of the Annual Participation Credits and Term Participation Credits. For savvy RIAs who seek to offer innovative solutions for their clients, IndexMax ADV can form a compelling part of a holistic and truly modern portfolio strategy.

Michelle Richter, MBA is Founder of Fiduciary Insurance Services, LLC. She has twenty years of experience inventing, deploying, advocating for, and scaling innovative products (trademarkable IP) and programs (servicemarkable IP) that create a scalable intersection between the historically disparate worlds of Insurance and Financial Services.

Michelle earned a bachelor's degree in Economics from Wesleyan University, and an MBA in both Management and Finance from Columbia University's Graduate School of Business. Michelle is both an investment adviser and an insurance advisor, and she is neither an agent nor a currently registered representative.

1 Federal Open Market Committee. (2020, December 16). Summary of Economic Projections. Retrieved February 04, 2021, from https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20201216.htm

2 Pfau, W., PhD. (2018, June 1). Managing Risks with Fixed-Indexed Annuities. Retrieved February 2, 2021, from https://greatamericanria.com/docs/librariesprovider2/agent-document-library/ria/managing-risk-with-fixed-indexed-annuities-in-the-pre-retirement-years.pdf

3 A surrender during the surrender charge period could result in a loss of premium. Surrender charge structure may vary by state.

4 Known as Term Participation with Annual Performance Credits in the contract.

5 Millinski, J. (2021, February 2). Is the Stock Market Cheap? Retrieved February 4, 2021, from https://www.advisorperspectives.com/dshort/updates/2021/02/02/is-the-stock-market-cheap

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The IndexMax ADV℠ is issued on base contract form AS203A/ICC20-AS203A, or appropriate state variation including all applicable endorsements and riders. This product, its features and riders may not be available in all states.

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