Perspectives

# The **IVA Revolution**

## How variable and index-linked annuities may help support a balanced portfolio

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Please note that these documents were accurate at the time of release and reflect the responses and interpretation of findings for that period in time.

# Building a more balanced portfolio

Market theories have long told us that investors must take on more risk to achieve a potentially higher return. Taking more risk is often the preferred strategy for accumulation-focused investors with a longer time horizon before they start retirement. The longer time horizon helps them to better absorb and rebuild from periodic losses due to market downturns.

The risk/return decision becomes more difficult the closer the investor is to retirement. Any losses could more negatively affect their retirement portfolio because they have less time to rebuild their investment portfolio from market losses. These investors face a key challenge – how to balance riskier equity investments designed to accumulate enough assets for retirement with the need to protect their portfolios against catastrophic losses.

In weighing this balance, each investor must consider risk and protection on a scale. On the risk side sit equity investments with unlimited growth potential and no protection against loss. On the protection side sit fixed income investments such as high-quality, shorter-term bonds, bond mutual funds, CDs, fixed annuities, or even the cash-under-the-mattress strategy. These options provide a greater level of certainty, but at the cost of lower growth potential, the risk of not keeping up with inflation, and other factors such as fees and charges for guarantees.

Despite a rebounding stock market, market gains have not dampened Americans' desire for protection. According to the 2013 Allianz *Investor Market Perceptions* survey conducted by Ipsos from July 24 – 29, 84% of consumers ages 25+ with $200,000 or more in investable assets said they want protection when planning for retirement, agreeing that one "should always have some kind of protection from loss, even if it reduces your potential gain."

Furthermore, 95% of the respondents said they would like a financial product with no potential for loss, or some level of protection from loss. They would also like that product to have the potential for modest growth or a balance of potential growth, rather than one with unlimited potential growth but also unlimited potential loss.

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One well-established strategy for balancing risk and reward is through an equity-bond portfolio, often shifting assets into bond funds as the investor approaches retirement. However, bond funds may not provide true protection because they carry risk of loss. For example, defaults or rising interest rates can cause bond funds to experience negative returns, thus not providing the protection one might have expected.

A relatively new way to target additional risk with some level of protection is through a variable and index-linked annuity (IVA). By adding this approach as part of an overall portfolio, investors can participate in the upside potential of equity market growth, but have a level of protection against a portion of loss that helps create a balance of risk and return. This protection is provided through a portion allocated to an index allocation option.

Assumptions: All hypothetical historical examples shown throughout this document do not represent any specific IVA investment. They illustrate one example utilizing one constant declared cap and buffer rate with one index allocation option. There are other factors to consider with each of the index allocation options. These hypothetical examples show conceptually how the cap and buffer might work in different market index environments and assume no change in the declared cap. They do not predict or project the actual performance of an IVA. Although an external market index or indexes may affect your values, the index allocation options do not directly participate in any stock or equity investments. An allocation to the index allocation options is not a purchase of shares of any stock or index fund and is not a direct investment in an index. These examples also do not reflect annual product fees and charges or withdrawals, nor do they consider taxes. If they had been reflected, results would have been lower. 1

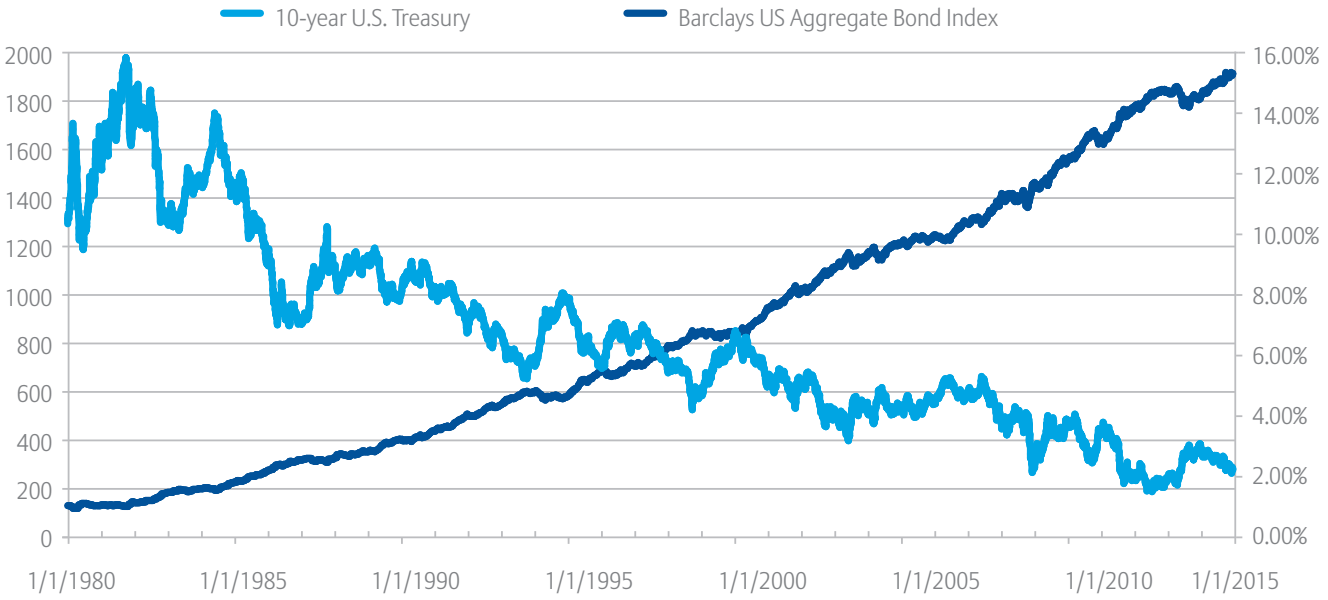
## Impact of interest rates on bond funds

Historically, the equity/bond strategy of balancing growth potential and protection has worked well for many investors, largely due to bond fund performance during the decreasing interest rate environment over the past 30 years. Since decreasing interest rates generally result in higher bond prices, the recent past has been a good period for many bond funds. The 10-year U.S. Treasury yield, a key indicator of the general level of interest rates in the U.S., reached an all-time high of 15.84% on September 30, 1981. Since then, rates have fallen steadily, with the 10-year U.S. Treasury hitting an all-time low of 1.43% on July 25, 2012 – a decrease of over 14 percentage points in slightly more than 30 years. The dramatic decrease in interest rates is largely why bond funds have been very effective at helping to manage risk in a balanced portfolio.

However, interest rates have little room to go down further, so bond funds will likely not be as effective in protecting a balanced portfolio of the future. In just the short period from May to August 2013, rising interest rates hit bond funds; the Barclays US Aggregate Bond Index declined 3.67% from May 1, 2013 to August 31, 2013.

> If interest rates continue to climb, an IVA may help investors achieve a more balanced approach.

Plus, investors may be unaware that bond funds can lose money. In a 2012 U.S. Financial Capability study by the FINRA Investor Education Foundation, 72% of adult Americans did not answer correctly or did not know the impact interest rates have on bond prices. If interest rates continue to climb, an IVA may help investors achieve a more balanced approach of growth potential with a level of protection against down markets.



## Absorbing market volatility

Despite a 1,000+ point gain in the S&P 500® Index between March 2009 and August 2013,[1] some investors seem hesitant to put money at market risk with nearly $8 trillion sitting in cash.[2] As the 2013 Allianz *Investor Market Perceptions* study shows, wealthy Americans are reluctant to risk their money in today's volatile markets, with approximately 80% of respondents saying they believe the market will continue to be volatile as they prepare for retirement, and nearly six in 10 (59%) noting market volatility as one of the top three economic concerns having an effect on their retirement outlook.

Part of this hesitation to invest comes from a lack of available financial products that help meet their needs for asset accumulation and protection. Nearly a quarter (23%) of respondents said a lack of retirement products offering a balance of growth opportunity and loss protection was preventing them from investing idle cash today.

The insurance industry has been listening to these concerns, and some insurers have responded with the variable and index-linked annuity (IVA) – a relatively new breed of variable annuity that may be a fit for consumers who are willing to trade some potential gains from market growth in exchange for a level of protection from down markets.

IVAs offer a variety of allocation and protection choices. Companies in the industry currently offer a level of protection from the first 10% to 30% of losses. Some IVAs also offer full principal protection, similar to fixed index annuities (FIAs). A popular index allocation option in the IVA increases the amount of annual index return potential by declaring much higher limits (or caps) on the return (or credit) coming from the growth of an equity index allocation option, for partial protection against the first 10%-30% of losses. This is referred to as a buffer (described further in "How buffers work" on page 5). While there is a level of protection from some downside risk, if the negative index return exceeds the buffer, there is risk of loss of principal. This is a fundamental shift for accumulation choices among variable annuities.

The variety of allocation choices available on IVAs in the industry includes index allocation options (or crediting methods) and traditional variable investment options. Keep in mind that any investment in variable investment options does not provide any protection against loss of principal, and money that is allocated to the variable investment option could be lost. The index allocation options available in IVAs do not directly participate in any stock, bond, or other investments. Clients are not buying any bonds, or shares of a stock index. The cap offered for new contracts which determines the return potential can generally vary as frequently as monthly and can experience significant highs and lows. Caps can also vary between contracts issued on different days and in different years. Industry cap rates of IVA products have ranged from 3.50% to 16.00% annually, with contractual minimums as low as 1.50% annually. Some product designs offer additional full market protection for the death benefit in exchange for an additional fee or a lower return potential. In addition, contracts are available with a variety of fee structures. Some products have an explicit annual fee and others apply a withdrawal charge if surrendered within the first five or six years of investment.

All of these options on IVAs allow clients to customize their contract allocations based on their individual accumulation objectives and risk tolerance, helping people to build a portion of their retirement income or savings. Because IVAs are meant to assist with asset accumulation and provide a level of protection, they also offer a possible solution for those seeking more return potential than they may get from bond funds.

[1] S&P 500® Index, historical data.

[2] JPMorgan, 2nd Quarter Market Insights, as of March 31, 2013.

A variable annuity is a contract between and individual and an insurance company that is designed to help them reach their long-term financial goals.

Variable annuities offer a unique combination of features, including market participation through a variety of investment options; tax-deferred growth opportunities; and optional protection benefits that can provide certain accumulation, income, and beneficiary guarantees for an additional cost.

As with any investment vehicle, variable annuities are subject to risk, including possible loss of principal. Investment returns and principal will fluctuate with market conditions so that contract values, upon distribution, may be worth more or less than the original cost.

Withdrawals will reduce the contract value and the value of any protection benefits. Additional withdrawals taken within the contract withdrawal charge schedule will be subject to a withdrawal charge. All withdrawals are subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal additional tax.

## Return potential of IVAs

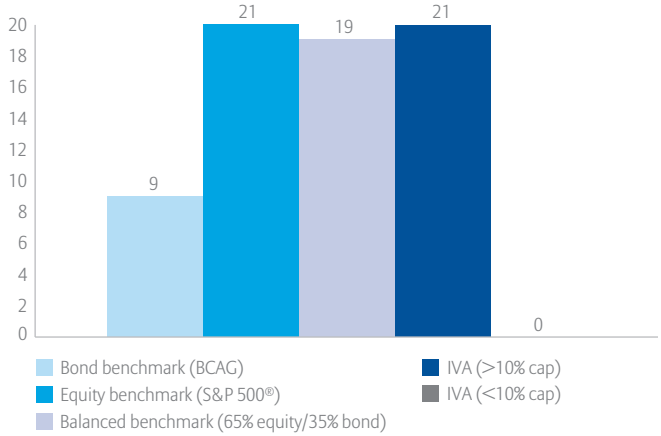
Based on the 2013 Allianz *Investor Market Perceptions* study, respondents identified a return of 10% as an acceptable rate of growth. Accordingly, for purposes of this discussion, let us define "growth potential" as the potential for returns of 10% or greater. Consider three benchmarks and two IVA investments with index allocation options:

1) Bond benchmark: 100% in the Barclays US Aggregate Bond Index (formerly the Lehman Aggregate Bond Index)
2) Equity benchmark: 100% in the S&P 500® Index
3) Balanced benchmark: A 65% S&P 500® Index/35% Barclays US Aggregate Bond Index allocation strategy
4) An IVA crediting on the index return of the S&P 500® Index with an annual cap greater than 10% and a 10% loss buffer
5) An IVA crediting on the index return of the S&P 500® Index with an annual cap less than 10% and a 10% loss buffer

Looking at the calendar-year returns over the last 38 years (the longest common period among the indexes), we see that the bond benchmark showed nine years (24%) that had an annual return of at least 10%. The equity benchmark had 21 years (55%) with an annual return of 10% or greater, demonstrating the higher growth potential of equities over bonds. As expected, the 65/35 balanced benchmark lies between the bond and equity benchmarks, with 19 years (50%) that had returns of 10% or greater. The notable aspect of this analysis is the performance of the IVA with a cap greater than 10% – it would have provided the same growth potential as the equity benchmark with 21 years (55%) with returns of 10% or greater.

### Number of years with 10% or greater return

Annual returns for calendar years 1977 – 2014 (38 years)




Sources: Bloomberg, Yahoo! Finance

An IVA with a cap of less than 10% would make a 10% credited return unattainable, so an IVA with a cap less than 10% would have provided 0 years with credited returns of 10% or greater.

Given a high enough cap, IVAs can have significant growth potential from exposure to equity indexes. Caps on in-force contracts are subject to change annually and may fluctuate significantly. While the IVA cap does mean that the investor gives up some of the upside of the index, the investor in this example would still have received the acceptable rate of return of 10% with a high frequency, with the IVA providing similar upside to both the 65%/35% balanced benchmark mix and the equity benchmark itself.

### Crediting methods of IVAs

For positive index returns, IVAs provide credits with the return of the selected index over the investment period up to a specified cap. The difference in market protection between IVA and FIA crediting is that IVA investors are exposed to downside risk through negative returns in order to have higher growth potential. One method of protection that can be used to realize this trade-off is a loss buffer, where the insurer absorbs a stated level of negative performance before the investor experiences losses.

## IVA's level of protection

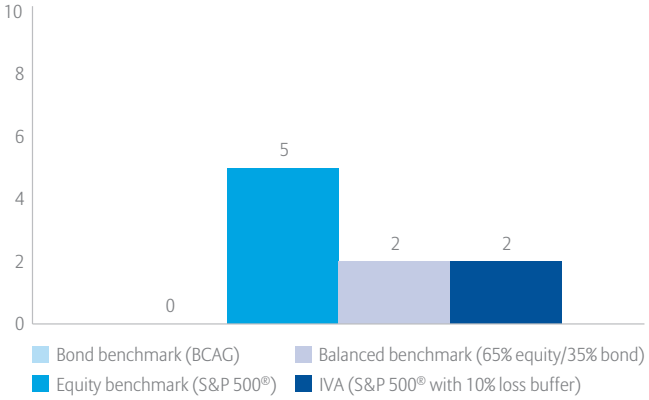
In exchange for giving up some of the upside, IVA investors with the index allocation option receive a level of downside protection through the buffer. In our hypothetical example structure, the 10% loss buffer means that the insurance company issuing the IVA will absorb the first 10% of losses on the index each year. Insurance companies currently offer buffers ranging from 10%-30%, and higher or lower levels may be offered in the future.

Survey respondents also identified 10% on the downside as a reasonable level of risk for the insurer to absorb. So, for purposes of this discussion, let us define "downside risk" as the potential to lose more than 10% in a year. Or, conversely we can define "protection" as the lack of losses of more than 10%. Expanding on the previous assumptions and analysis,

the bond benchmark showed the strongest protection with 0 years (0%) with a loss of more than 10%. The equity benchmark had the most risk with five years (13%) with a loss of more than 10%. The 65%/35% balanced benchmark and IVA with 10% loss buffer fell in between the bond and equity benchmarks and showed matching levels of protection against downside risk, with two years (5%) that had losses of more than 10% each. Note that using a buffer larger than 10%, such as 20% or 30%, would further reduce the frequency of losses of more than 10%. Smaller buffers would yield results that converge to those of the equity benchmark itself, which would be similar to using an IVA with a 0% buffer.

### Number of years with loss of more than 10% negative returns

Annual returns for calendar years 1977 – 2014 (38 years)




Sources: Bloomberg, Yahoo! Finance

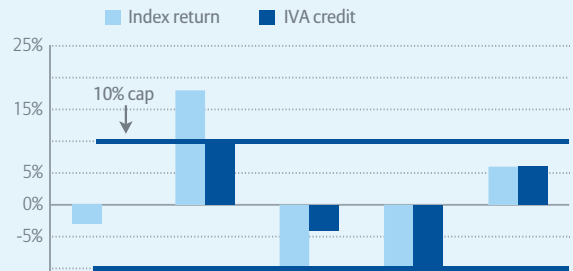
Historically, an IVA with a 10% loss buffer would have performed very well compared to other benchmark options. The IVA provided a similar level of protection as a balanced portfolio using bonds as a source of fixed income. However, the IVA helps avoid potential market value losses of bond funds when interest rates rise.

As the hypothetical examples have shown, IVAs can be effective in creating a new way to help balance risk and return. The potential for index returns over 10% with the level of protection of an IVA is very similar to taking the significant risk of an all-equity investment. Additionally, the level of protection provided by an IVA to buffer losses of greater than 10% is very similar to a balanced allocation of 65% equities and 35% bonds. Perhaps most significantly, IVAs would have provided similar historical levels of returns and protection of a balanced benchmark without the risk of market value losses due to rising interest rates. Of course, these are historical returns, and past performance is not necessarily indicative of future performance.

## How buffers work

The buffer method provides a first level of protection against losses rather than an ultimate floor on losses. Losses up to a stated percentage are covered, and the investor participates in losses that exceed the buffer. This means that the investor is still exposed to extreme losses for negative performance in excess of the buffer, but partially protected on any loss. Annual product fees and charges may be assessed which will reduce values.

The hypothetical example shows conceptually how cap and buffer rates work in an IVA product in different market index environments, utilizing a 10% cap and 10% buffer rate. The example assumes that the declared rates do not change after the contract is issued and do not include deduction of any annual product fees and charges that may apply, or taxes that may be incurred. The example does not predict or project the actual performance of an IVA. For index returns of 10% or greater, the investor would receive a 10% credit. For positive returns of less than 10%, the investor would receive a credit equal to the performance of the index. For negative returns up to -10%, the investor is protected by the buffer and would be credited with 0%. For negative returns in excess of -10%, the investor would receive negative credit on the portion of the return in excess of the -10% buffer. For example, an index return of -12% would result in a -2% credit.




| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| | -3% | 18% | -14% | -20% | 6% |
| | 0% | 10% | -4% | -10% | 6% |

# Conclusion

Balancing risk and return will continue to be a focus for many investors, particularly those who are closer to retirement. But traditional ways of achieving that balance are proving less effective in the current economic climate. With people living longer, a greater need exists for sizeable retirement assets to help ensure their money lasts as long as they do. This is unlikely to happen by keeping money under the mattress, on the sidelines in cash accounts, or even in conservative investments producing minimal returns. The IVA can help address the demand for protected growth potential – offering greater growth potential while providing a level of protection against both market volatility and loss of principal due to rising interest rates.