



## FIA EDUCATION SERIES

### PRODUCT COMPARISON

NAFA has created this series to promote education on how FIAs work and important factors to consider when buying one.

# INDEX-LINKED ANNUITIES

## LETTER FROM THE CEO

As the CEO of NAFA, the National Association for Fixed Annuities, I am pleased to introduce the latest in the Fixed Indexed Annuity Education Series. The Series is designed to help consumers better understand the inner workings of fixed indexed annuity (FIA) products and to develop an awareness of how they might fit into financial and retirement plans. NAFA's goal for this educational series is to help demonstrate how FIAs can provide enhanced returns for consumers while limiting downside, or losses, with their guaranteed minimum interest rates, a concept which becomes extremely important when planning for retirement.

As previous pieces in this Series have illustrated, fixed indexed annuities are insurance products that provide downside protection from loss of principal, with a guarantee that the interest earned on the annuity contract can never go below zero. In an FIA, the return or rate is determined based on an interest crediting formula or method established by the issuing insurance company that is linked to the performance of a market index, such as the S&P 500. It is also important to understand the risks and rewards of various products when planning for your financial future.

In this piece we illustrate how a Fixed Index Annuity differs from a product known as a Registered Index Linked Annuity (RILA). A RILA is a product registered as a security that provides a rate of return also based on an index crediting formula. However, RILAs provide more exposure to the actual index as a potential reward, while buffers and/or floors are in place to mitigate potential loss of principal. The associated risk is that RILAs do not have a guarantee that the interest earned can never go below zero like an FIA. This piece provides an understanding of risk and reward in these products. All pieces in this series are available at <https://nafa.com/education/consumer-materials/>.

NAFA is the premier trade association exclusively dedicated to fixed annuities. We are committed to providing information and education regarding the value of fixed annuities and their benefits to our members, journalists, and the general public to help Americans plan for a lasting and safe retirement.



**Charles J. DiVencenzo, Jr.**  
President & CEO

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## INDEX-LINKED ANNUITIES

If you're interested in an annuity that controls your potential losses and links its returns to an index, you have options and each can fit very differently into your overall financial plan. There are key differences between two kinds of annuities that do this and factors you should consider when deciding whether one of these is right for you.

There are two basic types of annuities that use an index and crediting strategy to determine what your account value is rather than direct investment in the index itself. The **fixed indexed annuity (FIA)** is a fixed annuity that calculates its returns based on index performance, with predetermined limits on the upside return, and never returning less than 0%. The **registered index-linked annuity (RILA)** may have a negative return, so it is registered as a security and can only be offered by a professional with a securities license. These are also known as structured, buffered, or indexed variable annuities.

### DIFFERENCE BETWEEN TWO TYPES OF INDEX-LINKED ANNUITIES

	LINKED TO INDEX	REQUIRES SECURITIES LICENSE	STRATEGY CAN'T LOSE MONEY	MORE LIKE AN EQUITY	MORE LIKE A BANK CD
FIA	✓		✓		✓
RILA	✓	✓		✓	

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## WHAT CREDITING STRATEGY?

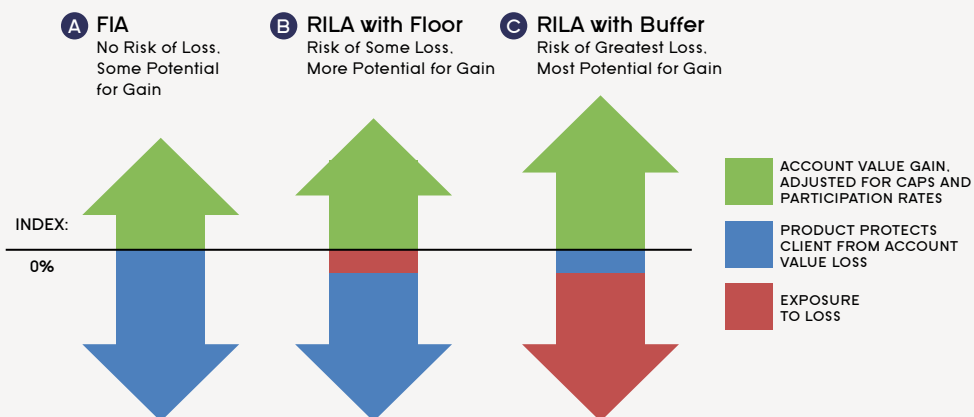
To understand how these products work differently from each other, you need to understand the crediting strategy of each product. All of these index-linked annuities use an index but the returns you get—positive or, potentially, negative—depend on the style of the crediting strategy. As the index moves up and down, the annuity protects you from some—or all—of those losses, while at the same time it limits the returns.

As with any financial product, there is a trade-off between the **risk** that you are willing to take on and the potential **return** that you may get over one period, or term. The performance of an annuity over time is generally the result of many periods in a row and we'll see later how that can affect your return as well. This illustration describes three types of risk trade-offs that are common in index-linked annuities.

Even when the crediting strategy guarantees that you will never have a negative return, your account value may go down when the FIA does not have a return and there are other fees associated with the account.

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## TRADING RISK FOR POTENTIAL GAIN



**A (FIA):** If you are willing to accept the risk that your credit will change each period (often, one year) but you want to avoid the possibility of losing any money, then you will get lower returns, or account value increases based on index performance in the positive years.

**B (RILA with Floor):** If you are willing to accept account value losses but want to put a limit on those negative returns in any period, you can get more of the increases in the positive periods for the index. This is called a FLOOR design because the floor establishes the most you can lose in a period. When the floor is 0%, it the same as A.

**C (RILA with Buffer):** If you are willing to accept the risk of a large market downturn reducing your account significantly but still want protection against smaller losses, you can get even more out of the index's increases. This is called a BUFFER design because it buffers your account against index declines within the buffer zone but then exposes you to losses when the index goes below the buffer. Large declines are less frequent, but the potential loss is everything below the buffer. Though extreme events are more rare than modest fluctuations within the buffer, the loss in one period could be much greater when compared to the floor design. When the buffer is 100%, it is the same as A.

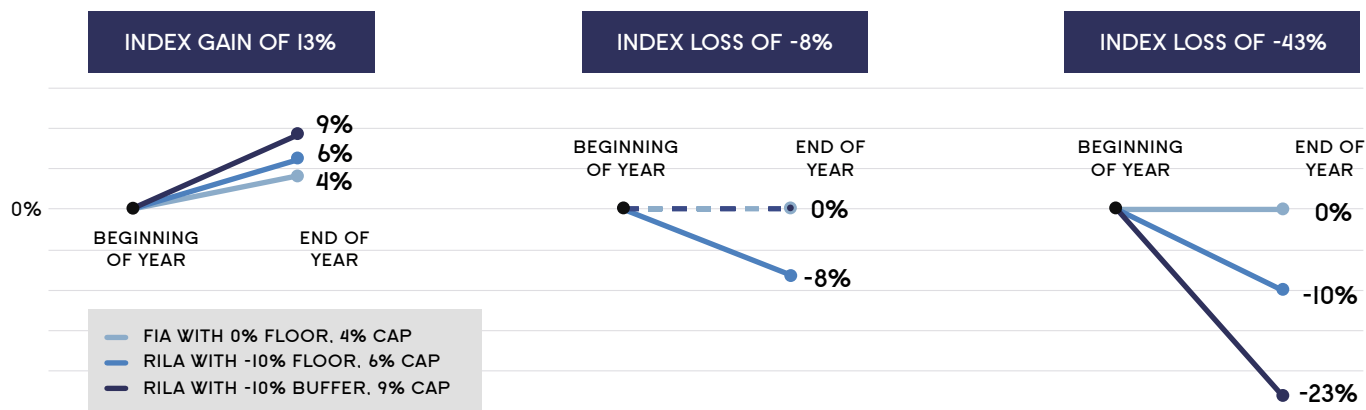
When we look at the three designs, A, B, and C, there is no “best” one. Each can serve a different role in your financial plan. Before deciding on a product, ask yourself what are you looking to accomplish with that annuity? If you want to assure that you will not lose any premium payments reflected in the account value and want index-linked gains, the FIA or a RILA with full loss guarantee may be the answer. If you can afford to take on some risk but want to control your losses, a RILA may be a good choice. In addition, there may be other features of a contract that are important, such as an income or a death benefit.

## THE BASICS: UPS AND DOWNS

To understand how these designs work, let's see how an FIA, a RILA with a floor, and a RILA with a buffer might perform in different market scenarios. In these examples, all rely on a commonly used cap strategy to keep the comparison fair and we change the cap to match the strategy (the riskier the strategy the higher the cap). [A detailed explanation about how cap strategies work](#) is available on our website in the Consumer Materials section.

Here, we take a look at three market scenarios and how each annuity design responds.

### PERFORMANCE BY STRATEGY: THREE MARKET SCENARIOS



**FIA with 0% floor and 4% cap:** We can see that the FIA account value never goes down, regardless how much the index declines in one period. If you owned this annuity over this period, you would never worry about the ups and downs of the index—despite significant market declines—and you would end up earning some interest in the years when the index goes up.

**RILA with a -10% floor and 6% cap:** The RILA with a floor exposes you to market fluctuations above the floor, as we see in the scenario when the index goes down by 8%. However, in a significant market downturn, you are protected from most of the loss, which we see in the scenario when the index goes down by 43%.

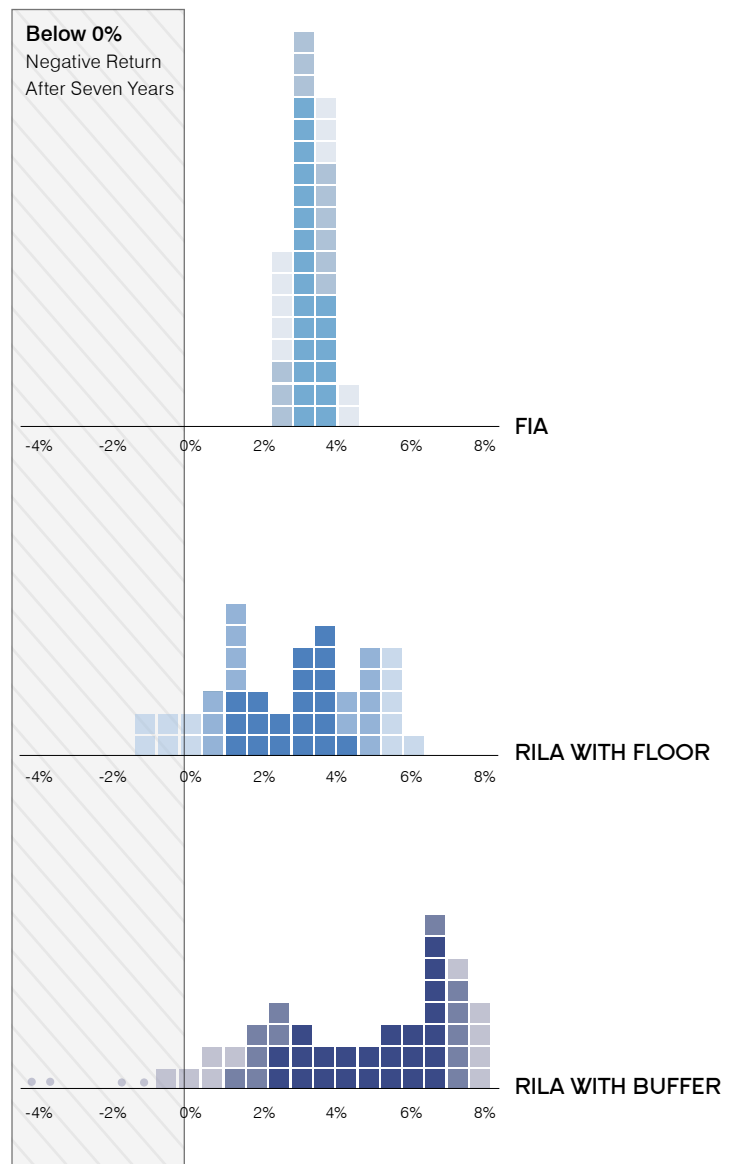
**RILA with a 10% buffer and 9% cap:** The RILA with a buffer protects the account from loss when the index decline is smaller than the buffer, which we see in the scenario where the index goes down by 8%. The account value absorbs all losses after the buffer. In this case with a 10% buffer, when the index drops by 43%, the account experiences a 33% loss.

## A HISTORICAL PICTURE

The yield of your annuity depends on the performance in each year over the time you hold it, so the sequence matters. To better understand that, let's consider how the same designs might have performed over many 7-year periods starting each month between 1980 and 2020 based on the S&P 500. We show this as an annualized return because the average smooths out years with unusually high or low returns. This statistical information—the range and frequency of outcomes—tells us how these crediting strategies would have performed under historical market sequences.

**DESPITE THE FACT THAT ALL THREE RELY ON AN INDEX AND A CREDITING STRATEGY THAT USES A CAP, YOU CAN SEE HOW DIFFERENTLY THEY PERFORM UNDER IDENTICAL CONDITIONS.**

### FREQUENCY OF RETURNS FOR ONE-YEAR STRATEGY REPEATED OVER SEVEN YEARS



*The darkest shade in each figure represents the middle 50% of results for each annuity design.*

## BALANCING ACT

Balancing risk and opportunity can be tricky, but it's important to ask yourself:

- 1 Can I tolerate the worst outcome?
- 2 How does the moderate outcome fit in my plan?



These results show how differently these crediting strategies perform based on the same index returns. The FIA performance is narrow and concentrated and always credits interest after seven years. Both of the RILA designs may have negative returns after seven years. Though this doesn't happen often, you may want to choose a design that only has positive returns. The floor design has a narrower range of results than the buffer design, both because it limits losses in any given year and because the cap is lower. The buffer has the broadest range of possible results, which includes both the greatest losses and a higher maximum because the cap is the highest of the three strategies. Despite the fact that all three rely on an index and a crediting strategy that uses a cap, you can see how differently they perform under identical conditions.


Looking into the future, your expectations and your worries about the market are important factors to think about when choosing a strategy that fits your goals. You should also consider how long the strategy period is and how long you will be holding the annuity. Even if you hold the annuity for a longer period of time and believe that will allow you to weather bad markets, there may not be enough time for the account balance to recover from a major event, as we see in the scenarios where the RILA has a net negative return even after the full seven years.



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## THE IMPORTANCE OF FINANCIAL PLANNING

Ultimately, the decision to use any product or strategy relies on a financial plan. The FIA can be part of a fixed income allocation or generate income through a benefit. The RILAs offer more equity-like returns but with greater risk than the FIA. Some of these also offer an income benefit.

An index is a valuable tool that gives you different levels of risk and opportunity to meet a wide variety of needs. On top of this, annuities themselves are uniquely able to provide income benefits to increase retirement security and shore up a financial plan. Annuities enable you to reduce many different risks and it is important that you understand the trade-offs when you decide whether one is right for you. 



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