EDUCATIONAL COMMENTARY

For consumers

USING ANNUITIES TO OFFER PROTECTION WHEN MARKETS GO DOWN

When the stock market is in flux, the fear of losing your hard-earned savings is real. Annuities can help you protect your money. It's called downside protection.

An annuity is a crucial part of a retirement portfolio. There are all types of annuities based on your needs, including ones that are popular for providing protected retirement income. You buy an annuity from an insurance company and get payouts for a set number of years or for your lifetime.

But certain annuities are designed to help you protect your assets by limiting or avoiding losses. So when the stock market drops, you can be more comfortable knowing you are protecting your assets.

"With the ramifications of the coronavirus, people, especially those near retirement, are more concerned about making sure they don't lose what they've accumulated; that puts more focus on the asset protection side," says Michael R. Harris, a senior educational advisor with the Alliance for Lifetime Income who holds CFP, CLU and CHFC designations. "'If I can make a little money, that's fine, as long as I don't lose any.'"

Say you're in your mid-50s. You know that in the future when you retire, you'll get Social Security retirement benefits, maybe a small monthly pension, and you've built up a nice pot of savings. With an annuity, you can protect your savings—and earn something.

Annuities come in different flavors, with many different features, including varying levels of downside protection. Here's what to look for if you're seeking to shield your nest egg.

IF YOU DON'T NEED SIZZLE, JUST DOWNSIDE PROTECTION

With a fixed annuity, you put in money for a certain amount of time and get a set interest rate. You get the fixed interest rate for the term of the contract, the number of years you pick as the length of the annuity. The insurance company guarantees your full principal. That's ensuring downside protection.

At the end of the term, say five years, you get your money back plus interest. You can end the contract, renew it, or buy a new annuity. "There's not a lot of sizzle to buying a fixed annuity," Harris says. That's just fine for some folks. These are the most conservative types of annuities.

Is there a way to protect your money but get a better upside potential? That's where indexed annuities come into play.

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IF YOU WANT DOWNSIDE PROTECTION WITH MORE UPSIDE POTENTIAL

Like a fixed annuity, with an indexed annuity, your principal is protected. But the difference is that the annuity is linked to a market index. You're not actually invested in the market. The market index you choose acts like a kind of measuring tool. If the market index is positive, you get earnings that are potentially higher than could be earned in a fixed annuity. If the market index is negative, you don't lose the principal investment you put in, but you may get no earnings, depending which options you choose in the contract. The earnings potential is spelled out in the contract. Usually there is some limitation in the earnings that the annuity permits, which is based on a cap or participation rate.

Does this mean a fixed annuity is better? After all, the fixed annuity promises a fixed interest rate. That's right, but remember there the upside is limited to that fixed rate. Instead, with an indexed annuity, you have the opportunity to make more than in a fixed annuity. "The indexed annuity consumer has a spark of optimism. 'I can still make something, but I'm not willing to lose money.'"

If you're bullish or optimistic that the stock market will go up, but still want protection in case it goes down, an indexed annuity might make more sense. If you're nervous and less optimistic, you might not want to be linked to an index, so a fixed annuity might be more appropriate.

Some people elect to buy both types of annuities, a fixed annuity and an indexed annuity, to complement each other. Another approach is to buy an indexed annuity that lets you put money in different buckets in the same contract. In each bucket, you decide where you park your money and for how long. One of those buckets can be fixed. So you could have one contract, with money in one bucket getting a fixed rate of interest, and money in another bucket with earnings tied to an index. That way you know you're going to at least earn something.

IF YOU WANT EVEN MORE UPSIDE POTENTIAL BUT STILL WANT SOME DOWNSIDE PROTECTION

A variant on the indexed annuity is one that provides some downside protection and offers even more upside potential. These are called registered index-linked annuities. Some people call them buffered indexed annuities or structured annuities. "It's not what you call it; it's how it works and what it does that's important," Harris says.

There's downside protection, just not 100%. You choose how much you want to protect in a downturn with what's known as a buffer. If you choose a 10% buffer, you'll be protected against the first 10% loss in the market. If the market loses 15%, you've lost 5%, and protected 10%. That's measured at the end of the term, the number of years you pick. At the end of the term, you're going to make money, lose money, or you're even. The higher your buffer, the lower your upside potential because the insurance company is giving you more protection.

Who should consider a registered index-linked annuity? "It's for a client who is not quite as risk averse but still wants some downside protection," Harris says.

The bottom line: "There are a lot of different options depending on your risk level," Harris says. That's why it's important to seek out the help of a financial professional who can help you choose the right options for you. A professional can help you assess your risk level, and determine how much downside protection makes sense for your retirement goals and needs.

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