RILAs can offer modern risk management amid economic uncertainty

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The U.S. stock market as measured by the S&P 500 index rounded out 2022 with a decline of 19.4%[1] as the U.S. Consumer Price Index (CPI) increased by about 6.5%.[2] The simple math of combining the percentage market index decline with the rise in consumer prices implies the real after-inflation value of the S&P 500 index decreased by 25.9%.*

One plausible interpretation of this math is that Americans' investment wealth was reduced by more than one-quarter for anyone who was entirely allocated to stocks without the benefit of an insurance option to help protect against losses.

While no financial professional would ever recommend such a lopsided allocation, investing in long-term bonds didn't offer much respite in 2022 either. The Barclays Aggregate Bond Index, for example, declined by a nominal 13%.[3] Oddly enough, gold prices—which tend to increase during inflationary times—barely budged from $1,805 to $1,813 over the year.[4] And let's not even discuss the performance of crypto currencies.

The S&P 500's decline in 2022 wasn't a historical anomaly, as you can see from the many triangles under zero in **Figure 1a**. In addition to showing returns on the index over the past 50 years, this chart also plots inflation rates in circles. So, what are prudent investors who want to protect themselves to do?

A partial answer may be found in the potential of registered index-linked annuities (RILAs), which use a stock market index to determine gains and losses. RILAs can limit losses during market downturns by giving contract owners the option to specify the maximum loss they are willing to tolerate with the flexibility to customize the product based on their own personal risk profile. While RILAs can offer higher potential for market gains than many other annuities, they are registered securities products because there is the potential for losses. I'll discuss RILAs further in a moment, after I provide a little more background.

What is a registered index-linked annuity (RILA)?
A RILA is a long-term, tax-deferred vehicle designed for retirement. It is subject to investment risk, its value will fluctuate, and loss of principal is possible. A RILA, which is an insurance contract, allows you to choose how you want to prioritize growth opportunities while managing the amount of loss you may assume. Earnings are taxable as ordinary income when distributed. Individuals may be subject to a 10% additional tax for withdrawals before age 59½ unless an exception to the tax is met.

*This is a hypothetical approximation and does not reflect the actual inflation-adjusted value of S&P 500 returns in 2022.

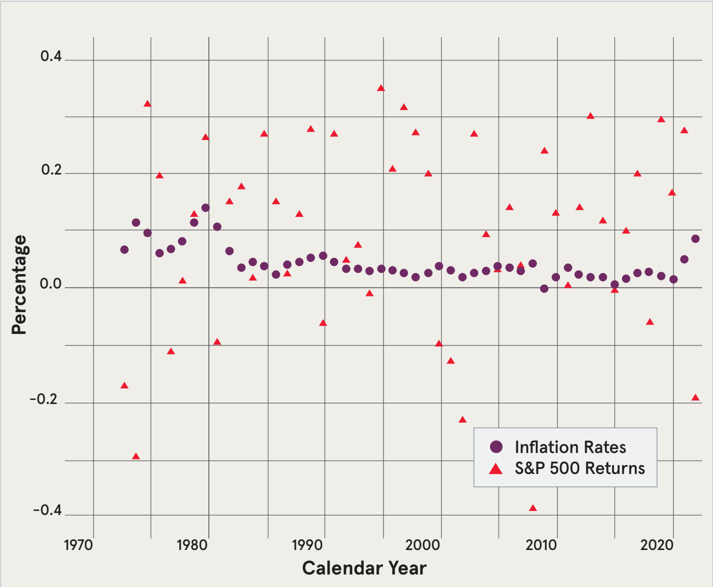
[1] Echo Wang, Reuters, "Wall Street ends 2022 with biggest annual drop since 2008," December 30, 2022.

[2] U.S. Bureau of Labor Statistics, "Consumer Price Index: 2022 in review," January 17, 2023.

[3] Andrew Rosen, Forbes, "The Worst Bond Year Ever Was 2022 – What Does That Mean For You?" February 9, 2023.

[4] Statista, Price of gold per troy ounce from 1990 to 2022, January 4, 2023.

FIG. 1A



This chart was provided by Moshe Milevsky and based on historical annual returns of the S&P 500 index and average annual Consumer Price Index (CPI) inflation rates for the period from 1973 through 2022. S&P 500 index data was provided by Macrotrends and CPI data sourced from the U.S. Bureau of Labor Statistics, February 21, 2023.

Some readers may have heard investment experts and pundits suggesting that over the long run, stocks offer shelter from inflation's storm. However, the exact opposite appears to have happened in 2022 and you will see that year wasn't unique.

But first, consider some historical facts. Had you invested $100 in a security that tracks the S&P 500 index price return 50 years ago, it would have grown to $3,252 at the end of that period based on a compound annual return of 7.212%.[5] While this doesn't include any dividends, the comparison seems fair since the S&P 500 is the basis for most registered index-linked annuities (RILAs) and fixed index annuities. On the negative side of the equation, the same $100 from 50 years ago would have depreciated in real terms to a mere $14.29—or about 14% of its original value—when adjusted for the corrosive power of inflation.[6] This is a main reason why the Federal Reserve is fighting so hard to wrestle inflation back under control.

The significant change in values shown in **Figure 1b** might come as a shock. Not only did inflation-adjusted buying power drop by roughly 86% over 50 years,[7] but the S&P 500 index grew from 100 to over 3,000 in the same period, a massive 3,200% increase.[8] To put this in real terms, multiply the $3,252 by 0.1429 and you arrive at $464.70. This means based on that initial $100 investment in stocks, we really are ahead by more than quadruple after a half century. Again, this is based on the index alone without dividends. But the stocks clearly trounce inflation. If we were to stop here, many readers might rightfully wonder why anyone would need downside protection at all.

[5] Calculations provided by Moshe Milevsky and based on historical annual returns of the S&P 500 index from 1973 through 2022 as provided by Macrotrends..

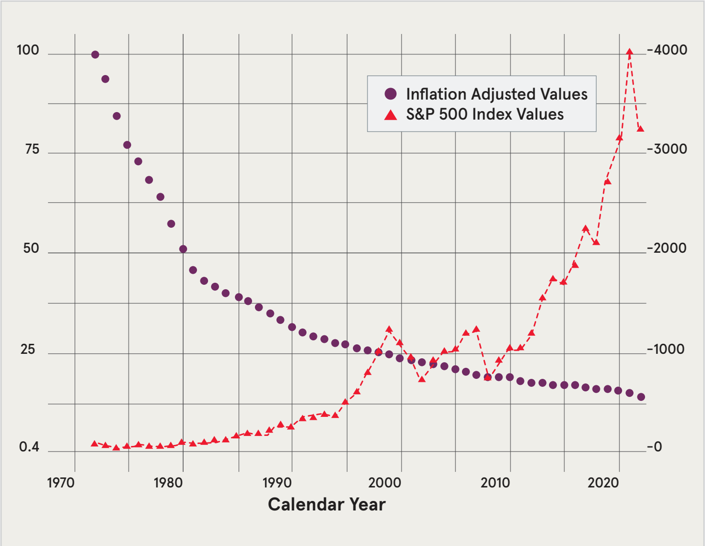
[6] Calculations provided by Moshe Milevsky and based on average annual Consumer Price Index (CPI) inflation rates from 1973 through 2022 as published by the U.S. Bureau of Labor Statistics.

[7] Ibid.

[8] Calculations provided by Moshe Milevsky and based on historical annual returns of the S&P 500 index from 1973 through 2022 as provided by Macrotrends.

But here is where it gets complicated and why some downside protection from a RILA can be so important. If we look at the same dataset of inflation versus the S&P 500 index over shorter horizons of just one year—such as 2022—a somewhat different picture emerges. **Figure 2** plots the behavior of inflation and the S&P 500 index jointly and in two dimensions, with each of the 50 dots representing a year. The horizontal axis is the inflation coordinate and the vertical is the stock index coordinate. You will note the negative trend line and the regression line estimate in the lower-right corner that shows the data relationship is not a fluke, but statistically significant. You also will note that over the most recent 30 years, the line has been negative.

FIG. 1B



This chart was provided by Moshe Milevsky, based on historical annual returns of the S&P 500 index and average annual Consumer Price Index (CPI) inflation rates for the period from 1973 through 2022. S&P 500 index data was provided by Macrotrends and CPI data sourced from the U.S. Bureau of Labor Statistics, February 21, 2023.

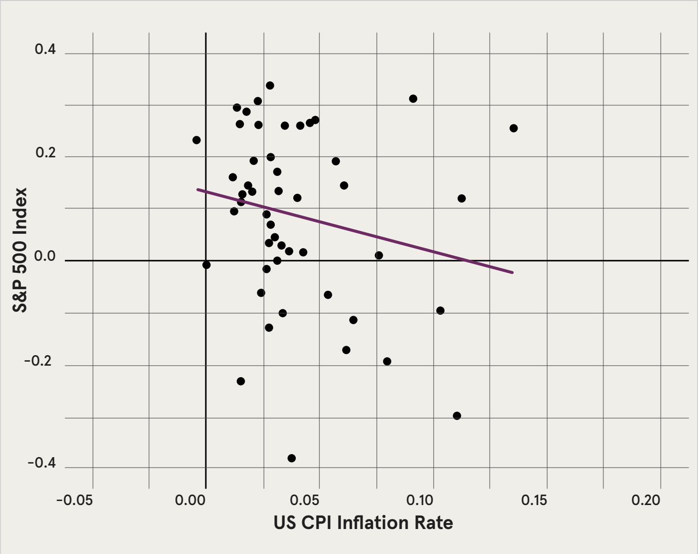
Herein lies a paradox. **Figure 1b** suggests that over long periods, the stock market index will counteract inflation, and there is perhaps no need for any downside protection strategy. However, **Figure 2** indicates that years in which inflation is worse than the 3.97% average,[9] the stock market index performs worse than the 7.21% average[10]. Put bluntly, if you worry that inflation will be worse than the historical averages, then you should also worry the S&P 500 index will fall below historical averages.

Again, the negative sloping line indicates above-average inflation —which is bad—is associated with under-average S&P 500 index returns—which are very bad. The year 2022 was an excellent example of this effect. Underscoring matters are the psychological and behavioral effects demonstrated when investors overreact, panic and sell off stocks in years markets are down.

[9] Calculations provided by Moshe Milevsky and based on average annual Consumer Price Index (CPI) inflation rates from 1973 through 2022 as published by the U.S. Bureau of Labor Statistics.

[10] Calculations provided by Moshe Milevsky and based on historical annual returns of the S&P 500 index from 1973 through 2022 as provided by Macrotrends.

FIG. 2



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This brings us to the question of what can be done. More specifically, how can investors reasonably protect themselves against the uncertainty associated with inflation and stock index returns? I've already alluded to the fact that a RILA can potentially help. Now let's examine this option in greater detail.

Untangling the Paradox

While it's clear in the long run the S&P 500 index—and similar indices—can overcome the eroding power of inflation, the lower right quadrant of **Figure 2** and the downward sloping trend line indicate that poor market returns tend to occur precisely in years when inflation is more disappointing than average.

And, even if inflation rates return to normal, the RILA still has an important role to play as a protection strategy.

This is why a financial product like a RILA can potentially help shelter investors from high inflation. As InvestmentNews noted in an article about inflation and annuities, numerous insurers have been adding these products to their rosters "with market volatility and overall uncertainty serving as selling points."[11] RILAs can potentially enable investors to continue to benefit from the best effects in **Figure 1b** over the long run, but partially protect against the negative trend shown in **Figure 2**. My key point is that inflation makes short-term market downsides worse and is all the more reason to consider the type of protection a RILA can provide.

The freedom with a RILA to select a tailored protection level from market loss—for example 10% versus 20% can help address another key aspect of inflation that hasn't captured much of the media's attention: the fact that it's highly personal in nature. The above-noted 6.5% inflation rate in 2022 was derived from many different inflation rates for various subcategories. For example, fuel oil and natural gas increased by more than 60% combined and the cost of electricity increased by more than 14%. Unlike those energy-related costs, there was an inflation decline—yes, an actual fall—of nearly 9% for used cars and trucks.[12]

In essence, inflation can affect everyone differently depending on their personal circumstances. An investor more sensitive to inflationary concerns might consider selecting greater levels of partial downside protection in a RILA product compared to someone who is not affected as much by higher prices for certain goods and services.

At another level, as investors get closer to retirement, they are more likely to focus on investment loss protection. The methods traditionally used for protection have included strategies such as portfolio diversification, investing in dividend paying stocks, or periodic portfolio rebalancing. These strategies have been around for many years, but they aren't foolproof and should be categorized as only partial downside protection. The year 2022 is proof of that.

The main message here is that another real strategy—and that may keep up with inflation—is to use modern risk-management and hedging strategies to partially remove the pesky market downturns and counteract the negative trend line in **Figure 2**. This option is one that can provide an established floor—or buffer—that limits the percentage loss an investor can experience in a year. Better yet, it avoids navigating the rather complex options and derivatives markets.

It's important to note that some RILAs also may have higher fees than other investment options and can limit investment upside potential. For these and other reasons, it's essential for financial professionals and their clients to carefully discuss all product features and benefits as they relate to a broader financial plan.

[11] Emile Hallez, InvestmentNews, "What inflation could mean for annuities," January 24, 2022.
[12] U.S. Bureau of Labor Statistics, "Consumer Price Index: 2022 in review," January 17, 2023.

Again, the effects of prolonged high inflation should not be amplified by disappointing investment outcome. But don't take my word for it. A research article that was published in the Journal of Risk and Insurance had this to say about RILAs: "[T]hey offer investors looking to save for retirement equity exposure with downside protection, and they do so at little cost and in a relatively transparent fashion."[13]

I couldn't have said it better.

For more information, visit jackson.com.

[13] Thorsten Moenig, "It's RILA Time: An Introduction to Registered Index-Lined Annuities," February 2021.

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