

## ONDEX FIXED INDEXED ANNUITIES

# Getting down to get up

Why lower participation rates may offer higher growth potential for FIAs

## Understanding the basics

Upside potential with downside protection. It's Fixed Indexed Annuities 101, the traditional value proposition of a product capable of addressing several of the most important income issues retirees will have to face, from market volatility to lifetime income. The second half of that value proposition – downside protection – is one of the keys to understanding the impact these products can have on retirement.

Many FIAs include a 0% floor on returns, meaning that although the product's growth is based on market indices, unlike a variable annuity the contract can't lose value as a result of market performance. This has a significant impact on the product's overall performance and goes a long way toward eliminating market volatility as a concern; the only way these contracts can lose money is as a result of product or rider fees.

## The tradeoffs for protection

But that downside protection comes with tradeoffs that have a direct impact on the upside potential half of our value proposition. The first tradeoff is that the contract's value isn't directly invested in the market. These are, after all, still fixed products. As a result, even if a given allocation option is based on the performance of the S&P 500® Index, dividends typically won't factor into the returns used to determine the contract value's growth.

The second tradeoff is that every FIA allocation option comes with a limiter of some kind that affects how much of the associated index's growth is applied to the contract's value. Two of the most common of these are return caps and participation rates. Understanding them is crucial to understanding how these contracts grow and why the typical standards used when evaluating products might limit a client's asset growth over time.

Return caps represent an upper limit on the amount of index growth that can be applied to the FIA contract's value in a given time period. So, for example, if an FIA credits interest annually based on the performance of the S&P 500® Index and is subject to a 5% return cap, the contract value's growth can't exceed 5% for the year. If the S&P 500® grows by 10% that year, the FIA contract grows by 5%.

Participation rates represent the percentage of index growth that's applied to the contract in a specific period of time. If an allocation option has an annual participation rate of 50%, for example, then half the index's growth is applied to the contract. In this case, if the S&P 500® increased by 12%, the FIA contract would increase by 6%.

It's important to understand that any specific allocation option offered by an insurance company can be subject to a return cap, a participation rate or both. Typically when

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an allocation option uses a return cap, the participation rate is guaranteed to be at least 100%. It's also not at all uncommon to find an uncapped option that features a participation rate that's less than 100%, because the flexibility to adjust the participation rate gives the insurance company more freedom to adapt to market conditions and potentially offer higher growth potential. So if a lower participation rate allows for a higher return cap or none at all, what impact would utilizing both have on a contract's value over time?

## Comparing allocation options

To answer that question, we'll compare two allocation options. Given its ubiquity throughout the FIA marketplace, both allocation options will be an annual point-to-point with growth based upon the performance of the S&P 500® Index. Their return caps and participation rates will differ, however.

- A traditional allocation option with a **100% participation rate**. As of September 2021, the average return cap for the ten best-selling FIA products was just under 4%. However, for simplicity, we'll use a 5% return cap.
- An allocation option with a **50% participation rate but a return cap that's 25% higher** than the traditional option, or 6.25%.

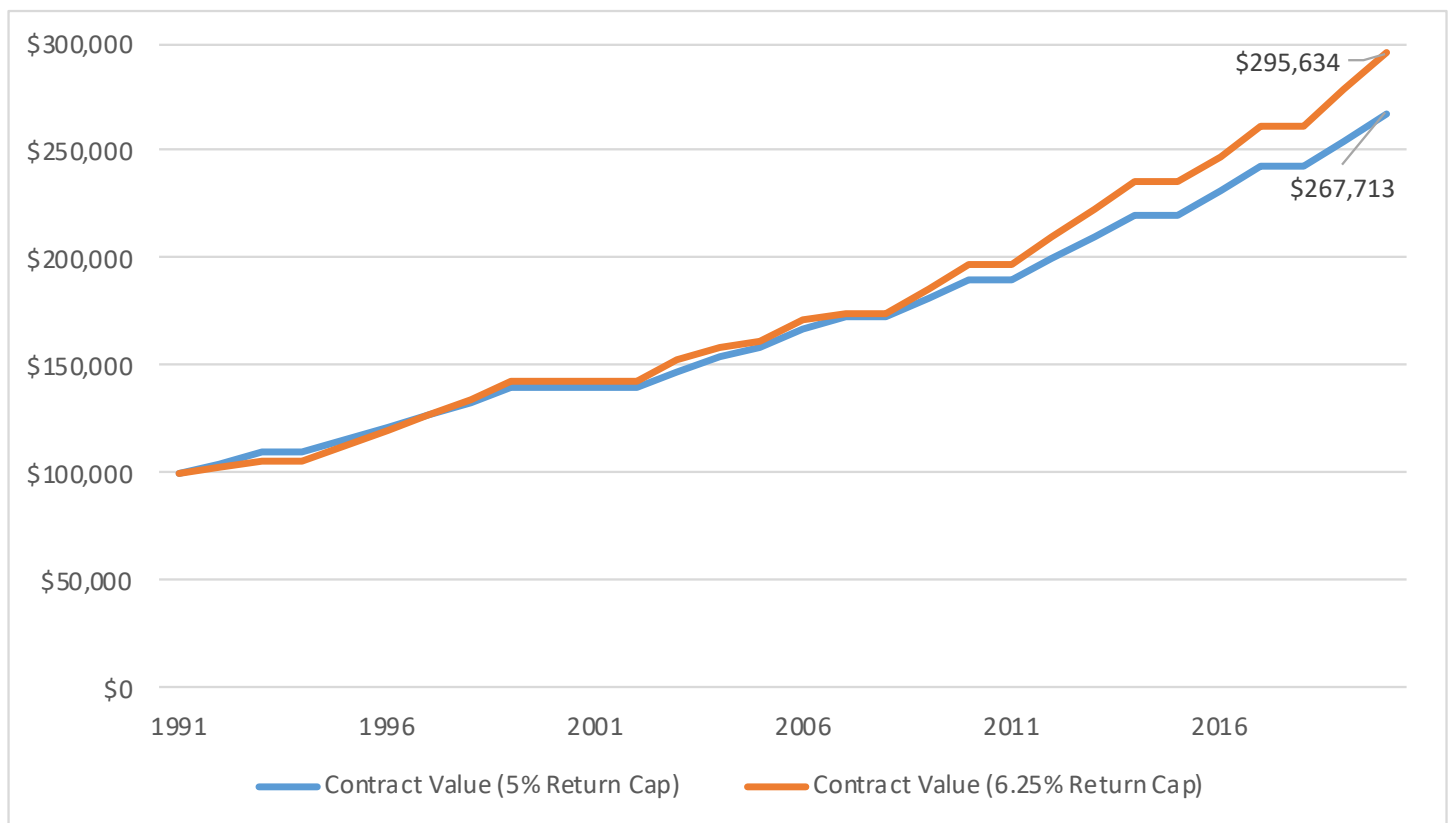
To evaluate each of these allocation options, we'll assume each contract starts at \$100,000 and look back at the last thirty years of S&P 500® performance, minus dividends, to see how each one fares (see graph below).

That's a difference of nearly \$30,000 or more than 10% of the traditional option's final contract value, even with a 50% participation rate. The reason becomes clear if we look at the pattern of index returns during this period.

Frequency of S&P 500® returns (1991-2020)			
Negative index returns	Positive index returns <10%	Positive index returns >10%	Positive index returns >12.5%
9	6	15	14

For FIA contracts, years with negative performance are irrelevant, meaning the two index options were equal in those 9 years. In the years with positive returns, however, the traditional allocation option can only outperform the lower participation rate option when index returns are less than 10% because once the 50% participation rate is applied, any returns greater than 10% will exceed the traditional allocation option's 5% return cap. In this 30-year period, that happened six times, or nearly 30% of the time during the years with positive returns.

Conversely, our allocation option with the 6.25% return cap outperformed the traditional allocation option fifteen times. That's more than 70% of the years with positive returns. And when index returns exceeded 12.5%, the allocation option with the lower participation rate hit the return cap, which happened fourteen times during this time period. That extra 25% of asset growth in fourteen separate years produced the outsized impact on the contract value's growth shown in our final values.



Although we can't use the past to predict the future, this pattern is consistent with S&P 500® historical returns, which have exceeded 12.5% 40 times since 1928. That's more than 65% of the positive years. But when interest rates are low, the return caps an insurance company can offer on a traditional annual point-to-point allocation option aren't likely to exceed 5%, meaning they'll frequently capture only a small portion of an index's returns. And that's exactly what we've seen happen under recent market conditions. As noted above, in September, 2021 the average return cap for the top 10 FIA products using an annual point-to-point with the S&P 500® was less than 4%.

Frequency of S&P 500® returns (1991-2020)		
Negative index returns	Positive index returns <8%	Positive index returns >8%
9	4	17

A traditional allocation option with a 4% return cap would be outperformed by an allocation option with a 50% participation rate any time index returns exceeded 8%. Over the last thirty years, that happened 17 times, a remarkable 80% of the years with positive returns. In other words, if interest rates decrease or remain low for an extended period of time, an allocation option with a lower participation rate but higher return caps has even greater potential to outperform an option with a 100% participation rate and lower return caps.

Conversely, when interest rates rise, insurance companies have more latitude to raise return caps and give traditional allocation options more opportunities to outperform.

However, it's important to note that, based upon the last 30 years of S&P 500® returns, it's not until a traditional allocation option's return cap rose to 9% (requiring index returns to exceed 18% for our 50% participation rate option to outperform) that it was able to outperform in more years than its competitor.

Frequency of S&P 500® returns (1991-2020)		
Negative index returns	Positive index returns <18%	Positive index returns >18%
9	11	10

### Taking growth potential higher

Lowering the participation rate allows for a higher return cap, and as demonstrated, may allow an allocation option to take advantage of outsized index performance and capture significantly more index growth over time. This effect is particularly pronounced in low interest rate environments like the market we've experienced for the last several years, in which insurance companies have a more limited capacity to offer higher return caps.

To help your clients achieve their retirement asset goals, Ohio National developed an allocation option for our ONdex fixed indexed annuity products that's unique in the industry, and offers a lower participation rate in exchange for a higher return cap. Our Annual Point-to-Point with S&P 500® (Higher Cap) crediting strategy typically offers a 50% participation rate and return caps that are higher than our competitors' comparable allocation options.



## Additional materials

- All about the ONdex fixed indexed annuities (Form 9701)
- The current rates for the ONdex annuities (Form 9707)
- A client-use flyer explaining the Higher Cap's potential advantages (Form 9731)



Want to learn more about our Higher Cap allocation option, Ohio National and everything we can do for your clients? Visit us at [joinohionational.com](http://joinohionational.com) or contact your regional representative.

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