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Navigating Today's Economy and Markets

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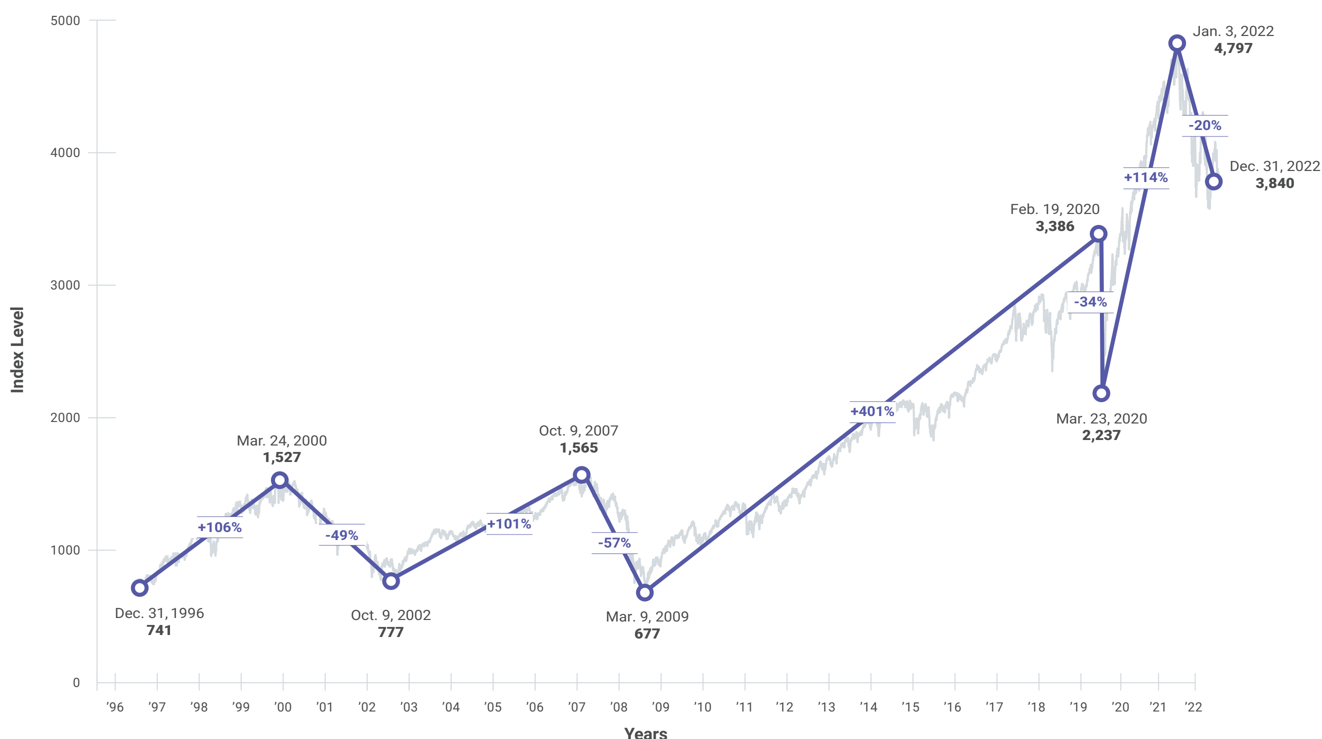
Points to Consider

- While the U.S. stock market may rise over time, there have been many periods when it has experienced a significant decline.
- Historically, investors have turned to bonds for diversification as they generally do not move in tandem with stocks and can perform well when the equity markets experience declines.
- However, today's environment of high inflation, rising interest rates, and growing recession risk have weighed on the markets. With both U.S. stocks and bonds down this year, diversification has struggled and caused many investors to rethink how to balance risk in portfolios.
- As a result, some investors are considering additional strategies, such as registered index-linked annuities, to help meet their retirement savings and income goals.

While the U.S. stock market may rise over time, it often experiences periods of notable decline

Stock market declines are the last thing most investors want to experience, but they are an inevitable part of investing. Looking back over the past 25 years shows that while the stock market has appreciated, there have been several instances when it experienced significant declines. These instances include declines known as the dot-com collapse in the early 2000s, the financial crisis in the mid- to late-2000s, and the COVID-19 pandemic that began in early 2020.

S&P 500® historical performance



Source: Guide to the Markets. J.P. Morgan Asset Management, December 31, 2022.

Returns are cumulative and based on the S&P 500 Index price movement only, do not include the reinvestment of dividends, and do not reflect the performance of any particular product. All returns and calculations are rounded to the nearest whole number. **Past performance is not indicative of future returns.**

To help reduce volatility and overall portfolio risk, investors might include bonds in their portfolio

Diversification is a common investment strategy that entails buying different types of investments to help reduce overall portfolio risk while helping to increase the potential for overall return. That's because some asset classes in a portfolio may perform well while others do poorly. This strategy is part of asset allocation, which takes into consideration how much of a portfolio is invested in various asset classes.

Two of the most common asset classes used to construct a portfolio are stocks and bonds. Stocks allow investors to own a piece of a company, offering the potential for higher long-term gains, but they can be volatile – especially in challenging economic times. Bonds can provide income for investors and may add valuable diversification and risk reduction benefits when included as part of an equity portfolio. Generally, bond prices have an inverse relationship with interest rates, which can help reduce the impact of highly volatile markets.

In seeking portfolio diversification, investors can blend these two assets together so their portfolio doesn't have too much exposure to any one individual asset class. It's important to note that diversification may look different for each investor. Time horizon, risk tolerance, and other factors should be assessed on a case-by-case basis to determine how to best construct each portfolio to fit the individual needs of each investor.

The 60/40 portfolio is a common starting point for what many consider balanced allocation

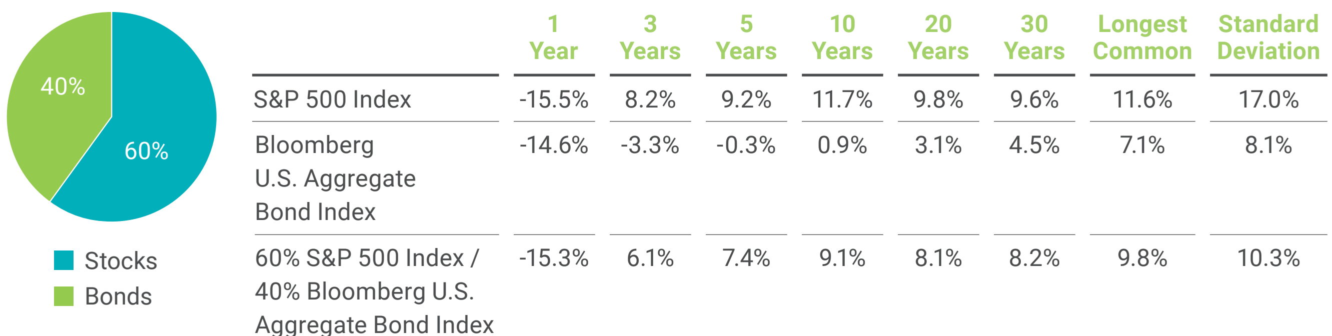
For a moderate growth investor with a longer-term time horizon, a common starting point for a diversified portfolio is one that allocates 60% to stocks and 40% to bonds (60/40 portfolio). Traditionally, a 60/40 portfolio potentially offers investors the best of both worlds: long-term growth potential from stock allocation coupled with a more conservative bond allocation that can help offset volatility in the equity markets.

Over the past four decades, the 60/40 portfolio has provided investors with attractive risk-adjusted returns and demonstrated an ability to weather volatile market environments. Since the start of the 1980s until recently, total average annual returns for the 60/40 portfolio (represented by 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index) was 9.8% as referenced in the chart below.

While the 9.8% return for the 60/40 portfolio was slightly lower than the returns of a portfolio consisting of 100% stocks, the 60/40 portfolio managed to deliver its performance with about a third less volatility (as measured by standard deviation) than an all-stock portfolio over the same period.

Historical performance of stocks, bonds, and a 60/40 portfolio

(January 1980 – September 2022, beginning with the most recent year)



	1 Year	3 Years	5 Years	10 Years	20 Years	30 Years	Longest Common	Standard Deviation
S&P 500 Index	-15.5%	8.2%	9.2%	11.7%	9.8%	9.6%	11.6%	17.0%
Bloomberg U.S. Aggregate Bond Index	-14.6%	-3.3%	-0.3%	0.9%	3.1%	4.5%	7.1%	8.1%
60% S&P 500 Index / 40% Bloomberg U.S. Aggregate Bond Index	-15.3%	6.1%	7.4%	9.1%	8.1%	8.2%	9.8%	10.3%

Source: Bloomberg. Performance and standard deviation calculated are based on monthly returns from 01/03/1980 to 09/30/2022. All returns and calculations are rounded to the nearest tenth of a percent. **Past performance is not indicative of future returns.**

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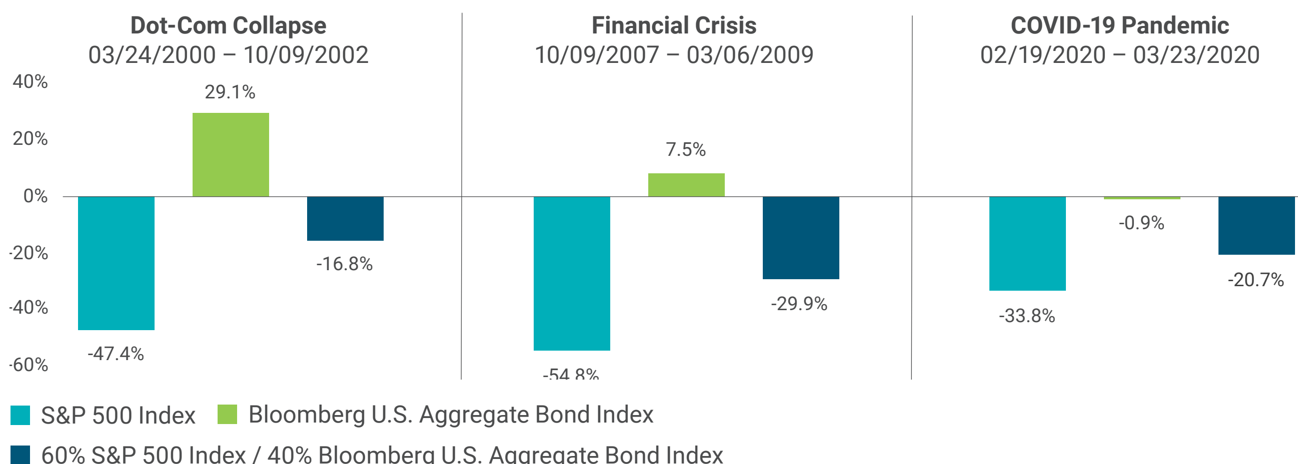
To help illustrate the lower volatility characteristics of the 60/40 portfolio, let's look at three distinct periods when the stock market experienced a significant decline: the dot-com collapse, the financial crisis, and the COVID-19 pandemic. Notice how bonds delivered positive performance in both the dot-com collapse and the financial crisis periods and only slightly negative performance in COVID-19 period. As a result, bonds helped provide valuable diversification and risk reduction benefits when incorporated into the 60/40 portfolio, helping to mitigate downside losses as compared to an all-stock portfolio.

Asset class performance during three different significant stock market declines



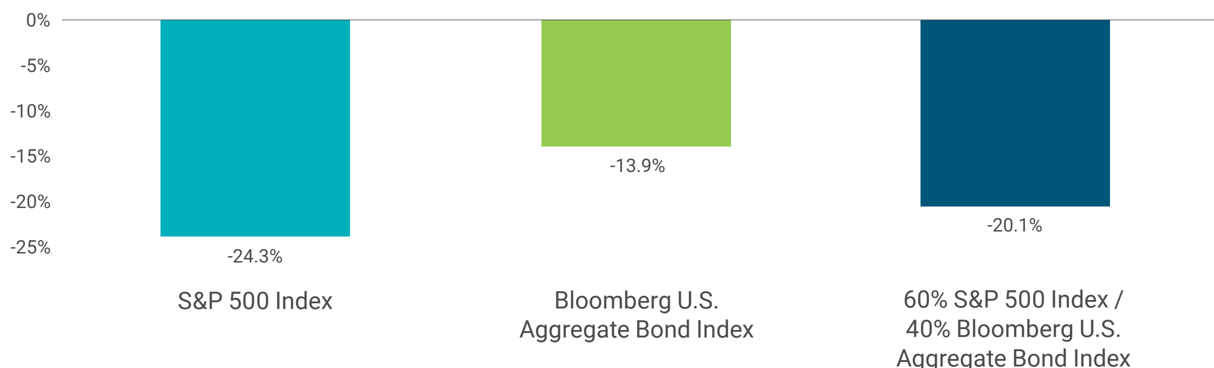
Potential challenges ahead for the 60/40 portfolio

While there is nothing inherently broken with the 60/40 portfolio, some believe this allocation mix faces several potential headwinds in the years ahead.

First, investors today must contend with what appears to be a very different set of economic and market conditions than the past three decades. Concerns around high inflation, rising interest rates, and growing recession fears have battered markets recently and caused both U.S. stocks and bonds to decline in tandem in 2022. This has put the 60/40 portfolio under considerable pressure, leaving many investors to rethink how to balance risk in their portfolio.

Year-to-date asset class performance

Daily cumulative performance (01/01/2022 – 09/30/2022)



Source 1: Bloomberg. Returns are cumulative and based on the total return of each respective index. Dot-com collapse dates were selected based on the highest S&P 500 Index close in 2000 to the lowest close in 2002. Financial crisis dates were selected based on the highest S&P 500 Index close in 2007 to the lowest close in 2009. COVID-19 pandemic dates were selected based on the highest S&P 500 Index close in 2020 to the lowest close in 2020. All returns and calculations are rounded to the nearest tenth of a percent. **Past performance is not indicative of future returns.**

Source 2: Bloomberg. Returns are cumulative and based on the total return of each respective index. All returns and calculations are rounded to the nearest tenth of a percent. **Past performance is not indicative of future returns.**

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Second, some investment strategists warn that if inflation levels remain persistent, it could lead to a higher, more positive correlation between stocks and bonds in the years ahead. This could reduce the potential diversification benefits of the stock/bond mix within a 60/40 portfolio.

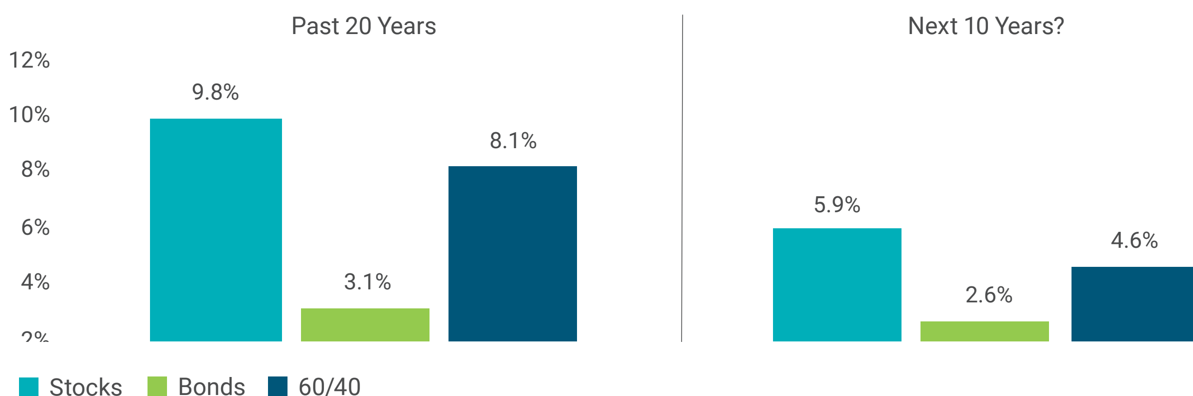
Lower expected returns may tempt investors to increase equity exposure

Another potential challenge for the 60/40 portfolio in the years ahead is the fact that many investment advisers believe that future investment returns won't be as high as they have been historically, citing various reasons such as high equity valuations, rising interest rates, and the risk of higher inflation.

For example, a 2022 survey of 40 large investment firms[1] evaluating the capital market assumptions of 10-year total average annual returns found that the average annual expected return for Large-Cap U.S. Stocks over the next decade is just 5.9%. This is much lower than the long-term historical average for this asset class over the past 20 years. In that same survey, the average annual expected return for U.S. Corporate Bonds over the next decade is just 2.6%. Again, this is much lower than the long-term historical average for this asset class over the past 20 years.

Historical past 20-year performance versus expected returns over the next decade

Historical performance as of 09/30/2022 and expected returns based on 10-year total average annual returns from surveys of 40 investment firms[1]



Based on those assumptions, a 60/40 portfolio (allocated 60% to Large-Cap U.S. Stocks and 40% to U.S. Corporate Bonds) could provide an expected average annual return of just 4.6% over the next decade. Keep in mind that these return expectations don't account for any potential additional annual operating expenses of underlying investment options and/or any annual advisory fees that many investors incur. If those were considered, it would result in an even lower return expectation. Will investors be able to meet their long-term retirement savings goals if low return expectations were to occur?

These lower expected returns may tempt some investors to increase their allocation to stocks in hopes of higher returns to meet their long-term retirement goals. For example, to achieve a 5% annualized return over the past 20 years, an investor would have only needed to allocate about 30% of their portfolio to stocks (represented by the S&P 500 Index), while the remaining about 70% could have been allocated to bonds (represented by the Bloomberg U.S. Aggregate Bond Index).

Hypothetical example for illustrative purposes only.

Sources: Past 20-year returns from Bloomberg as of 09/30/2022. Stocks represented by S&P 500 Index Total Return USD and bonds represented by Bloomberg U.S. Aggregate Bond Index Total Return USD. Returns are based on the total return of each respective index. Next 10-year expected returns from Survey of Capital Market Assumptions from Horizon Actuarial Services, LLC, published August 2022. Stocks represented by U.S. Large-Cap Equity and bonds represented by U.S. Corporate Bonds. The survey includes assumptions from 40 different investment firms. Included are average survey assumptions for expected returns over a 10-year horizon using geometric returns. The return expectations are based on indexed returns and do not reflect any fees or additional returns that may be earned due to active asset managers outperforming the market, net of investment expenses. All returns and calculations are rounded to the nearest tenth of a percent. **Past performance is not indicative of future returns.**

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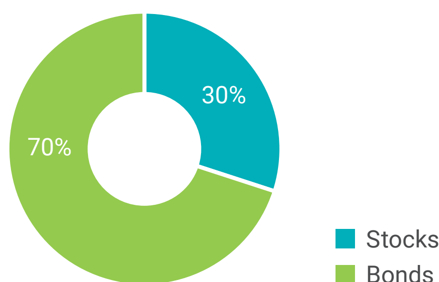
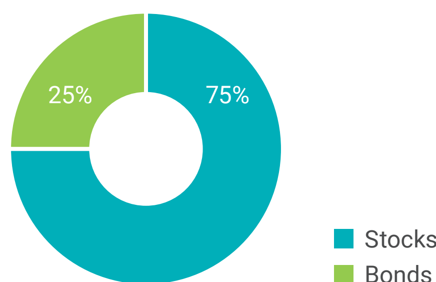
However, based on the expected returns from the survey just discussed, for an investor to meet that same 5% annual return goal over the next 10 years, it would require a portfolio with about a 75% allocation to stocks and the remaining 25% in bonds. Of course, having this high of an allocation to stocks may increase overall portfolio volatility and could leave an investor vulnerable to large losses in the event of significant market volatility. So, what can investors do?

Stock allocation needed for a 5% annual return

Past 20 years
Based on historical performance of the S&P 500 Index and Bloomberg U.S. Aggregate Bond Index through 09/30/2022



Projected next 10 years
Based on capital market assumptions of 10-year total average annual returns from surveys of 40 investment firms[1]



The potential role of certain annuities to help in portfolio diversification

We should acknowledge that sticking with a 60/40 allocation may continue to work for some investors. The 60/40 portfolio could continue to deliver solid risk-adjusted returns in the future. Bonds may remain good diversifiers for stocks, helping to mitigate the effect of volatility, even if they don't offer the same degree of diversification as they did before.

However, for investors seeking alternative diversification approaches to help balance portfolio risk, annuities could play a role. Annuities are a type of long-term financial product designed to help investors save for retirement. Certain annuities – such as fixed annuities, fixed index-linked annuities, and registered index-linked annuities – may offer different options and features like protection against market downturns or a steady stream of guaranteed income payments.

A registered index-linked annuity (RILA) typically offers upside growth potential with some protection against market downturns. For example, some RILAs let an investor participate in growth opportunities, up to a certain percentage (known as a cap rate), by tracking the performance of a market index, such as the S&P 500® Index, Russell 2000® Index, or MSCI EAFE Index.[A,B,C] However, a RILA does not directly invest in either an index or the market. At the same time, some RILAs can help limit losses by providing a level of protection (known as a buffer) if the index return is negative.

The selected buffer determines the level of protection against loss at the end of the term. The issuing insurance company provides a guarantee for any losses to the given buffer percentage. An investor experiences loss when the negative index return exceeds the buffer percentage, reducing the account value. The cap rate percentage is the maximum index return that may be received at the end of the selected term. Generally, a higher level of protection means a lower cap rate.

Hypothetical example for illustrative purposes only.

Sources: Past 20-year returns from Bloomberg as of 09/30/2022. Stocks represented by S&P 500 Index Total Return USD and bonds represented by Bloomberg U.S. Aggregate Bond Index Total Return USD. Returns are based on the total return of each respective index. Next 10-year expected returns from Survey of Capital Market Assumptions from Horizon Actuarial Services, LLC, published August 2022. Stocks represented by U.S. Large-Cap Equity and bonds represented by U.S. Corporate Bonds. The survey includes assumptions from 40 different investment firms. Included are average survey assumptions for expected returns over a 10-year horizon using geometric returns. The return expectations are based on indexed returns and do not reflect any fees or additional returns that may be earned due to active asset managers outperforming the market, net of investment expenses. All returns and calculations are rounded to the nearest tenth of a percent. **Past performance is not indicative of future returns.**

Important considerations when selecting a registered index-linked annuity

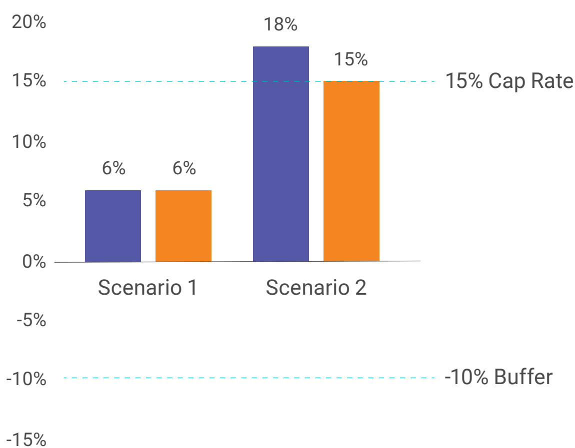
When considering a RILA, there are key terms and definitions to know:

- **Term** – An investment time horizon (e.g., 1-, 3-, or 6-year terms). The index return at the end of the term, excluding dividends and subject to the cap rate and buffer, is credited to the account at the end of the term.
- **Index** – Clients can track the performance of their selected market index or indices through which interest is earned.
- **Cap Rate** – The maximum rate that can be earned when index performance is positive at the end of the term.
- **Buffer** – The maximum amount of loss the issuing insurance company will absorb if index performance is negative at the end of the term. The investor would experience the amount of loss that exceeds the buffer.
- **Withdrawal Charge** – A percentage charge applied to withdrawals in excess of the free withdrawal amount.

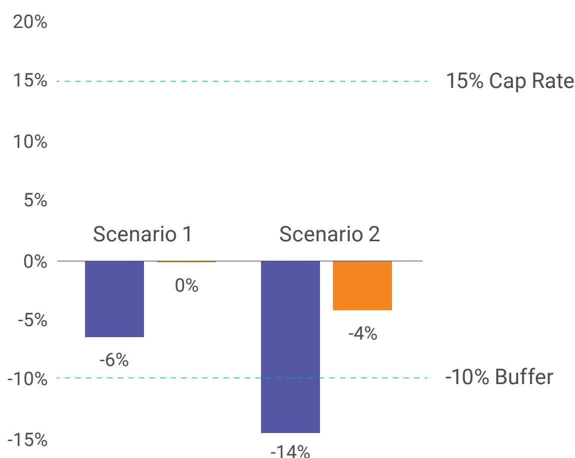
Let's look at a few hypothetical scenarios in both up and down markets to help illustrate how some RILAs work. As we discussed, a RILA offers growth opportunities during an up market. For example, suppose a client selected a 15% cap rate and the index increased by 6% at the end of the term. In this example, the account would be credited 6%. However, if the index were to increase by 18% at the end of the term, the account would only be credited 15%, which was the selected cap rate.

RILAs may also provide some protection during a down market. A buffer protects an investor from a percentage of loss. However, clients can be exposed to losses if index performance exceeds the buffer. For example, suppose a client selects a buffer of 10% and the index declines 6% at the end of the term. In this example, the account would be credited 0%. However, if the index were to decrease by 14%, the first 10% of losses would be absorbed by the insurance company and the account value would experience the remaining 4% of losses.

Growth opportunities during up markets



Level of protection during down markets



Index Return   Strategy Return

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Case study: A registered index-linked annuity in action

RILAs are designed to help long-term investors accumulate retirement savings. In addition to offering some protection and growth opportunities, this type of annuity allows investors to experience tax-deferred growth.

Let's look at a case study on how a hypothetical RILA would have performed over the past three years. In this example, there is an environment of high market volatility in which both U.S. stocks and bonds experienced both up and down periods. For this illustration, we've selected a 3-year term time horizon with 1-year annual crediting, meaning that the account is credited every year based on the performance of an index. In this example, the S&P 500 was selected as the tracking index with a cap rate of 15% and a buffer of 10%.

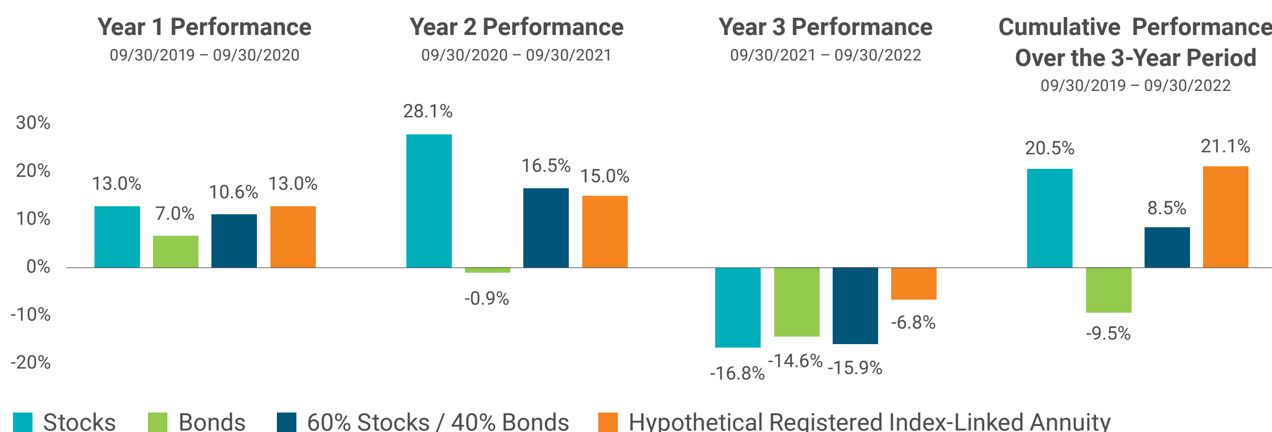
As you can see in Year 1, the S&P 500 Index returned 13% and the RILA was credited the same 13%, outperforming both U.S. bonds (represented by Bloomberg U.S. Aggregate Bond Index) and a 60/40 portfolio (represented by 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index). In Year 2, the S&P 500 Index returned 28.1% and the Bloomberg U.S. Aggregate Bond Index returned -0.9%. However, the RILA was only credited 15%, which was the maximum amount based on the 15% cap rate. While the 60/40 portfolio outperformed the RILA by 1.5%, the RILA was still credited with a significant amount (91%) of the total 60/40 return for that year. In Year 3, the S&P 500 Index declined 16.8%, but the RILA was only credited -6.8% because of the 10% buffer (16.8% minus 10%). In Year 3, the RILA outperformed the S&P 500 Index, the Bloomberg U.S. Aggregate Bond Index, and a 60/40 portfolio composed of these two asset classes.

When evaluating the performance of our hypothetical RILA over the cumulative 3-year period, we can see how it returned 21.1%. This compares favorably to the S&P 500 Index, which returned 20.5%, the Bloomberg U.S. Aggregate Bond Index, which returned -9.5% and a 60/40 portfolio, which returned 8.5%. The outperformance of the RILA over the 3-year period can be explained by its participation in up markets and its ability to limit losses in Year 3 by providing a level of protection (up to the buffer) when the index return was negative.

Of course, it's important to note how different time periods and market conditions might result in a different outcome for the RILA as compared to these other asset classes.

Hypothetical registered index-linked annuity case study

Based on the performance of the S&P 500 Index (09/30/2019 – 09/30/2022)
Assumptions: 3-year term | 1-year annual crediting | 15% cap rate | 10% buffer



Hypothetical example for illustrative purposes only.

Source: Asset class performance from Bloomberg as of 09/30/2022. Stocks represented by S&P 500 Index and bonds represented by Bloomberg U.S. Aggregate Bond Index. Stock returns are based only on the S&P 500 Index price movement and do not include the reinvestment of dividends. The 60% Stocks / 40% Bonds portfolio is represented by 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index. **Past performance is not indicative of future returns.**

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Conclusion

While the U.S. stock market tends to rise over time, there have been multiple periods when it has experienced a significant decline. During volatile periods, stock investors can experience significant losses. To help reduce volatility and overall portfolio risk, investors might include bonds in their portfolio. From a historical perspective, bonds tend to provide a source of diversification because of their low correlation to stocks. That is, they tend not to move in tandem with stocks and historically can perform relatively well during times of highly volatile markets.

However, today's environment of high inflation, rising interest rates, and growing recession risk have resulted in a period when both U.S. stocks and bonds declined simultaneously. This has caused diversification to struggle and left many investors rethinking how to balance risk in their portfolio. As a result, some investors are now considering alternative diversification strategies, such as annuities, to help meet their long-term retirement savings and income goals. One type of annuity that investors may consider is a registered index-linked annuity, which can provide a tax-deferred long-term savings option and the opportunity for growth while limiting exposure to downside risk.

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[1] The survey comprises assumptions from 40 different investment firms, including average survey assumptions for expected returns over a 10-year horizon using geometric returns. The return expectations are based on indexed returns and do not reflect any fees or additional returns that may be earned due to active asset managers outperforming the market, net of investment expenses. This survey is not intended to be a substitute for the expectations of individual portfolio managers, financial professionals, or actuaries performing their own independent analyses. Survey of Capital Market Assumptions. Horizon Actuarial Services, LLC, 2022.

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Withdrawals of taxable amounts are subject to ordinary income tax. Withdrawals made before age 59½ may also be subject to a 10% federal income tax penalty. Distributions of taxable amounts from a non-qualified annuity may also be subject to the 3.8% Net Investment Income Tax that is generally imposed on interest, dividends, and annuity income if the modified adjusted gross income exceeds the applicable threshold amount. Withdrawals will reduce the death benefit and account value. Withdrawals may be subject to withdrawal charges.

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