THE RISK PREMIUM CHALLENGE

FINDING SOLUTIONS THAT FIT TODAY'S ECONOMIC CLIMATE

Helping your clients manage risk is a core part of helping them prepare for a successful retirement. Common strategies include asset allocation, diversification, dollar cost-averaging and many more. But whatever strategies the consumer utilizes, risk management is critical to keeping hard-earned savings protected and losses to a minimum.

And remember - as losses get larger, the return that's necessary just to get back to where you were also increases. It takes an 11% gain to recover from a 10% loss. But it takes a 100% gain to recover from a 50% loss. That makes playing defense every bit as important as playing offense.

HOW RISK PREMIUM WORKS

One key concept you should incorporate into client discussions is Risk Premium, and in particular, what Risk-Free Premium they require of their investments.

The risk premium is the investment return an asset is expected to yield in excess of the "risk-free" rate of return. The risk-free rate of return is theoretically the rate of return of an investment with zero risk – essentially the interest a client would expect from an absolutely "risk-free" investment over a specified period.

Realistically, a truly risk-free rate does not exist because even the most conservative financial vehicles carry at least some risk, whether it's market risk, interest rate risk, inflation risk, or other such considerations. For this reason, the interest rate on a three-month U.S. Treasury bill (T-bill) is often used as the risk-free rate for U.S.-based clients. We often consider the risk premium to the potential reward a client hopes to receive in exchange for taking risk, similar to the risk/reward concept of investing in high-risk investment products.

To better serve your clients' best interests, it's advisable to evaluate how much risk premium they demand. One crucial question to discuss with clients is how much anticipated return would they require above the risk-free rate in an investment?

UNDER THE RISK-RETURN TRADE OFF: THE MORE RISK AN INVESTOR IS WILLING TO ACCEPT, THE MORE RETURN THEY ARE GOING TO EXPECT.

HOW THE CAPE RATIO AND EXPECTED RETURNS AFFECT RISK PREMIUM

To begin the Risk Premium discussion, you need to first understand the current market and forecast for the future. While no one can predict the future performance of the markets or any particular investment type or category, we can review information available to us such as historical data, back-testing and analysis presented by industry experts to help guide our investing and retirement strategies.

One such concept to consider is the CAPE Ratio, also known as the Shiller P/E ratio. Developed by American Economist, Robert B. Schiller, it's a valuation metric that measures a stock's price relative to the company's earnings per share (EPS) over an extended time period. EPS is a company's profit divided by the outstanding equity shares. The CAPE ratio is similar to the price-to-earnings ratio and is used to determine whether a stock is over-or under-valued.

The CAPE Ratio is used by Schiller to develop his investment forecast for the coming decade. According to the ratio, when the CAPE ratio of the market is high, it suggests that stocks are overvalued, and returns over the next 20 years are expected to be relatively low. In contrast, whenever the ratio is low, it means the stocks are undervalued, and returns over the next 20 years could instead be good. The CAPE Ratio climbed to 38 in late 2021, the third highest on record, and currently sits at around 27.6.

While we aren't attempting to predict true market performance here and no one knows what the future holds, the data suggests that it may not be prudent to expect more than a 6% return in the equity returns over the next 5-10 years. Setting higher expectations with clients could be a recipe for disappointment – and potentially jeopardize their financial security.

ACCORDING TO SHILLER, HIS 10-YEAR ANNUALIZED NOMINAL FORECAST USING THE CAPE RATIO HAS AN EXPECTED RETURN OF 6% FOR THE UNITED STATES.

APPLYING RISK FREE PREMIUM

Once you have determined a reasonable expected future return, it's time to select the financial tools that can offer your clients a better chance of reaching their retirement goals while minimizing their risk. Ask yourself how much risk you recommend they take in exchange for a potential 6% return. Does it make sense to allocate a significant portion of their assets earmarked for retirement income in an investment that could drop by 30-40% if the expected return is 6%?

USING A MYGA TO REDUCE RISK

It's in economic climates such as we're experiencing now that it might make more sense to consider the Multi-Year Guaranteed Annuity (MYGA) as a possible solution. With average guaranteed interest rates currently hovering just at or below 5%, a MYGA can provide your clients with competitive interest without uncertainty and no risk of market loss.

The MYGA is a type of fixed annuity that offers a guaranteed fixed interest rate for a certain period. MYGAs typically offer higher interest rates than Bank CDs and the client can choose the length of the interest rate guarantee, which usually ranges from 3-10 years. At the end of the interest rate period, clients can surrender the annuity without penalty or renew it at a new interest rate offered by the insurer, based in part on current market conditions. In addition, the interest credited isn't taxed each year. Rather, the money is taxed only when withdrawn, allowing the funds to accumulate more quickly than a taxable investment.

And like all fixed annuities, your clients' funds are guaranteed not to lose value due to market loss. They typically have access to a portion of their money penalty-free each year and may also convert the annuity into a guaranteed lifetime income stream if they choose.

This combination of benefits and the current interest rates offered might make MYGA a powerful solution to help your clients save for retirement while reducing their investment risk.

WANT TO LEARN MORE ABOUT RISK FREE PREMIUM AND MYGAs?

CALL 781-919-2337 OR CLICK TO SCHEDULE A MEETING

Annuities are long-term insurance products designed for retirement income and may not be suitable for everyone. They involve fees and charges, including possible surrender penalties for early withdrawal. Annuity withdrawals are subject to ordinary income taxes, and if taken before age 59-1/2, may incur a 10% federal penalty. Annuity product and feature availability may vary by state. Annuities are not FDIC-insured. All guarantees are backed by the financial strength and claims-paying ability of the issuing company. Investing in securities involves risk, including possible loss of principal. No investment can protect against financial losses or guarantee a profit. Past performance may not be used to predict or project future investment results.

The Schiller P/E (CAPE) Ratio: Any past or simulated past performance including back-testing, modeling or scenario analysis contained herein is no indication as to future performance. No representation is made as to the accuracy of the assumptions made within, or completeness of, any modeling, scenario analysis or back-testing. The forecast of any return may also fluctuate as a result of market changes. It is not intended to be a forecast of future events, a guarantee of future results or investment advice with respect to any securities or other investment products. Professor Shiller is Sterling Professor of Economics at Yale University and Fellow at the International Center for Finance, Yale School of Management