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Concerned about market volatility? Here's one way to protect your retirement savings.

Now that we've entered a bear market for the first time since 2009, many pre-retirees are likely asking questions about the impact on their retirement savings. Will the stock market sell-off wipe out years of growth in their 401(k)s? Are there any steps that can be taken to protect savings and investments against future volatility?

These are important considerations. While the recent stock market sell-off is a reaction to concerns around COVID-19, an unprecedented global event, it's a sobering reminder that volatility can strike at any time. And while the general idea of a financial vehicle like a 401(k) is to play the long game and hold investments through market highs and lows, it's still important to protect your retirement portfolio against those lows.

Building a portfolio with principal protection

Fortunately, pre-retirees can work with financial professionals to diversify their portfolio in a way that distributes risk and prepares their retirement savings for growth in a variety of economic environments. It's even possible to build in some principal protection with the inclusion of Fixed Indexed Annuities (FIAs).

FIAs are insurance products that can guarantee income to contract holders over a period of time — even over a lifetime. Unlike a 401(k), the insurance company absorbs the risk of market downturns, guaranteeing a minimum floor, and protecting contract holders from market losses.

In other words, an FIA offers the potential for interest based in part on the performance of an external index without the risk of market loss. Your principal amount is guaranteed, subject to any withdrawals you take or any surrender charges incurred due to early termination of the contract. Any growth in annuities is tax-deferred and most compound annually, meaning gains are locked in and added to your principal, with future interest earned on that compounded amount.

That means, for example, if an FIA purchased in the amount of $100,000 were to earn 3% in its first year, the insurance company would consider $103,000 to be the new “floor,” guaranteeing this amount from market loss. The same process occurs annually through the end of the FIA contract.

Risk, reward and inflation

As with every investment or retirement product purchase, there are benefits and costs. With FIAs, insurance companies are absorbing all of the market risk. FIAs typically include an interest rate floor and an interest rate cap on the percent of interest credited in a given year. In some cases, FIAs do not have an interest rate cap, but that doesn’t mean they have unlimited interest. Insurance companies use models that factor in participation rates, spreads, margins or other measures to determine creditable interest.

And, although FIAs guarantee lifetime income, inflation has the power to diminish the purchasing power of that income. It is therefore recommended that purchasers work with a financial professional who can help contract holders understand their target income for retirement, and how to build a balanced strategy with enough growth potential to account for inflation.

Looking ahead

While the circumstances of the latest market decline are unusual, market volatility is something pre-retirees will likely continue to experience as they save for retirement. Don’t panic. Take this opportunity to evaluate how much you will need to save with IALC’s retirement calculator, and talk to your financial professional about whether an FIA might be right for you.

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