ADVANTAGE
COMPENDIUM

Produced for Annuity Marketing Services Summer 2014

Fixed Index Annuities: The Reality Of Uncapped Methods

Managed volatility indices used in conjunction with fixed index annuities are legitimate new approaches that attempt to produce competitive fixed index annuity (FIA) interest crediting in a low interest rate environment. Based on my modeling and analysis these new methods, as presented, offer a realistic and competitive addition to existing crediting methods; the theory behind them is sound. However, because they are new there appears to some confusion over the reality of how they work and their potential. This is not intended to be comprehensive, but simply highlight a few of these realities.

Little To No Track Record

For the most part these uncapped managed volatility indices have been around less than two years. They were essentially reverse engineered by looking at what happened in recent history and then created as a reaction to this history. There is a line stated in every investment prospectus saying that past performance does not predict future results. These uncapped indices do not even predict past performance because even the past is hypothetical.

Limited Hedge Partners

Fixed index annuities base interest crediting on the movements of an external index. Insurance carriers transfer much of this exposure to a third party through hedging, often by purchasing call options on the index. In established indices there are multiple third parties that make a market in providing hedges. These hedge providers compete on price – the lowest hedge price wins because it offers the highest interest earning potential for the annuity owner. Going forward, there is no assurance that the new uncapped indices will have the same competitive pricing environment for hedging and the availability of multiple sellers competing on price.

From a return pricing perspective every index annuity crediting method is priced to perform the same over time

Unrealistic Expectations

The effective role of the hedge provider is keeping the playing field level. What this means is whether the underlying index is managed or unmanaged, or whether the methodology used has a cap or a spread or manages volatility that the potential payout risk to the hedge provider is the same based on the hedge purchased – in other words, from a hedging cost perspective every index annuity crediting method is priced to perform the same over time; the hedge provider always tries to ensure that the risk of the expected outlay (return paid to the annuity carrier for the index annuity) is equal to the money received.

To put this into financial terms, if an annuity carrier spends $3 to buy a hedge the hedge provider is hoping to ultimately return less than $3. If a particular hedge exposes the hedge provider to greater liability they will demand a higher price or dilute the risk of paying a higher potential return. In the past, averaging has mainly been used to accomplish this. A newer way of doing this is by managing volatility whereby funds are transferred away when a certain volatility ceiling is reached in one asset segment to another asset segment with lower volatility – this has been referred to as dampening rising market performance.

This does not mean that an uncapped fixed index annuity crediting method will never pay more than a capped one. In any given year an uncapped strategy has the potential to produce more interest than a capped one. However, over time, competitive pricing on hedging these different methods should produce similar returns over time.

A Potential For Abuse

The fixed annuity industry got into trouble a decade ago for a message that was perceived as saying "get all of the stock market upside without a downside", which was not how fixed index annuities worked. Today, I'm hearing managed volatility methods sometimes being explained as "all of the index upside less a spread" or stressing the "uncapped" nature of the design. Both claims are clinically accurate, but what does the potential annuity buyer think is being said?

The concern is not with the proprietary indices *per se*. All indices make changes from time to time in the composition of their index and, since inception, carriers have allowed, and sometimes encouraged, annuityowners to periodically rebalance their annuity policy index choices (or done it for them). The concern is possible misrepresentation of potential index annuity performance. These are new indices and new concepts. If the potential annuity buyer's reference point for index gains is the financial news and it's the end of 2009, they may feel cheated, even with 7% or 10% interest earned, when all the indices on the news are reported to be up 18% to 44%. Or if it’s 2004 they may wonder why they earned 3.6% with an "uncapped" method when the S&P 500 was up 9% and corporate bonds returned 8.7%.

If your goal is "uncapped returns" don't buy a fixed index annuity

Stressing that the return method is uncapped focuses attention on the wrong benefit. The primary benefit of an FIA is that it protects the premium, credited interest and lifetime income from stock market losses. If the primary objective is high returns the consumer should not buy a fixed index annuity. In strong rising stock markets fixed annuities should under-perform investments due to the cost of providing these protections and guarantees.

These Are Creative Methods

Managed volatility methods are a creative way to provide more value to the consumer in the current low interest rate environment by effectively raising index participation. The concept is valid. The main potential problem is of unrealistic expectations of the interest that may be earned causing annuityowners to benchmark the potential interest earned against the stock market and not other fixed annuities.