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Better than Throwing Darts

By Kerry Pechter *Thu, Jun 25, 2020*

'We have all these insurance agents selling billions of dollars of fixed indexed annuities. But they have few clues about how the crediting rates have performed,'' says Kent Jacquay. With his Indexalyzer software, he proposes a solution.

When Kent Jacquay, a 47-year-old former insurance producer with a knack for computer programming, speaks to groups of insurance agents about selling fixed indexed annuities (FIAs) his favorite prop is a dartboard—a metaphor for how they tend to pick contracts for clients.

To improve their methodology, Jacquay set up a software company in Fort Wayne, Indiana in 2018 called Index Resource Center LLC. His anchor product is **Indexalyzer**, a Excel-based tool for sorting, filtering and comparing fixed indexed annuity (FIA) contracts.

Jacquay has been acquainted with FIAs since 1996, when the products were new and only insurance agents sold them. He believes FIAs can uniquely enhance the financial lives of American retirees by giving them a chance for higher returns than fixed-rate products but with equal protection from loss.

“The FIA was designed to beat MYGAs (multi-year guaranteed rate annuities), bonds, and certificates of deposit—anything that’s guaranteed not to lose money,” he told *RIJ*. “And it does its job really well.”

But FIA insurance marketing organizations (IMOs) and agents who sell FIAs don’t do an equally good job of explaining—or even understanding—the growth mechanisms that drive the products, he says. And when it comes to navigating the bewildering array of “crediting” strategies and indices that determine a contract’s likely returns, they don’t know much more than their clients.

“We have all these agents selling billions of dollars of these products. But they have few clues about how the crediting rates have performed,” Jacquay said. “If I look at the crediting choices and try to choose where to put my money, how do I know what to do? Do I choose a two percent monthly cap on the S&P 500 Index, or a 120% participation rate on the Barclays Focus 50? Nobody knows.”

Lots of tools are advertised on the Internet that claim to help insurance agents and financial advisers select the “best” FIA. “There are a million different software vendors trying to sell their wares to marketing organizations,” said Sheryl Moore, CEO of Wink, Inc., the annuity data and analysis firm, noting that there’s little or no regulation of them.

But that is changing. Many broker-dealers (who are more closely regulated than insurance agents) now sell FIAs. At the same time, the Securities & Exchange Commission’s “Reg BI” (Regulation Best Interest) is about to require brokers to be more ethical. Demand should grow for tools like Indexalyzer that can document an adviser’s due diligence regarding product recommendations. The tools themselves are likely to come under greater scrutiny as well.

How Indexalyzer works

Via GoToMeeting, Jacquay guided me on a virtual tour of Indexalyzer this week. He demonstrated its sorting and comparison functions. The number of variables is immense, and the number of potential combinations of those variables must run into the millions.

Options to consider include the insurance carrier, the strength rating of the carrier, and the various products each carrier offers. Within each product, there are multiple term lengths, multiple indices, and a host of triggers, caps, spreads, fees and participation rates that affect returns (and reflect the structure of the underlying call options). Some products offer lifetime income options and/or bonuses.

(A “cap” means that the client is credited with interest equal to the index gain up to a cap. A “participation rate” indicates the percentage of the index gain that the client’s account will receive.)

Jacquay proudly pointed out Indexalyzer’s ability to back-test the performance of a specific crediting strategy. He showed me the annual returns of a specific strategy using a specific index. He knows that past returns don’t predict future returns, but he thinks they allow for rankings that reveal the strongest contracts. (Mutual funds use past returns in their marketing, of course.)

“We take the past ten years’ movement of the indices, to the month, to see how the products performed. We apply every bonus and every fee that would affect the average 10-year compound rate of return. Updating the indices every month is crucial. Most of the others do it once a year. We update rates from carriers every day. Indexalyzer shows how each crediting method and index performed over the past 10 years.

"We don't try to predict the future," he added. "We're just looking at the most recent ten years. We don't say, 'You can expect a certain percent return out of this product.' We're showing exactly what happened in a real market cycle, for all the different crediting options. We help the client and agent make a more informed decision about seven or eight or ten options, to see which performed well and which didn't."

(His back-tests showed that some contracts averaged returns of 8% or more over the past ten years, but that shouldn't be surprising. The S&P 500 Index rose three-fold over a recent 10-year period, to 3,335 on Feb. 5, 2020 from 1,066 on February 5, 2010.)

For investors, a perplexing and even deal-breaking aspect of FIAs is that carriers can, after the first crediting term, change their caps or participation rates in response to changing investment conditions, such as interest rates or volatility levels. The minimums are published in the contracts, Jacquay said, but they do not commonly appear among the specs on product rate sheets.

(These are not the minimum non-forfeiture interest rates paid by issuers of fixed annuities and required by state insurance laws. They are the lowest rates that the issuer can use without re-filing the contract for approval by regulators.)

"You have this one variable that can't be predicted, and that's the carriers' ability to change the rates after the first year," he told *RIJ*. "You might see statements from the carriers about their past renewal records, but you don't know what will happen in the future. The insurance companies always have a card they can play: they can take the performance down to the minimum."

Jacquay can't predict such reductions, but can model hypothetical reductions in the rates, to stress-test a crediting rate. Such reductions don't necessarily destroy the contract value, he said. "The agents and IMOs get furious when a carrier lowers its rates. But I say, Let's look at what that really does to the final return. We can adjust the rates in Indexalyzer to the minimum to see how it performs. The product may still be doing its job in outperforming guaranteed fixed rate products. I'd like to own a product that does its job [of outperforming fixed-rate products] even at the minimum."

Takeways

Of course, no one can predict the returns of an FIA, just as no one can predict the returns of a risky security. But an FIA's caps and participation rates are so suggestive of future returns that it's difficult not to be enticed by them. For instance, some contracts offer participation rates of more than 100%, while other have no caps on returns.

But there must be rules of thumb that agents can use when for comparing FIAs, right? Here are some takeaways from my conservation with Jacquay:

- Consider term length first. Does the client have the desire or ability to park the money in an investment for one year? Three years? Ten years?
- Will the client use the product to generate retirement income? Contracts that are designed for income may not be optimal for accumulation and vice-versa.
- The client’s risk tolerance is an important consideration. Would he or she buy from a company with a B++ credit rating if the payouts were potentially higher, or only from an A rated company? This decision may depend in part on the term length.
- The month-to-month crediting strategy, which may appear to have tremendous potential, has consistently produced low returns in the recent market cycles.
- The crediting strategy (caps, participation rates) is a more important consideration than the index. An uncapped strategy (100% participation) is more advantageous when equity markets are rising. In flat markets, a capped strategy may be more advantageous than a participation rate.
- When choosing an index, most agents recommend and most clients adopt the S&P 500 Index. But Jacquay suggests that other indices, with higher risk profiles, may be more suitable for less risk-averse clients. Differences in indices, however, may be rendered moot by offsetting differences in crediting rates.

Bottom line: Don’t expect fixed indexed annuities to produce equity-like returns. Their advantage stems from their ability to outperform other products with no-loss guarantees, such as fixed rate annuities and certificates of deposits.