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# Complex Annuities for a Complex Era

By Kerry Pechter *Thu, Jun 1, 2017*

*Indexed variable annuities (IVAs) offer a potential solution for paralyzed clients—perhaps for those who feel baffled by a market where both bond and stock prices are at all-time highs. Allianz Life and Brighthouse Financial have just issued new IVA contracts.*

When sophisticated investors hold long positions in equities but worry about market volatility, they can create "collars" with out-of-the-money puts and calls. The options establish a floor under potential losses on the investment and a ceiling on potential gains.

Indexed variable annuities are packaged products that give investors a similar way to hedge their bets. These accumulation-oriented products, available since 2011, offer more upside (but less protection) than indexed annuities and more protection (but less upside) than variable annuities.

How do they differ from ordinary fixed indexed annuities? In the conventional FIA, most of the premium is invested in bonds, with the rest used to buy options on an equity index. If the index goes up over a certain designated term, the options appreciate and the gains are credited to the accounts, up to a cap. There's no risk of loss, aside from fees.

With an indexed variable annuity, you get a similar division of the principal between bonds and options. But the caps on gains are higher because the investor accepts some downside risk. Typically, in a down market, the issuer assumes the first, say, 10 points of loss and the investor accepts losses beyond that point.

Despite the conceptual complexity, Allianz Life, AXA, MetLife, and CUNA Mutual have all been selling IVAs, with increasing success. AXA's IVA sales were $2.62 billion in 2016, up from $1.45 billion in 2015. Allianz Life's IVA sales more than doubled in 2016, to $1.31 billion from $611 million the year before.

In May, both Allianz and Brighthouse (MetLife's retail spinoff) announced new versions of their IVAs. Hoping to appeal to fee-based advisors, Allianz Life issued Index Advantage ADV, which doesn't pay a commission. To appeal to commission-based advisors who want lower fees, and are willing to accept lower caps in exchange, Allianz Life issued the NF version of the same product. Brighthouse Life, meanwhile, announced the Shield 10, an extension of MetLife's Shield series of "index-linked separate account annuities," which are registered indexed annuities, not variable annuities.

These types of products offer a kaleidoscope of indexes and crediting strategies that might baffle a newcomer to indexed products. Both the Index Advantage ADV and NF and Brighthouse's Shield 10 include trigger options whereby the investor receives a pre-set return if the index is flat or up. Index Advantage ADV and NF offer only year-to-year crediting terms, four indices and a $10,000 minimum initial premium. Shield 10 offers year-to-year crediting periods, three indices, and has a $25,000 minimum premium.

Do these products offer too many choices? Yes and no. To the frustration of annuity manufacturers, advisors are famous for loving product flexibility but hating product complexity. IVAs (except for CUNA's) introduce a twist that some people have trouble getting their heads around: Downside "buffers" that protect the client from, say, the first 10 percentage points of annual loss but leaving the so-called tail risk to the client.

If you revel in choice, if your client is looking for a middle path between indexed and variable annuities, and if you're not afraid to sell a product that has only a very short performance history, an IVA might be the solution. As for income generation, these are accumulation products. Their obligatory annuitization options, like that perfunctory black doughnut in the trunk of your car, will probably see little use.

**Index Advantage NF**

Responding to broker-dealer input, Allianz Life decided to bring out a version of its four-year-old Index Advantage contract for fee-sensitive clients. This commission-based, called Index Advantage NF, offers the same index allocation choices as the original but without the product fee. Both the new NF version and the original contain two sleeves.

First, there's a non-indexed investment sleeve where investors can put money in mutual funds. The sleeve offers three investment options: a Growth Index, Moderate Index and a Government Money Market fund. In the NF version of Index Advantage, there's a 1.25% mortality and expense risk fee on the money in this sleeve. In both versions, the fund fees range from 65 to 73 basis points.

But the mutual funds are not the main attraction here. Most clients will be interested in the indirect exposure to equities through the index options. The investor can choose to have his money track the S&P 500, Russell 2000 Small-Cap, Nasdaq-100 and EURO STOXX 50).

If that seems like a lot of choices, there's more. The product currently offers three crediting strategies, with different caps for different indices and higher caps for the   version than for the NF version.

**Protection.** As long as the index is flat or up over each one-year term, the investor receives a credited return of 3.75% for the original version and 1.5% for the NF version—no matter what the actual index gain may be. If the index is down, the investor loses nothing (other than the fees deducted quarterly from the contract).

**Performance.** The caps under this crediting method for the original version are 11.75% for money linked to the S&P 500 Index, 11% for the Nasdaq-100 Index and 15.75% for the Russell 2000 and EURO STOXX 50 Indexes. The caps for the NF version are 7.25% for the S&P 500 and Nasdaq-100 Indexes and 10.75% for the Russell 2000 and EURO STOXX 500 Indexes. The issuer absorbs the first 10% of losses in down years.

**Guard.** The caps under this crediting strategy for the original version are 11.5% for the S&P 500 Index, 10.75% for the Nasdaq-100 Index, and 12.25% each for the Russell 2000 and EURO STOXX 50 Indexes. The caps for the NF version are 7.25% for the S&P 500, 7% for the Nasdaq-100 Indexes, and 8.5% for the Russell 2000 and EURO STOXX 500 Indexes. But, instead of a buffer, this product provides a floor. The investor absorbs the first 10% in losses in down years. Allianz Life covers the downside beyond that.

**Index Advantage ADV**

The Index Advantage ADV is a contract has a six-year surrender period and the same cap rates as the original commission-based Index Advantage but with a first-year surrender charge of 6.5% and an annual

product fee of 25 basis points. It has the same cap rates as the commission-based version, but not the 1.25% annual fee by which the insurer recovers the commission. The advisor charges his own management fee instead.
"This category is booming because of the need to get dollars off the sideline and out of cash," said Matt Gray, senior vice president of product innovation at Allianz Life. The Index Advantage series has a return of premium death benefit, and a performance lock feature. If you're satisfied with your account value at mid-year, you lock it in for the rest of the year. "These differentiators and the market need have been the drivers of our sales," he told RIJ.

**Shield 10 from Brighthouse Life**

MetLife is in the process of spinning off its annuity business over to Brighthouse Life. On March 6, certain MetLife annuity and life products were rebranded as Brighthouse Financial products, including the Shield Level Selector annuities and the variable annuities with FlexChoice. The Shield 10 was the first new product to be born under the Brighthouse brand.

As its name suggests, the Shield 10 offers a 10% downside. (Other Shield contracts offer different levels of protection.) There are three available indexes: the S&P 500, the Russell 2000 Small Cap, and the MSCI EAFE Index, which offers exposure to equities in Europe, Australasia and the Far East.

While Allianz Life's Index Advantage offers only one-year crediting methods, Shield 10 nominally offers three term lengths (1, 3 and 6 years). (The calculator on the Shield 10 web page allows only the one-year term option and the website lists only one-year rates, however). The minimum investment is $25,000. The six-year surrender period has a first-year charge of 7%.

**Step Rate.** Shield 10's "Step Rate" option corresponds to the Index Advantage's Precision option. If the index is flat or positive over a contract year, the Shield 10 pays 7.5% (on the S&P 500 Index), 7.9% (on the MSCI EAFE Index) or 9.4% (on the Russell 2000 Index). Brighthouse absorbs the first 10 percentage points of loss.

**Maximum Growth Opportunity.** This option corresponds to the Index Advantage's Performance option. As with the Step Rate option, Brighthouse absorbs the first 10 percentage points of loss. But the caps are higher here: 10% (on the S&P 500 Index), 10.5% (on the MSCI EAFE Index) or 12.5% (on the Russell 2000 Index).

Brighthouse Financial has chosen Wells Fargo to distribute this product, despite Wells Fargo's well-publicized problems, with the abrupt resignation of its CEO amid a mis-selling scandal and significant federal fines in recent years. When questioned about the choice of distributor, a Brighthouse spokesman said, "Wells Fargo Advisors is a key distributor for several Brighthouse Financial products and we are excited to be working with them to bring to market Shield Level 10."

**Criticism of IVAs**

Outside observers at the SEC and at one consulting firm have in the past been skeptical of IVAs. The SEC has publicly questioned the logic of saddling the client with the extreme end of the downside risk. A consulting firm, writing in 2013, determined that it would be difficult for an advisor or investor to assess the comparative value of various IVA options.

“This class of variable annuity is a markedly different type of investment than traditional variable annuities, and requires a much more sophisticated analysis of the product parameters, especially the tradeoff between capped upside potential and buffered downside losses,” wrote analysts at the Securities Litigation Consulting Group in Washington, DC, four years ago.

“To many investors, the term annuity suggests stability, low risk, and guaranteed income. While spVAs [structured variable annuities] still bear this title, their crediting formulas are highly complex and the resulting account accumulation may be very different than what investors expect.

“Due to this complexity, it will like prove difficult for investors to compare spVAs to each other or to traditional variable annuities, which allow an investor to select the degree of equity exposure desired, rather than allowing the risk and return of his or her investment to be determined by the issuer of the product.”

Even an advisor familiar with annuities might find choosing among the many options as difficult (and ultimately as arbitrary) as choosing where to place chips on a craps table. An advisor who is accustomed to dealing with market risk primarily through asset allocation and Modern Portfolio Theory might not feel comfortable with IVAs or indexed products generally

On the one hand, index-linked insurance products offer solutions for paralyzed clients—perhaps for those who feel baffled by a market where both bond and stock prices are at all-time highs. On the other hand, the multitude of options in structured variable products can itself be paralyzing. If annuities are a puzzle, indexed annuities are a puzzle within a puzzle and IVAs even more so.