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## In Defense of 'Buffered' Annuities

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By Kerry Pechter      Thu, Dec 12, 2019

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*A Wall Street Journal's article last weekend ('An Imperfect Solution to a Calamity') could have put structured variable annuities (aka registered index-linked annuities) in a much more positive light.*

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As the annuity industry celebrated record sales of structured, or “buffered,” index annuities last week (\$12.5 billion in the first three-quarters of 2019, according to the LIMRA Secure Retirement Institute), the *Wall Street Journal* published a tepid review about the whole category of registered index-linked annuities.

The December 6 article, which called structured annuities “An Imperfect Solution to a Calamity,” was, like the low interest rate environment of the past decade, a bit unfair to annuity issuers. The two are related. (On the web, the [article](#) was titled, “What Nervous Investors are Buying to Feel Brave”.)

By reducing the fed funds rate to nearly zero in the Great Financial Crisis, the Fed pinched the annuity industry’s oxygen hose. That decision made sense at the time. Low rates helped support the prices of existing bonds, flooded banks with liquidity, and financed a stock market rebound.

But it occurred just as the market for guaranteed income products was blossoming and it greatly reduced the yields that life insurers use to make the benefits of those products attractive to retirees and near-retirees. In 2009, I asked the largest writer of single premium income annuities how long he thought the life insurers could endure such conditions. “Five years,” he said.

Don’t get me wrong. A rising stock market and easy credit helps the entire economy. And life insurers have found ways to survive the interest-rate drought. They’ve invested in BBB bonds and mortgage-backed securities. More to the point, they’ve relied increasingly on products that get their juice indirectly from the equities markets. As variable annuity subaccounts have grown (to \$1.95 trillion), they’ve generated more asset-based fees. As stock indices have risen, index-linked annuities have enjoyed rising sales.

But this strategy plays to the strengths of asset managers, not to the strengths of annuity

issuers. It also encourages journalists to frame annuities as over-priced investments or as inadequate protection. Which brings us back to the *Journal's* article.

The column begins, "One of Wall Street's hottest investments lets you participate in most of the gains on stocks while sidestepping some of the losses." From this statement on, structured products are at a disadvantage.

First, Wall Street may create the structured annuity's derivative strategies, but index-linked annuities are more likely to come from Des Moines, Minneapolis, Cincinnati, Philadelphia and Columbus. Second, structured annuities aren't investments. They're insurance products. Investments convey risk to people. Insurance products transfer risk to insurance companies. It's burritos and hoagies. No comparison.

Third, the article says that structured annuities "encourage gun-shy investors to keep some money in the stock market." Owners of structured annuities don't have money in the stock market. They buy options on equity indices, and the options expire at the end of each term.

Further down in the story, we arrive at a more vital issue. Zweig notices something strange about the downside "buffer" that so many structured annuities offer. He's right. It's counter-intuitive. When this product type was first introduced eight years ago, the SEC, too, thought it strange (before approving it). In a structured annuity with a buffer (as opposed to a "floor"), the insurance company absorbs the initial 10% or 20% of losses while the contract owner absorbs the net loss beyond that. Yes, it exposes the *owner*, not the life insurer, to the tail risk.

This dour, man-bites-dog observation drives the headline of the story. (It also inspired the illustration that accompanies the story: A large man, standing waist-deep in the ocean, is wearing an inadequate, child-size life vest while a version of "The Great Wave" looms behind him.) The implied lesson for *Journal* readers is that structured annuities are the worst of both worlds—weak growth potential and weak protection—rather than the best of both worlds, as annuity issuers try hard to frame them.

But the article should have explained that there are versions of these products that offer "floors," which resemble traditional insurance deductibles. A floor stops a contract owner's losses at five, 10 or 20 percent. It might also have mentioned the reason why life insurers sell more buffered structured annuities than floor versions. (I could not find data on sales of the two.)

A buffer is cheaper to buy than a floor, which means that buffered annuities can afford

higher caps than floor annuities. Investors like higher caps. The last time I compared the caps on floor-based structured annuities with the caps on buffer-based structured annuities, the buffer caps were about 2.5 percentage points higher for each of the indices.

There's other contextual information that the article might have provided. It might have compared structured annuities favorably with structured notes, their after-tax, non-insurance, derivative-driven cousins. It might have mentioned that structured annuities offer much more upside potential than fixed indexed annuities, which promise zero loss of principal if held to term.

The *Journal* article closed with an aside that we in the annuity industry hear a lot. "Insurance companies and financial advisers make a lot of money selling these products," it said. Yes, they make money. That's why they're in business. But they surely don't make as much as the equity industry has made over the last decade, thanks largely to the same low interest rate environment that makes life tough for annuities.

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