# In Search of a Safer Bet

By Editor Test *Tue, Jul 19, 2011*

*Asset transfer programs and managed risk funds are playing a significant role in revitalizing the VA industry, and their benefits may ultimately reach the wider world of investing, writes this close follower of the annuity business.*

Not long ago, the business of following VA trends had everything to do with tracking roll-up rates and other living benefit enhancements. The so-called arms race saw insurers ratcheting up their benefits during a period of relatively low volatility and decent interest rates. However, the financial crisis has changed all this—for the better—and trend watching has become a much different sport.

For one thing, insurers are more likely to mind their own business, or at least view their competitors with a more curious than avaricious eye. Many have willfully stepped back from VAs, reducing inflows and restricting sales to less-rich products that sit comfortably within their risk tolerance. These companies are unconcerned with their market share and would be hesitant to take on a significant volume of new business even if it stood at their doors.

The emerging trends have more to do with risk management than rich benefits.  Prudential Financial, for instance, has forged tremendous success out of its Highest Daily line of withdrawal benefits and the asset transfer program that reduces the hedging onus on the insurer.

This type of system, which is based on constant proportional protection insurance (CPPI), uses an algorithm to move policyholder assets into a safe portfolio following certain triggers. A key difference between these asset transfer programs and CPPI is that the portfolio never becomes “cash-locked”—i.e. with all of the assets in the safe portfolio.

This strategy shifts some of the hedging mechanism from the insurer to the policyholder, reducing equity volatility risk and costs for the insurer. This helps keep costs reasonable for clients and makes the product’s overall risk profile more palatable for the manufacturer.

Although some companies have followed in Prudential’s footsteps, the asset transfer trend has not become the most popular means to mitigate VA risk. Instead, many insurers have chosen to embed similar tactics within variable funds.

AXA Equitable was the first to integrate a dynamic asset allocation component into its variable funds. Such funds use derivatives to add even more oomph than an asset transfer program. Within the context of VAs, fund-based risk management gives the insurer more flexibility over time to adapt the strategy to unforeseen changes in economic conditions. By comparison, asset transfer programs are contractually based, leaving little room for such flexibility.

Initially, sub-advisory structures dominated dynamic asset allocation, if need be allowing the insurer to dictate specifications to suit its hedging program. However, asset managers have launched and placed their own off-the-shelf strategies that some insurance companies are adopting, making this type of solution accessible to manufacturers of all sizes. After all, the sub-advisory structure demands a minimum volume of assets to make sense for all parties.

Among other things, this latest generation of products incorporates elements of hedging into products at a level where it is apparent to the investor. This takes hedging out of the black box where it used to reside, and creates the potential for new product innovations outside of the realm of VAs.

A fundamental benefit of these new strategies is the reduction of volatility. At the same time that Prudential reduces its hedging onus, it also gives its policyholders a means to preserve contract value. That benefit, though not be a bona fide guarantee, is still valuable. The same is true for dynamic asset allocation. With or without an explicit guarantee, the reduction of volatility can also benefit investors.

Our understanding is that companies are already translating the dynamic asset allocation strategies of VA funds into retail mutual funds. A similar strategy could be used in managed accounts, and even in defined contribution plan accounts.

While asset transfer programs and managed risk funds are playing a significant role in revitalizing the VA industry, their benefits may ultimately reach the wider world of investing. In the “new normal” of acute risk awareness, the price of guarantees would otherwise become prohibitive. As customers learn more about the benefits of these new risk management devices, they may embrace their use in other settings, creating potential for new product and strategy concepts.

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