It’s Hot Around the ‘Collar’

By Kerry Pechter *Thu, Mar 29, 2018*

Nervous investors can get an indexed collar strategy from an annuity or an ETF. Great West Financial and Innovator Capital Management have new products in the category. Cap-and-buffer products, pioneered by AXA, are the brightest spot in a dismal annuity sales picture.

With the equities boom showing signs of fatigue, and with so many investors near retirement, it’s no wonder that collar-type products, which insulate investors from various levels of downside risk, have become a fertile area of innovation for both life insurer actuaries and the financial engineers on Wall Street.

A number of insurance-based and investment-based versions of these accumulation-oriented products are now available. Starting with AXA in 2010, a half-dozen life insurers have developed structured or indexed variable annuities with collar-like capabilities. And a Wheaton, Illinois-based ETF firm is awaiting SEC approval for what it calls the first options-based ETF with such features.

In February, Great-West Financial introduced its first indexed variable annuity (IVA), Capital Choice. In a departure from previous IVA designs, it offers contract owners a choice of four indexes and either a buffer or a floor. That is, investors can choose to absorb either all loss down to a 10% floor or all net loss beyond a 10% buffer.

On the investment side, Innovator Capital Management (ICM) has plans to introduce four “Innovator Defined Outcome ETFs,” each holding a select basket of puts and calls on the S&P 500 Index. Each fund delivers returns within a different range of upside caps and downside buffers. Milliman Financial Risk Management, a subsidiary of Milliman, Inc., is the product’s subadvisor. It, along with Cboe and S&P Dow Jones, designed the options-based methodology.

For advisors who might use either an investment or an insurance product to protect their near-retirement and newly retired clients from market volatility (i.e., sequence risk) during the risky “retirement red zone,” we thought it would be useful to look at these two somewhat similar products side by side.

Great-West Capital Choice

This product is a single-premium indexed variable annuity with a one-year point-to-point crediting method and exposure to four different equity indices: S&P 500, Russell 2000, NASDAQ-100 and MSCI-EAFE. The protection strategy costs 1.20% per year and the six-year surrender period starts with a 7% penalty.

"We've taken the best elements of the three or four competing products and said, 'Here's what we think has resonated with advisors and clients,'" said Lance Carlson (right), national sales director for individual annuities at Great-West. "We put it all together and now have a product with three or four distinct characteristics that we think will make it sellable.

"For instance, there are other products that charge no explicit fee for the benefit. We charge 120 basis points. Because of the fee we have a larger risk budget, which means we be more competitive in the cap rate environment. We say, 'This is what you'll get and this is what it will cost you.'"

As noted above, Capital Choice has both floors and buffers. A client can choose a floor of zero (comparable to a fixed indexed annuity), -2.5%, -5%, -7.5% or -10%. This means the client absorbs any losses up to those percentages but nothing worse. Alternately, a client can choose a 10% downside buffer. If the S&P500 goes down 9%, the client loses nothing for the year. If the index drops 17%, the client loses 7% of his investment.

"We have both a buffer and a floor, and the floor has a lot of intermediate levels," Carlson told *RIJ*. "When we were talking to home offices, they said they wanted a minus-five percent floor option. The broker-dealers told us that if they wanted to a minus-five floor, they had to combine a zero floor with a minus-10 percent floor.

"Let's say the cap rate for a zero-loss floor is 3.85%, while the cap rate for minus-10% floor is 8%. So, on average, they can get an effective cap of about 6%. Our cap for the minus-five floor version is 7.15%. Our return of premium death benefit is also part of the chassis, and we're writing it up to age 90. So if you're 82 and you have money to pass on, and you can't qualify for life insurance, this product can protect that money and give you a chance for growth.

“Also, there are a lot of financial advisors with a huge legacy book of VAs whose owners bought them for income but don’t need the income. Instead of paying 3.5% or 4% fees for that product, they can exchange it for our product, which costs only 1.20%. That will be a differentiator for us.”

Innovator Defined Outcome ETF Series

ICM needed a special SEC ruling to be able to offer their basket of puts and calls on the S&P 500 as an ETF. There are four versions of the ETF, each with a difference risk/reward trade-off and each with a “defined outcome” (within a specific range) based on specific one-year periods. The expense ratio is expected to be 79 basis points.

“It’s a simple, transparent investment in a basket of six to eight options contracts. We’re essentially using options to replicate structured note-like payoffs inside an ETF,” said Bruce Bond, co-founder of ICM, in an interview. “This product gives you performance up to a cap, and a defined downside protection level over the course of approximately one year. You don’t know exactly what you’ll get. But you know it will be between certain parameters.”

The four versions of the ETF are the Innovator S&P 500 Buffer, the Innovator S&P 500 Enhance and Buffer, the Innovator S&P 500 Power Buffer, and the Innovator S&P 500 Ultra. The caps on upside potential haven’t been declared, and won’t be until the start of one of the funds’ one-year “outcome periods.” Here’s a brief description of each ETF:

- The Innovator Buffer insulates investors against the first 15% of S&P 500 Price Index losses during the “Outcome Period.” Investors bear all S&P 500 Price Index losses exceeding 15% on a one-to-one basis.
- The Enhance & Buffer Fund insulates investors against the first 10% of S&P 500 Price Index losses during the Outcome Period. Investors bear all S&P 500 Price Index losses exceeding 10% on a one-to-one basis.
- The Power Buffer Fund provides a buffer against S&P 500 Price Index losses of

between -5% to -35% during the Outcome Period. Investors bear the first 5% of S&P 500 Price Index losses and all S&P 500 Price Index losses exceeding 35% on a one-to-one basis.
- The Ultra Fund provides no downside protection, and aims instead to maximize upside.

These are open-ended, fully liquid funds, and investors can buy or sell at any time. As noted in the Innovator prospectus, the caps and buffers apply only to money that comes into the funds at the beginning of each designated one-year period. Bond said that there will be up-to-date information on the Innovator website to show new investors where the funds are in their one-year trips through the market. People who buy and hold will already be in the fund when it starts a new cycle of option purchases.

"If we launched the Innovator Defined Outcome ETFs today, and you bought, for example, the Innovator S&P 500 Power Buffer, which is designed to provide upside exposure to the S&P 500 Price Index, up to a cap, and a downside protection level between -5% and -35%, you'd be able to earn up to an 8% or 9% cap, if the product were struck today, and you'd have a downside buffer of 30%, beginning at -5%," Bond said.

"But if you bought it 100 days after the launch, the S&P 500 might already be down 15%—and there would be less 'protection' left. Or, on the flip side, the index might be up 4%, in which case you may only get five more percentage points of growth before hitting the cap."

It's not clear whether these timing implications pose any greater hazard to an investor in the Innovator ETF than in an indexed variable annuity like Capital Choice, as long as the investor knows what he has and hasn't purchased. With a product like Capital Choice, the insurance company can change the caps in response to market developments, so that people who buy at different times will see different risk/protection combinations.

Sales potential

Both ICM and Great-West see lots of potential for this type of semi-protected product when millions are investors are either holding cash or sitting nervously on a pile of unrealized capital gains. Matt Kaufman, a principal at Milliman, expects a ready market among advisors who may not use structured notes or insurance products.

"When we talk to financial advisors, they often ask, 'How else can I access a defined outcome strategy?' For the portion of their clients who are looking for alternatives notes to structured notes or structured annuites, this gives them similar opportunities, through a low-cost, efficient vehicle like the ETF,” Kaufman told RIJ.

Milliman, which serves as a sub-advisor to variable annuity subaccounts, uses a managed risk strategy in many of those portfolios. But for this product it chose an options-based approach. “Many managed risk strategies focus on providing investors with stable volatility and downside risk management,” Kaufman said. “Innovator Defined Outcome ETFs are different. Like many structured notes and annuities, they are less focused on volatility and more on the outcome parameters they can provide.”

For Great-West’s Carlson, the Capital Choice product is part of a long-term strategy to expand Great-West’s individual product offerings in the broker-dealer channel and in the US generally. “Most of our $3 billion in profits comes from Canada or the UK. Only 10% of our profits are currently in the US,” said Carlson, who came to Great-West from a similar third-party distribution job at MetLife.

“We have not been in the retirement space for individuals, except through our relationships with Schwab and TD Ameritrade. It was a nice little business, but we did not have a big broker-dealer distribution. That’s what we have been building over the last two years.

“Instead of 10 broker-dealer relationships we now have 100. We now have 28 wholesalers focused on third party distribution, but to be a top five player we’ll need 60 or 70. A couple years ago, we did zero third-party variable annuity distribution; this year we’ll do a billion through Schwab and TD Ameritrade. We’d like to get $4 or $5 billion in annuity sales.”