Milliman Offers Hedging Strategies to Distributors

By Editor Test *Tue, Mar 16, 2010*

With three trading platforms around the globe, the Chicago-based actuarial consultant has come a long way from merely advising insurers.

Milliman, the global actuarial consulting firm that for years has been advising annuity manufacturers, has diversified its business strategy and is now working directly with financial products distributors.

While the firm continues, among other things, to assist insurance companies in creating variable annuity living benefits riders, the consulting firm will now also help wirehouses and advisory platforms offer customized hedging strategies for individual accounts.

“This is the first time that were working with the financial platforms. Our activity is basically identical but the kind of group that we’re working with has changed,” said Kenneth P. Mungan, Milliman’s Financial Risk Management Practice Leader.

He did not say which wirehouses or advisory platforms Milliman has started working with, but he indicated that they included some of the largest.

The new strategy was apparently catalyzed by the financial crisis and its aftermath. Individual investors are looking for a way to protect equity-rich portfolios going forward. Since diversification in commodities or real estate didn’t work last time, advisors and their clients are expected to be receptive to hedging strategies.

“Individuals can go through advisory process with an unprotected portfolio, with complete exposure to the market. Or, at the other end of the spectrum, you have variable annuities with living benefits,” he said. Milliman sees a market opening up for a middle strategy, using uncomplicated hedges that would mitigate the effects of severe market downturns, without creating a huge drag on returns.

“We’re seeing the emergence of a client account on a platform with a protection strategy that would contain hedge aspects. So many people have withdrawn from the market. This would give them protection,” Mungan said.

Milliman would offer clients its economies of scale, its hedging experience, its technology base, called the Milliman Grid Computing Facility, and its ability to monitor risk 24-hours a day through trading floors in Chicago, London and Sydney.

The new strategy might appear to threaten annuity manufacturers, because wirehouse clients will be able to get their hedging programs straight from Milliman without having to buy it in the expensive context of a variable annuity with a living benefit rider.

But Mungan said that his group will create new business for insurance companies by enhancing demand for their unbundled living benefit riders, also called stand-alone living benefits or SALBs. Some of the clients who use Milliman-made hedges to protect their equity investments may want to add SALBs), which add protection against longevity risk by guaranteeing lifetime income.

"Under this model, the cost of the hedge for the insurance company drops dramatically, so that the customer could end up with the optional [lifetime income] guarantee at a lower price point," Mungan said.

Besides the failure of diversification in the crisis, demand for Milliman's new service is driven by low bond returns, and the prospect of low total bond returns for many years ahead in a rising rate environment. The third driver is the fact that Baby Boomers haven't saved enough for retirement, and therefore have to invest in equities to reach their goals.

"Most investors haven't saved enough money to invest only in bonds," he said. "They would be locking in failure if they do."

A March 1 article on Milliman's website, "Challenges for financial advisors," by Milliman project manager Matt Zimmerman, explains the new hedging strategies in general terms. The article describes a hypothetical hedged portfolio of large cap stocks that employs a "5% stop-loss rule" to lock in gains during a rising equity market. During a falling market, the hedge assets are intended to grow and the gains are "harvested" when they reach a "pre-set threshold."

Part of the protective effect would be behavioral, Zimmerman wrote. The presence of an equities hedge would make investors less likely to panic and sell their stocks during a sharp downturn, since they know that the hedge, like a bungee diver's cord, would prevent them from hitting bottom.