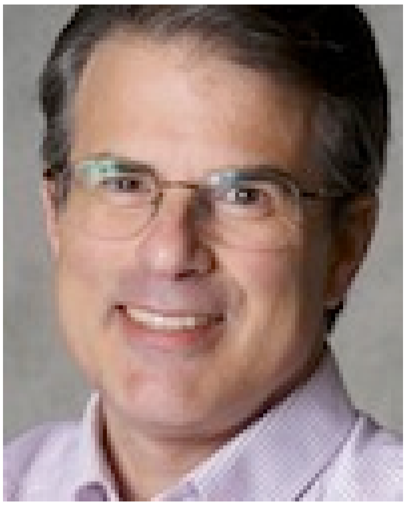
Ten Rules-of-Thumb for Choosing Indices in Annuities

By Kerry Pechter *Thu, Jun 10, 2021*

Here are some heuristics, provided by experts at Milliman, Annexus and elsewhere, for selecting and blending the increasingly complex indices found inside today's top-selling index-linked annuities.



Once an adviser and client decide to buy a specific index-linked annuity contract, they need to allocate the client's premium to one or more of the indices on whose performance their returns will depend.

The client, on his or her own, will have no idea how to make that decision. When it comes to the newer hybrid, factor-driven, sector-driven or volatility-controlled indices, most advisers may be out of their depth as well.

That's understandable. Index-linked annuities are the screwballs of the financial product world. Once they leave the pitcher's hand, so to speak, their flight toward the catcher's mitt is largely unpredictable. They may flutter, wobble or sink en route to the strike zone—or outside it.

All investments are wagers on an unknown future, of course. But it's especially hard to forecast the yield of even the plain-vanilla indices in annuities because their performance is refracted by the lens of a crediting formula—i.e., the caps, spreads, and participation rates—which in turn are determined by the variable cost of the options on the index.

But allocations must be made. The folks who build these products shared some advice with *RIJ* about choosing indices inside FIAs and RILAs. We've summarized their wisdom below.

Diversify, diversity. Rather than try to guess which index will perform best over a one-year crediting period or the multi-year term of the contract, the experts recommend dividing your money up evenly among all of them. The conventional wisdom is that if you choose five different indices, one of them is bound to perform well enough so that the overall contract produces an average annual gain of 5%.

That said, it's important to avoid choosing indices that are highly overlapping or correlated and don't help diversify the contract. Considering that many indices are indices of indices, and that they shift their sub-allocations in response to quarterly, monthly or even daily market signals, you'll never know the effect, if any, of your addition to an already extensive diversification process.

Price index versus total return index. When choosing an index, determine whether the index tracks only the change in the market price of the underlying assets or if it tracks the total return, which will include dividends. Often, the issuer will use the price-only index because the options on it are cheaper, which allows the issuer to buy more upside with its options budget.

"Uncapped" rates: Too good to be true? The open secret of the FIA business is that advisers and clients look at the crediting rates first, rather than the index, and will opt for crediting rates that are "uncapped." In other words, the client will get 100% of the return of the index. But what if 100% of that index is doomed, by dint of its own internal governors and mufflers, never to exceed 75% of the S&P 500 Index? I'm told that you should go for the uncapped strategy so that you won't miss out on a rare Golden Goose (the opposite of a Black Swan).

"Anyone can build a good back test, and there is data mining going on. But if you do it the right way, certain factors or markets will outperform going forward. It's a bet that—based on sound merits and economic research and an analysis of long-term expected returns—warrants greater return. That possibility exists," said Tom Haines, senior vice president, Capital Markets and Index Solutions at Annexus, in an interview.

Be alert to the trade-off between volatility targets and caps. The higher the volatility target of a volatility-controlled balanced index, the higher the equity component will be and the lower the performance cap will be, and vice-versa. But how does one choose between an index with a 10% target and a 5% cap, and one with a 5% target and a 10% cap?

"A volatility managed index is inherently cheaper to write an option on," said Adam Schenck, head of the Portfolio Management Group at Milliman, the actuarial consulting firm, in an interview. "That allows the issuer to increase the upside for the customer. So if you have a cap of 3% on an S&P 500 Index without volatility controls, you might have a cap of 10% on the same index with volatility controls."

Beware OD-ing on vol-control. Sometimes the volatility control mechanism in an index will be too effective. Instead of smoothing out volatility en route to a safe 5% return, it drugs the poor index into a stupor. In that case, the index may be slow to wake up to the fact that markets have recovered. To mix metaphors, you want an anti-lock braking system rather than brakes that might lock up.

"Some indexes may not be good at detecting when markets will be calm, and they lock you out of the returns," Schenck told *RIJ*. "There's too much risk management in place. The volatility forecast misses too high, and the index thinks that markets are more volatile than they really are, and it under allocates to equities."

What "ER" stands for. This doesn't stand for Emergency Room. It stands for Excess Return. You may see two indices that appear identical, but one will have the capital letter ER at the end of its name and the other won't. An in-depth explanation is beyond the scope of this article, but ER indicates that the return is based on changes in the prices of index futures rather than changes in the price of the index. "The excess return (ER) indexes use an excess return methodology by tracking the price of futures, which mitigates the impact of short-term interest rates," an Allianz spokesperson told us.

Academically gifted? Some observers have a special predilection for indices created by well-known academics and based on their original research. Two examples would be Robert Shiller, the Nobel Prize-winning economist, or Roger Ibbotson, the Yale professor and entrepreneur who created Ibbotson Associates and sold it to Morningstar before starting Zebra Capital Management.

Stagger your purchases. Two people can buy the same annuity and choose the same indices in the same proportions yet experience very different returns. That can happen because one person bought the contract three months before the other, for instance, and so timed the market differently. Some advisers practice time-diversification by breaking up a client's premium into multiple contracts, purchased at three- or six-month intervals.

Be careful when using bonds for risk-mitigation. "If the index uses bonds for risk control, make sure the re-allocation to bonds is tactical, so that you're participating in bonds differently," said Haines. "But you need access to all of the risk mitigation strategies—to global indexes, tactical bond indexes, short strategies. Combine them all. Don't think that all you need for risk control are an S&P 500 Index and a bond fund."

Managing expectations. Index-linked annuities should be viewed as alternatives to bonds, we were told by several people. Regardless of the caps or participation rates, investors should expect the products to provide them with the kinds of returns—and level of safety—that they used to expect from bonds. By chance, they'll deliver double-digit returns in one specific contract year. But, by design, they'll attempt to use options on equity indices or hybrid indices to achieve an average annual return of 1.5% to 2% above the yield on highly rated corporate bonds, while eliminating or buffering the risk of loss.

Why not DIY? You might wonder, "Why couldn't my clients just buy the options that an annuity issuer would buy, and get the same potential reward? Why do they have to hand over $100,000 to an insurer so that it can spend $2,500 of their $100,000 on options?"

One answer we got was that private investor can't access the options markets, or get exposure to sophisticated indices, to the extent that the annuity issuer can. The second answer was brief: the annuity offers tax deferral. The short-term capital gains from trading options could easily be eaten up by taxes.