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# The Ghost of VA Contracts Past

By Kerry Pechter *Thu, Dec 12, 2013*

*Insurers and asset managers love managed-vol funds and VA portfolios, whose sales are climbing. But in a low-vol bull market, advisors wonder about their value.*

The Ghost of Contracts Past haunts the VA market this holiday season. The living benefit story—guaranteed income plus liquidity and legacy—still has legs, but many advisors find today's contracts are Scrooge-like compared with the rich contracts of years past.

"Managed-volatility" funds or funds-of-ETFs are a point of contention. Only if insurers require investors to use such funds, which react defensively when equity volatility kicks up, can insurers—those still in the VA/living benefit game, that is—offer those enticing 6% or 7% deferral bonuses.

The managed-vol story is, in a sense, yesterday's news. Everyone knows that it "saved" the VA industry (at a price), yadda yadda. But on the conference circuit this fall, people were still talking about this loosely defined risk management method, which seems to have no formal benchmark.

Actuary Ken Mungan of Milliman, whose risk-management technique sits quietly inside many managed-vol funds, promoted it in presentations from New Orleans to Washington, D.C. Nationwide Life applied to the SEC for a new managed-vol living benefit rider. AllianceBernstein boasted that it's bringing its private-wealth dynamic asset allocation tool to the masses.

On the distribution frontier, however, advisors grumble. Asked about managed-vol funds in VAs at an industry roundtable, a roomful of broker-dealer managers fell silent for a moment. The last thing they want is more investment restrictions, which managed-vol funds entail. Finally, SEC officials demurred that managed-vol funds may make VA guarantees redundant.

Nonetheless, managed-vol funds are selling, both inside and outside VA wrappers. Fed by demand from VA manufacturers, sales of managed-vol funds have been one of the bright spots of the post-financial crisis era. Sales rose from just $30.9 billion at year-end 2006 to $200.1 billion by mid-2013. About 64% of the assets, or $127.9 billion as of mid-year 2013, was in variable annuity separate accounts and the rest available as taxable funds or ETFs.

### B/Ds are hard to please

At a recent industry roundtable discussion, for instance, senior representatives of broker-dealers expressed disappointment with them. "They handcuff you a bit," said one b/d annuity manager. "We all understand the need for risk management in a variable annuity. But we're not in love with them."

The grumbling springs from two sources. First, volatility management cuts both ways. The same strategies that buoy these funds in down markets can hamper them in up markets. That's simply their nature, but it doesn't endear them to advisors during rallies, like the one that investors have enjoyed in 2013.

For instance, the TOPS Managed Risk Growth ETF, available in Ohio National, Securian VA contracts, which has an equity allocation of about 75%, has grown by 13.8% this year. That's not far behind, say, Vanguard's target-risk LifeStrategy Growth fund-of-funds (18.7% YTD), which allocates about 80% to stocks. But it's less than half the S&P500 Index's 29% return YTD, which is the headline rate that advisors' clients see on CNBC.

Second, managed-vol funds in a variable annuity can make advisors feel like Houdini, roped in iron chains, locked in a trunk and submerged in the Hudson River. Advisors once hoped—and were encouraged to believe—that the VA living benefit rider alone, with few or no investment restrictions, would serve as investment insurance. Now they wonder why they also need to pay for another layer of protection through the mandatory use of managed-vol funds if they want a GLWB with a roll-up.

"It's a belt-and-suspenders strategy," said one broker-dealer. "Except that the client wears the belt and the insurers wear the suspenders." In other words, the client may pay extra (with a portion of the managed-vol fund assets) for a risk management technique that mainly reduces the insurer's balance sheet risk.

Regulators share some of the advisors' wariness of managed-vol funds in VAs. The SEC has discouraged the use of the word "protected" to describe the funds, requiring at least one fund manager to take the word out of its brand name. And the SEC shares the advisors concern about the shifting risk-reward proposition.

"These contracts are sold on the basis of a living benefit rider that focuses on downside protection," said William Kotapish, assistant director of the SEC's Division of Investment Management, at an American Law Institute conference last month. "If I paid for that kind of rider. I would want my equity funds to shoot for the moon.

"That's why I bought the protection in the first place. A fund that is managed with reference to an insurance company's obligations under its rider raises significant conflicts of interest and fiduciary issues."

Another and perhaps more important matter is that "managed-volatility," like "target date," can mean many things. Fund managers and sub-advisors evidently use a range of hands-on and computer-driven tools to manage volatility. They may or may not use derivatives and/or leverage. They use different ways of measuring volatility, and maintain very different asset allocations.

**Miracles of financial engineering**

That's the glass-half-empty view. VA manufacturers, asset managers and actuarial firms see managed-vol as a miracle of financial engineering. It brings a strategy that "once was available only to $100 million pension funds to people with $5,000" and they "saved" the VA industry, said one fund manager who asked for anonymity.

Managed-vol enables even conservative mutually owned life insurers to keep offering a product—the VA with a 10-year, double-your-money roll-up and a 5% lifetime income guarantee—for which there is undeniable demand, in a repressive interest rate environment that would otherwise stop them from offering any GLWB at all.

One managed-volatility fund manager conceded that managed-volatility funds alone can eliminate “95% of the risk of a person running out of money,” assuming the same withdrawal rate restrictions as a GLWB. “But people are saying, ‘I don’t care, I want 100% protection and I’ll pay the extra 1.30% [for a living benefit rider] to get it.’ ”

Advisors wouldn’t object to the use of managed-volatility funds in VAs, he added, if they weren’t compelled to use them: Compulsion elicits resistance.

At conferences, Milliman’s Mungan, whose company now manages or sub-advises on over $20 billion in some 30 managed-vol funds, has asserted that managed-vol is a win-win for insurers and consumers.

For insurers, he says in his presentations, the strategy allows for “lower and more stable reserves and capital,” which gives them more capacity to offer richer VA riders. At the same time, he argues, the strategy can provide “improved risk-adjusted returns for the policyholder” over the long haul.

**“Income Capture”**

In the meantime, the big asset managers clearly see managed-vol funds as a sales opportunity. AllianceBernstein has adapted its own Dynamic Asset Allocation service from Bernstein Global Wealth Management to offer a managed-vol solution in the VA space.

Mike Hart, managing director of insurance services at AllianceBernstein, said his firm’s manager-driven solution reacts more spryly to market changes than managed-vol solutions that run on auto-pilot.

“Our concern about algorithmic solutions is that they look with equivalency at market environments that are vastly different,” Hart told *RIJ* recently. “For instance, if market volatility in March 2008 was the same as in March 2009, their view of the risk would be the same.” The company’s Private Client page boasts that its process is designed to “mitigate the effects of extremes in the market…without sacrificing long-term returns.”

If the low interest rate environment compels VA owners to share more risk with insurers, so be it, Hart said. “Insurers are saying, we have a unique ability to produce guaranteed income. But because of balance sheet issues, there are parameters. It’s a reasonable way of approaching the business,” he said.

AllianceBernstein’s Global Dynamic Allocation Portfolio is one of the managed-vol options in MetLife variable annuities. According to one product (broadside sense??), it has a “10% equity volatility cap (including emerging market and high yield debt).” Judging by the wording of the literature, the fund managers have a very free hand.

Nationwide has a managed-vol strategy (the algorithm was written by Nationwide, and the trades will be executed by BlackRock, *RIJ* is told) for people who buy the forthcoming Income Capture lifetime withdrawal benefit on its Destination 2.0 variable annuities. Purchasers of Income Capture must invest in a suite of five funds (or funds-of-funds) that includes a managed-vol offering from American Funds and four from Nationwide. That new rider is discussed in greater detail in today’s issue of *RIJ* (see “Nationwide”).

It will take a few more market cycles before we know if managed-vol funds can actually deliver the win-win—lower risk and higher long-term returns—that they promise. But, given investors' level of risk-aversion since the global financial crisis (and assuming that bonds alone can't offset equity risk as well as they once did), the supply of and demand for managed-vol funds—both inside and outside variable annuities—seems only destined to grow.

"Based on what I've heard, the growing trend of having risk-managed strategies inside variable annuities with living benefits is not going away anytime soon," Hart said. "It will be fundamental to product development. There will be next-generation products, maybe involving more active management or alternatives or factor investing."