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Too Much 'Hocus Pocus'

By Kerry Pechter *Fri, Jun 4, 2021*

David Lau of DPL Financial Partners, the fee-based annuity platform, likes indexed annuities but doubts the value of the 'volatility-controlled' indexes often featured in them.

David Lau has been marketing fee-based annuities to Registered Investment Advisor (RIA) firms and their Investment Advisor Representatives for years. He helped start Jefferson National Life, which pioneered the sale of low-cost variable annuities to RIAs; the firm was later sold to Nationwide.

A serial entrepreneur, he then launched DPL Financial Partners, a web platform where advisers without insurance licenses can learn about, purchase, and bill on a variety of no-commission insurance products. He likes indexed annuities as bond alternatives. But the FIAs and RILAs offered on the DPL platform do not contain volatility-controlled indexes.

"I generally don't like the custom indexes that are in the market. I think there's a lot of hocus-pocus going on," he told *RIJ*. "They're built to illustrate well and show well when you present to a clients. These products have been built to be sold, not built to be used.

"I don't have a problem with volatility controls. That's part of risk mitigation. If volatility control prevents the investor from moving to cash in a downturn, then it makes sense." But he finds that some index designers deliberately set low volatility targets (restricting the range of returns) because the options on the index will cost less and their option budget will buy more potential upside.

"When you see popular indexes with target volatilities of only 4% or 5%, you know that they're doing it to get more money to buy options and to get higher caps. If it sounds too good to be true, it probably is." Lau told *RIJ*.

"For instance, an issuer might offer the S&P 500 Index with a 4% cap in an FIA. If you put volatility controls on that index, suddenly you can afford to offer a 10% cap. That illustrates well to the client. It makes them feels like they could get 10% every year. The product will look good but it has very little chance of actually performing in that well."

A RILA, or registered index-linked annuity, which also uses options on indexes to generate yield, can advertise even higher caps and participation rates than FIAs. But those higher rates are not illusory, he pointed out because the investor has increased his options budget by selling off part of the downside protection that an FIA offers. Instead a floor of zero returns, the RILA might have a downside “buffer” of 10%, which means that the investor is responsible for all losses beyond 10%. For instance, if the index goes down 14%, the client loses only 4%.

That makes sense to him and to his customers. “Clients love RILAs. They provide excellent risk protection and a strong return. Who doesn’t like the notion that you might get as much as 15% in a year and also have 10% protection on the downside?” he said.

Anyone who believes that an annuity issuer can take a tiny fraction of a contract owner’s annuity assets and turn it into a big gain doesn’t understand the math, Lau explained. That’s doubly true because many of the indexes used in annuities track the index price without including the yield.

“The carrier has an options budget. You can see what it is by what they’re paying in the fixed account. They might have 3% of the client’s money to buy options on the index. I don’t think you can generate multiples of that return by buying options on an index. It’s not going to happen. The index also has a lot of expenses that the fixed account doesn’t have. Roger Ibbotson once looked at 90 years of index returns and concluded index annuities should outperform bonds by only about 10%.”

That said, Lau thinks the no-commission index annuities have great value for advisers and clients near retirement. Low interest rates and high correlations of asset performance are the reasons. “In the RIA world, these products are underused,” he said. “We’ve seen a lot more correlation of assets in the last ten years. As a result, diversification alone isn’t enough.

“You also have to look at the purpose of the product. It replaces fixed income. You’re looking for predictable return because that’s what you’re replacing. As an adviser, I might allocate 50% of a client’s assets to the fixed account, which might pay 2.5% to 3.1%. For the other 50% I’ll look for some upside from an index, perhaps the Russell 2000 or MSCI.

“At DPL, we’re trying to create insurance products, or bring products to market, that are built to be used by an advisor in a portfolio and not to be sold by a salesman,” he added. “So we go with the basic indexes like the Russell 2000 and S&P 500. We will be offering a custom index ourselves later this year. It’s going to include dividends. It will be built to provide consistent, real performance.”