WHY DO INDEX ANNUITIES NEED VOLATILITY CONTROLLED STRATEGIES?

July 6, 2017 by K.C. Wingert

The Simple answer is: They Don't! Index annuities, by design, are volatility controlled. The worst indexed interest rate a consumer can receive is ZERO. By its' very nature, a Fixed Index Annuity is designed so a consumer won't lose money when the market index that their interest rate is linked to is negative. This is the ultimate in volatility control.

Volatility controlled investment indexes were originally created by the investment industry to provide unsophisticated investors access to complex investment strategies used by Wall Street professionals. The concept is to maximize total investment results by minimizing the effects of negative volatility and maximizing the effects of positive volatility on your investment dollars. The process of accomplishing this goal is often done with the use of complicated and often proprietary (not shared with the public) investment formulas that move funds between different asset classes based on preset triggers.

Do these volatility controlled indexes work? According to Frank Partnoy, a University of San Diego professor who once structured complex investments for Morgan Stanley, "These kinds of products are terrible for retail investors. They often are similar to what I call "the wolf in sheep's clothing". (As quoted in a 2016 Bloomberg article by Yakob Peterseil: Wall Street finds new ways to sell old, opaque products"). The proprietary indexes have drawn significant attention from the SEC according to the Bloomberg article.

In addition to the challenges for proprietary index investors outlined in the Bloomberg article, it is important to understand the additional challenges these indexes have inside of Fixed Index Annuities. Remember the basics, index annuities are principal guaranteed insurance products at their core. This means the carriers have strict investment and capital standards that they must adhere to. The quality of their investments and amount of their excess capital is important to regulators, rating agencies, consumers, and the carriers themselves. These investment quality concerns mean they are investing their policy holder's money in primarily investment grade bonds, mortgages, and real estate.

In order to provide consumers interest rates linked to an outside market index, they don't invest directly in the index because the funds they are guaranteeing to the consumer would be at risk in the event of market losses. Instead, they purchase an artificial hedge from another large financial institution who agrees to cover the insurance company's interest rate liability to the policy holders. The potential liability to the third-party institution is limited by triggers such as caps, participation rates, and asset fees. These limiting triggers also limit the actual annual out of pocket cost to the insurance company to their cost of the hedge.

All of this can seem complicated but the bottom line is: If an insurance company earns 5% on its' investments and needs 2% of those earnings to cover expenses, taxes and profits, that leaves 3% for the policy holder. The money can be paid to the policy holder as a fixed interest rate or used to purchase a hedge so the policy holders can earn a "potentially" higher index interest rate.

Logic tells me that the large third party financial institutions selling the hedges and promising to cover future interest rate liabilities aren't going to enter that transaction if they believe they will consistently pay out more (LOSE MONEY) than they receive from the insurance company.

Remember back testing and hypotheticals are not guarantees or representations of future performance!