Alternative indices and the quest for customer value

Retirement planning has changed

Fewer retirees today have access to pensions that provide guaranteed income, while years of low interest rates have sent investors into more volatile parts of the market in search of higher yields. In this environment, financial professionals and their clients have sought new ways to add a mix of relative stability and growth potential to their retirement income plans—leading to the growth of fixed indexed annuities (FIAs) as a popular retirement planning tool.

FIAs offer the opportunity to earn interest credits based in part on the growth of an underlying market index, such as the S&P 500®. Index interest crediting strategies combine protection from loss due to market downturns with the potential for growth that many people want in their retirement income plans. This combination has made FIAs increasingly popular, with sales reaching $60.9 billion in 2016, up 12 percent over the previous year.*

Amidst that growth, another trend has emerged as insurance carriers look to differentiate themselves from competitors: an explosion of crediting strategies that track alternative indices. Yet this proliferation of choices can be daunting to financial professionals seeking the right options for their clients' needs. How do these strategies differ, and how can you determine which alternative indices provide real customer value?

To answer these questions, it's important to understand the objectives behind alternative indices and then assess whether a crediting strategy linked to a particular index is designed to deliver on the potential it offers.

*LIMRA, "LIMRA Secure Retirement Institute: Fixed Annuity Sales Hit Record $117.4 Billion in 2016," February 21, 2017.

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The rise of the alternative index

FIAs work by crediting customers with an interest rate that's based in part on the performance of a market index. When the index rises in value, customers participate in a portion of those gains in the form of an interest credit. They are protected from loss due to market downturns because the interest rate will never fall below zero. While it's possible to earn zero percent interest in any given interest crediting period, they can never earn less than zero.

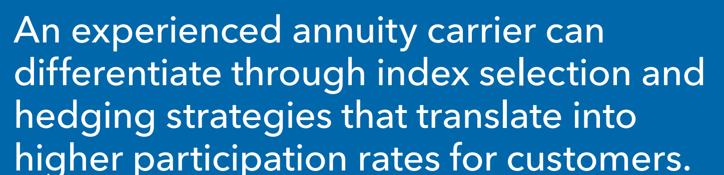
The first generation of FIAs typically used the S&P 500® as an index "measuring stick" to calculate interest credits. With little variety in the marketplace, it was difficult to differentiate any single product.

So the annuity industry innovated. Today, nearly a quarter of fixed indexed annuity premium is allocated to interest crediting strategies that track hybrid or alternative indices in an effort to provide more value to customers and differentiate products in the marketplace. For example, rather than tracking the S&P 500®, a strategy might track an index made up of a custom blend of asset classes or global markets. Another might track an index that's negatively correlated with the S&P 500®, offering the potential for upside when traditional equity indices are down.

Using volatility controls to produce more stabilized returns

Alternative indices generally include volatility control overlays that limit the range of both the positive and negative performance of the index, striving to make index performance more stable and predictable over time by avoiding very high positive returns and very low negative returns. These control mechanisms typically consist of two components: the underlying index and a stable asset, usually cash. A rules engine rebalances assets between the two based on measured volatility. The idea is to manage volatility to a specified target. It's a bit like a thermostat: adjusting the "mix" of heating and cooling to achieve the desired room temperature.

This combination of alternative indices and volatility controls is designed to produce more consistent returns, allowing insurance carriers to offer higher participation than may be possible with traditional broad-based indices. What's more, the proprietary relationships that carriers develop with index sponsors means that they can negotiate terms for the financial instruments they use to protect against downside risk—potentially allowing them to pass a greater portion of any gains on to customers. This way, a carrier can differentiate not only through bespoke index selection, but also by implementing efficient hedging strategies that can translate into higher participation rates passed to the customer.



Assessing alternative indices

The proliferation of alternative—and, in some cases, esoteric—indices has created greater differentiation among products in the FIA marketplace. But it has also made it more important for financial professionals to understand how various factors can affect an annuity's features and benefits, including the raw index performance and the degree to which the customer participates in the index return.

One common method of comparing annuities is though backtesting hypothetical results over a past time period. However, backtesting inherently reflects historical market performance, which may not occur in the future. For an annuity based on an alternative index to make sense, we believe that advisors must assess the index according to the following criteria:

Design.

Is the construction of the underlying index based on sound economic theory that supports its objective? For example, consider an index with a goal of providing more stable returns. If that index is made up of high-dividend paying stocks, you might be confident in its design intent because historically, predictable dividend payments have smoothed out a portfolio's returns.

Fit.

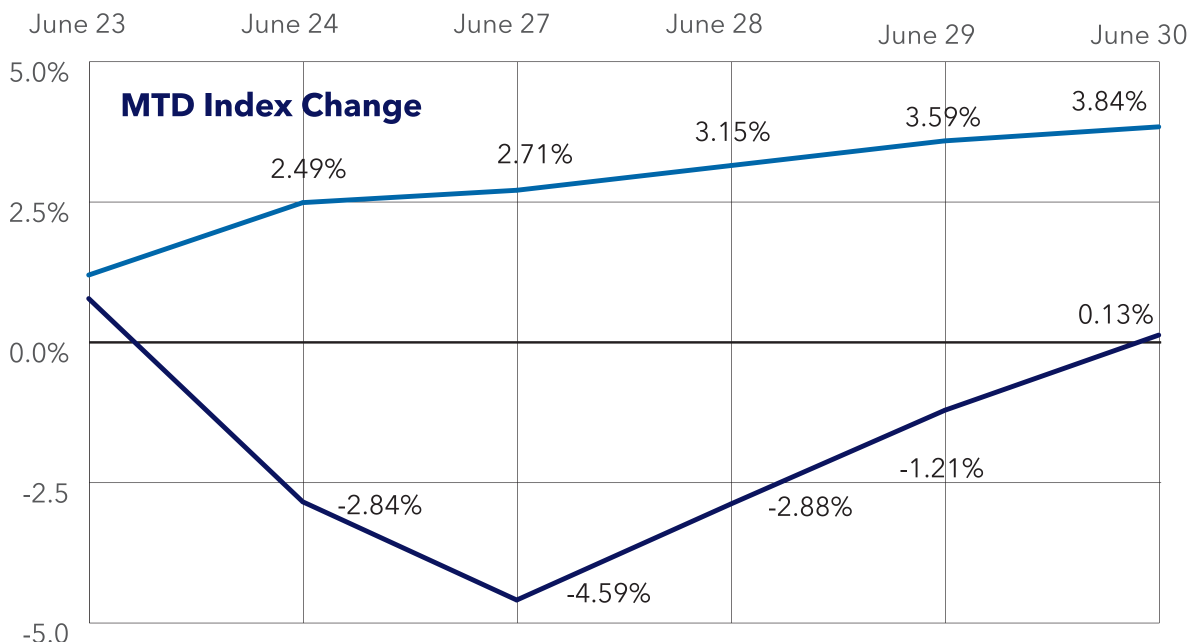
Is the index likely to offer different performance characteristics than other indices? For example, if an FIA's other crediting strategies track the S&P 500®, alternative indices might include different assets or provide noncorrelated performance to represent a truly alternative option.

Value.

The alternative index space often relies on proprietary relationships between annuity providers and index sponsors. Providers must be in a strong position to negotiate with sponsors to ensure the lowest possible cost, which will allow them to offer potentially higher participation rates—and greater potential value for customers.

To see this analysis in action, consider the BNPP Multi-Asset Diversified 5 (MAD 5) Index, which Athene tracks in several of its index crediting strategies. The index design is based on a diversified portfolio of stocks, bonds, and commodities from various global markets in an attempt to diversify against the swings of the S&P 500®. That underlying mix of assets is rebalanced daily using a rules-based methodology that seeks a hypothetical portfolio with the highest past returns[1] subject to a certain level of volatility and weighing constraints.[2] A volatility control overlay targets an annualized realized volatility of 5 percent. If the volatility of the index rises above that rate, daily controls rebalance the portfolio into larger holdings of cash.

This construction means that the BNPP MAD 5 Index tends to move differently than the S&P 500®. The chart below compares the seven-day period following the United Kingdom's June 2016 "Brexit" vote to leave the European Union. The S&P 500® fell sharply during the period, while the BNPP MAD 5 maintained steady upward momentum due to rebalancing and volatility controls. Keep in mind that this is a singular occurrence that is not representative of future events.



The steady performance of the BNPP MAD 5, combined with our decade of experience negotiating downside protection tools with index providers, has allowed Athene to offer additional participation potential to annuity customers. It's the approach we use to determine whether any new index should be added in order to help achieve our goal of passing greater value on to customers.

Financial professionals can adopt a similar strategy to navigate the complicated world of FIAs on behalf of their clients. Carefully examine whether an annuity's underlying index appears to be based on sound theory, offers an opportunity for diversification, and comes from a sponsor with the track record and market presence to negotiate affordable means of downside protection. When a product meets these criteria, there is a better chance that you can successfully use the FIA as part of a diversified retirement savings and income plan that provides the mix of stability and growth potential that today's retirees are seeking.

Discussing alternative indices may result in giving securities advice. Athene has a dedicated phone line to help insurance-only agents ensure they are not giving securities advice.

[1] Computed based on a trend indicator that compares current component level to past component level over a one-year period.

[2] The BNPP MAD 5 Index is an "Excess Return Index," meaning its returns are derived from changes in the price of its underlying components (known as "price return") and profit or loss gained from rolling from one futures contract to another (known as "roll return"). Unlike Total Return Indices, it does not derive returns based on interest earned on cash or other collateral deposited in connection with the purchase of futures contracts (known as "collateral return").

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