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December 2018

'These Go To 11:' Indexing Beyond Rates, Renewals

Indexes have increased in choice but with more choice comes greater complexity.

By Eric Thomes

There's a famous scene from the movie mockumentary *This Is Spinal Tap* in which guitarist Nigel Tufnel proudly demonstrates an amplifier whose volume knob is marked from zero to 11, instead of the usual zero to 10.

When the film's director, Marty DiBergi, asks Nigel the logical question "Why don't you just make 10 louder?" Nigel hesitates before responding blankly, *"These go to 11."*

This exchange is often used to reference situations where things that are essentially the same are seen as different due to mislabeling or a lack of necessary context. Unfortunately, this type of confusion is becoming more prevalent in the world of indexing inside of annuity and life insurance contracts.

Comparisons between indexes too often are made without a firm understanding of the structure behind the index. This causes frustration for financial professionals and clients with something that should be viewed as a positive — that is, the variety of index choices now available in today's annuity and life insurance products to support the specific client goals the indexes have been designed to achieve.

The popularity of index solutions has steadily increased over the past several years. From fixed indexed annuities to fixed index-linked universal life insurance to indexed variable annuities, indexing is becoming the method of choice for providing accumulation potential while limiting risk.

Indexing also has experienced significant innovation in recent years. The days of having a few benchmarks to choose from are over. A wide variety of new options with different objectives and structures allows financial professionals to offer a better match to the client's goals and the economic environment.

However, with this increase in choice comes an attendant increase in complexity. Financial professionals recommending index solutions need to explore all of the options before they assist their clients with the appropriate strategy for their specific situation and the current economic environment. This evaluation requires an understanding of what an index tracks, how the index tracks it and how those factors impact the rates available on a product.

What The Index Tracks

Indexes track diverse segments of the U.S. or international markets or specific market sectors. These market segments may represent the equity market, the bond market or a mix of these elements. Indexes today also may employ additional techniques to control volatility — such as daily balancing between equities, bonds and other constituents (using cash, commodities, etc.) — in an effort to reach a desired level of volatility. How these elements are incorporated into an index design will have a direct impact on its potential for both growth and volatility.

Before making any comparisons between indexes, you must first understand how the'index is structured and how that affects its long-term outlook for performance. In other words, there is a wide variety of index structures designed to react to the economic environment in a variety of ways. Each index first should be evaluated based on how closely these options match your client's goals and how many indexes are available on the particular contract.

How The Index Tracks It

First you must understand the "what" or goal of the index, its constituents and the mechanisms it includes to achieve that goal (equities, bonds, cash, daily balancing, etc.). Then you must turn your attention to the "how." Each index will track changes in its constituent parts in different ways. Two of the most common variations are using changes in the "current price" of the index or using changes in the "future price" of the index to track its value. This distinction is critical because it can affect the client's experience — even if the ultimate credits are expected to be the same.

"Current price" indexes typically do not reflect changes in short-term interest rates and do not include dividends. "Future price" indexes reflect changes in short-term interest rates and dividends. These two factors — whether interest rates and dividends are included — have a major impact on the rates that will be available for a particular index. Price return indexes typically will see the most change in new and renewal rates available. Meanwhile, "future price" indexes typically will see more stability in new and renewal rates available on a contract.

When evaluating the index offerings available on a given contract, you should know if there are options available in terms of "how" the index will be tracked. Having the ability to select between both approaches can be valuable because they will provide a different experience for your clients.

Index Rates

Finally, how does this combination of factors impact index rates? Among available participation rates on three different indexes, which would you choose?

A. 100 percent.
B. 75 percent.
C. 50 percent.
D. Need more information.

Under the “these go to 11” model of thinking, Option A seems to be the obvious choice, since more is always thought of as better. However, the correct answer is actually Option D: Need more information.

The interplay of “what” the index tracks and “how” it is tracked has an important impact on the amount of change — in terms of performance, index volatility and rate volatility — a client should expect to see from year to year. The rates (e.g. participation rate, cap or spread) available on the index need to be understood in the context of these factors.

You cannot simply assume that 100 percent par option is always best and offers the most opportunity for growth and that a 50 percent par offers the least opportunity for growth. In fact, 100 percent par on a “future return” index and 50 percent par on a “price return” could represent a very similar outlook for performance, but the experience of the client along the way would be very different.

A client who chooses the “future return” version should typically expect to see the renewal par rates stay close to the original 100 percent year after year. A client with the “price return” index should typically expect to see the par change more frequently.

If you look at only the participation rate number itself, you risk missing out on the experience that index will give your client. This becomes more important when the “price return” index offers a 110 percent par versus 90 percent par on the “future return” version. The 110 percent par will give your clients a very different experience (more volatility in renewals) and both you and the client should be aware of that when the decision is made.

Bottom line, an understanding of the stability in renewal experience, in conjunction with interest credit outlook, can be very important when addressing your client’s expectations for their contract. This should be a factor you consider when assessing which index is appropriate for a client’s specific financial situation.

Focus On Product Value

Indexes in life insurance and annuity contracts have come a long way since the days of having only a few well-known benchmark (mostly price return) indexes to choose from. The value you can bring to your clients as a financial professional has increased substantially as well.

Knowledge of these index elements is precisely the kind of value you bring to clients. You are uniquely able to provide guidance on the allocations that are appropriate for your client’s individual goals.

If index solutions are part of your recommendations, move beyond comparing rates to delivering tailored solutions using all the available allocations within a product. Assess whether steady, predictable credits and renewal rates is the goal for your client, or whether maximizing potential credits while providing the assurance that “0” is the worst-case scenario is the priority.

And, since no single allocation performs the best in every economic scenario, a diversified approach is often the most prudent strategy to pursue. Client preferences differ, so you can make the difference for your client between success and failure across many economic environments.

Having a detailed understanding of an index’s goal and structure — and more importantly when and why to recommend adjustments to a client’s allocations — is part of your value proposition. Avoid being the Nigel who indicates an index “goes to 11.” By demonstrating a deeper knowledge of index products, you can set yourself apart as a financial professional who brings a higher probability of success to your clients.

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