Equity Exposure In FIA Indices

A Dismal 2022 For The Markets

Now that the dust has settled, one thing is for certain – 2022 was a brutal year for investors.

According to Blackrock, it was the *worst year ever* for bonds and the 7th worst year for stocks since 1926. And the problem wasn't just in stocks and bonds. According to Morningstar mutual fund categories, 105 out of 112 asset classes lost money in 2022. The red ink was everywhere.

We're not going to dive into all the economic headwinds over the past year, but there's certainly a recurring theme that's dominated headlines: inflation. Inflation ran rampant, and the Fed continually raised interest rates to rein it in. These rate moves rippled outwards and caused a path of destruction in the equity and bond markets.

Fortunately, indexed annuities are downside protected. They did what they were built to do. They weathered the storm. A zero return when the market is negative feels like a win – and it is. But no advisor or client wants to stack consecutive 0-return years on top of one another.

Where Do We Go From Here?

The same Blackrock report we referenced earlier also provides some glimmers of optimism.

- The average annual return for U.S. stocks (S&P 500) after a losing year is 13.2%.
- Many economists also believe the Fed will halt their rate increases at some point in 2023.
- When the Federal Reserve finishes any rate hike cycle, the S&P 500 is up 19.9% the following 12 months, on average.

However, many clients at or near retirement don't have the risk tolerance for full-on equity exposure.

Knowing this, what's the best way to take advantage of a possible market bounce-back inside of downside protected vehicles like FIAs? What types of index-linked crediting strategies provide the best opportunities given the current economic environment?

Let's dive in.

Opportunity With S&P 500 Strategies

At their core, FIAs provide downside protection with index-linked upside potential. The most common, and most utilized index within the FIA chassis is the S&P 500 crediting strategy. According to Wink, nearly 44% of all FIA sales are allocated to this index. However, full upside exposure to the S&P 500 is too expensive for a carrier to offer a client. A cap rate or participation rate must be applied to limit the upside. At Life Innovators, we track weekly fair market caps and participation rates on the S&P 500.

As of this writing, the current fair market rates for a 10-year growth and accumulation FIA is an 8.65% cap rate and 52.88% participation rate on the S&P 500. Compared to the last few years, today's affordable cap rates are extremely competitive. And, amazingly enough, they're not even as attractive as they were a mere 3 months ago. Fair market caps peaked at 11.30% in November of 2022. Record breaking annuity sales in 2022 are a testament to these favorable rates.

Although fair market rates have lost a bit of steam, there are still 19 annuity carriers with cap rates of 10% or greater, with the top cap rate on a 10-year FIA currently at 15% (no charge). Competitive fair market participation rates are more scarce. Currently, only 4 annuity carriers have participation rates of 50% or greater.

So which is better? It depends on your perspective of equity market performance moving forward. We examined S&P 500 returns over the last 50 years, on a monthly basis, to determine how a client would fare in each strategy. We rounded slightly to an 8% cap rate and 50% participation rate and also felt compelled to show a 10% cap rate comparison also due to its widespread availability.

High-Level S&P 500 Return Statistics – Last 50 Years

- The S&P 500 was positive 75% of the time
- The S&P 500 averaged 8.8% annually
- When the S&P 500 was positive, the average annual return was 16.3%

8% Cap Rate vs 50% Participation Rate Scenario – Last 50 Years

- 56.6% of the time, a client would be better off with an 8% cap rate
- 43.4% of the time, a client would be better off with a 50% participation rate

10% Cap Rate vs 50% Participation Rate Scenario Over- Last 50 Years

- 68.2% of the time, a client would be better off with a 10% cap rate
- 31.8% of the time, a client would be better off with a 50% participation rate

Even if cap rates come down slightly on subsequent annual renewals, a possibility that we discussed in a recent Innovator Insights post, the S&P 500 with an annual cap rate serves as an appealing index allocation for clients --- especially if 10% or higher.

Crediting strategies that have a declared participation rate and no cap might also be attractive given our findings. Historically, large drawdowns in the S&P 500 are followed by significant index returns. We saw this play out in the wake of the Financial Crisis of 2008 and in 2020 --- and it's evidenced by the S&P 500 averaging 16.3% when it's positive. The right call is up to you and your clients.

Opportunity With Volatility-Controlled Indices

According to Wink, over 41% of new FIA sales are allocated to *engineered or volatility-controlled indices.*

The naming convention of "volatility-controlled" pays homage to the inner mechanics. Volatility is controlled inside the index itself by shifting between high volatility and low volatility assets in order to maintain a specified target volatility. The high volatility assets are nearly always equities, while the low volatility assets are typically fixed income securities. Virtually every engineered index also has a cash component that can step in and out to maintain the overall level of targeted volatility.

Along with nearly every major asset class, volatility-controlled indices were crushed in '22. The underlying equity components were largely negative. Indices that relied on long-duration fixed income for their low volatility asset class faced even larger losses due to rising interest rates and, therefore, falling bond prices. According to the Index Standard, only 3 indices, out of the hundreds in-market, had a positive return.

High Volatility vs Low Volatility in Engineered Indices

When you evaluate the landscape of volatility-controlled indices, you'll find different volatility control targets that typically range from 4.2% to 20%, with the vast majority at 5%. From there, the life insurer applies a participation rate to calculate the actual credit to the account.

Index volatility and participation rates are inversely correlated. Why? Because of the cost of the underlying options and what carriers can offer given an available option budget. The more volatility an index possesses, the higher the cost of the option strategy, and the lower participation rate offered. This is why most indices are targeted to a low volatility level that allows life insurers to offer relatively high participation rates even with a low option budget.

If you want to maximize your client's return profile, and take advantage of a potential equity market rebound, which is better:

- *An index with a higher volatility target and lower participation rate?*
- *An index with a lower volatility target and higher participation rate?*

Theoretically, the two should be identical, but that's not what we see in the real world. Indices must constantly rebalance exposure to equities, fixed income and cash in order to maintain the specified volatility target. Historically, fixed income has been a very low volatility asset class which has allowed engineered indices to maintain a relatively high equity exposure even if the overall volatility target for the index is low.

However, 2022 upended that assumption as fixed income volatility increased dramatically. As a result, engineered indices had to pivot to greater cash allocations in order to maintain their overall volatility target. What was left on the chopping block? Equity exposure. Some engineered indices had *zero* equity exposure at certain points in 2022 because the volatility target was being eaten up with unexpectedly and abnormally high fixed income volatility.

While no one has a crystal ball, your view on the macroeconomic environment can help guide your allocation decisions with clients. As we stated previously, the equities market should be poised for a large move upwards if history repeats itself. Contrarily, some economists are shouting from the rooftops about a pending recession. Time will tell. If you're betting on a swift upwards equity move, however, a higher volatility target is your best bet. Why?

The simple answer is that a higher volatility target will give a client more equity exposure.

Low volatility indices won't capture a significant portion of equity upside, because when volatility spikes (and the equity market rises significantly) the index algorithm causes a shift away from its equity allocation and moves into safer asset classes --- the cash or fixed income components. Even more, fixed income allocations had minimal volatility until recently. Spikes in fixed income volatility forces an index to either lower its overall leverage and/or move into a heavier cash allocation.

Index	Participation Rate	Equity Exposure	Fixed Income Exposure	Cash
High Vol Target	Lower	Higher	Lower	Lower
Lower Vol Target	Higher	Lower	Higher	Higher

Volatility Target Examples

Let's look at an example index but with varying volatility targets. We hypothesized what the underlying asset allocation weights might be, and potential returns in a market rebound. For this exercise, we used an actual index with a 5% volatility target and its current asset allocations. We then extrapolated the data using estimates based on the original weights and underlying asset class volatility. We also increased the leverage for the higher volatility targets. In reality, these indices would have algorithms that adjust the underlying components daily. For simplicity's sake and for a fair comparison we've kept the allocations constant. To calculate the FIA participation rate, we've used a 4.3% option budget.

FIA Index	Equity	Fixed Income	Cash	FIA Par Rate	Actual Equity Exposure
Volatility Target = 5%	5%	60%	35%	200%	10.0%
Volatility Target = 8%	16%	59%	25%	129%	20.6%
Volatility Target = 10%	27%	58%	15%	104%	28.1%
Volatility Target = 15%	71%	24%	5%	70%	49.7%

If we're looking strictly at equities, we would argue a client would be much better off in a higher volatility index. Not to mention, if volatility spikes, and the equities markets has a sharp downward move, the higher volatility index would nosedive. No problem. A client is downside protected. And the index value would reset on contract anniversary, at the much lower value, translating to more upside potential for the inevitable rebound.

Taking the fixed income component into account, lower volatility indices with heavy fixed income allocations *could* perform well if interest rates decrease significantly in the future. These decreases would increase the value of the underlying fixed income component, which would be turbocharged by higher index participation rates.

Buy-Up and Negative Floor Options

Many FIAs offer strategies that deduct a specific fee, usually between 0.75% and 1.5% on an annualized basis, which goes directly to purchasing more upside exposure to the index for the policyholder. For an engineered index with a 15% volatility target, an extra 1.5% fee might push the participation rate from 70% to 93%, which allows for significantly more equity exposure. Whether the fee is worth the extra equity exposure depends on the performance of the index.

A simpler and more straightforward way to increase equity exposure is by taking a defined level of downside risk. Currently, there are products on the market that allow policyholders to have access to account options with negative floors *as long as the previously accrued gains can cover the losses*. This allows policyholders with previously accrued gains to put some of those gains at risk in order to dramatically increase their upside potential – without drag from policy fees.

The impact of even small amounts of downside risk is profound. By reducing the floor from 0% to -5%, the participation rate on an engineered index with a 15% volatility target jumps from 70% to 110%, allowing for an overall equity exposure of nearly 80% (using the data from the examples above). We believe that these products – sometimes referred to as FILAs – offer a powerful and compelling option for policyholders who want to have the ability to take a defined amount of downside risk for a significant boost in upside potential.

Conclusion

With the extreme market downturn we saw in 2022, it's reasonable to assume there will be some sort of market rebound over the next 12 months. We base this on what's happened historically after corrections occur and when the Federal Reserve finishes rate hike cycles. Inside FIAs, we believe the best way to participate in a rebounding equities market is to increase equity exposure. This can be done in two ways. Allocations can be made to S&P 500 strategies, specifically cap rates given the competitive pricing found with a number of carriers, or through higher volatility target indices.