

IUL Uncapped Strategies

The S&P 500 has been among, if not the most followed index in the US for the majority of the last 100 years. It is important, it is prestigious, it does tell a broader story on the current financial environment in our country, but is still just a tool, and a metric, nothing more. It has been immortalized over time, and sometimes used as the primary gauge for a retirement plan in general. In casual conversations you have with people they will tell you, market is down, market is up, economy is this or that, but a lot of what they are saying is based on how the S&P 500 is doing. The life insurance industry furthered this importance and built decades of products and poured billions of dollars into options on the S&P 500 as the underlying performance driver of equity index policies. This was true for the majority of policies that were offered in this space until around 2014, when some carriers started to migrate to other indices. By offering other indices carriers created more possibilities for clients and derisked the policies by the sheer fact of diversification in general, as well as taking advantage of lower priced options on alternative indices. This brings us to where we are at today, where S&P 500 caps are averaging 8.00%, and the majority of policies offered have at least one volatility controlled index offering. The indices allowed for investment banks and large fund companies like Goldman Sachs, Credit Suisse, Fidelity, JP Morgan and a variety of others to enter the space, each offering their own index with it's own unique twist. Just like anything else, the solution to the problem (lack of index options beyond S&P 500); because a problem in an of itself. Financial advisors, now have to evaluate the policy from a pricing, underwriting, financial strength and now index crediting basis. Prior to the market shifting, the evaluation process was simpler because it was just S&P 500 based. You would just need to evaluate the underlying terms of the crediting, whether it be the cap, participation rate, or the type of crediting method, annual point to point vs. monthly point to point or others. Now it's an entirely different ball game, and it can be tough to differentiate. Maybe you like the backtesting or methodology of a Goldman Sachs rather than a JP Morgan, that is fine, but beyond who is offering what, there are fundamental differences in how these indices operate, what they are offering, what consumer protections are in the contracts, and ultimately how the policy will perform, and that is what we will be discussing here, tools on how to evaluate which index to choose.



The S&P 500 was generally offered with a 100% participation rate, and a variable cap rate. Cap rates float annually, with very minimal floors of as low as 2.00%. Current cap rates for inforce policies are averaging around 8.00% currently, down from as high as 17% at issue. The majority of Volatility control indices offered are offered on an uncapped participation rate basis. With S&P 500 participation rates down averaging well under 50%, due to recent low interest rates and volatility in the markets, the volatility control index offerings with participation rates generally north of 100% on an index life policy have become a very compelling offering.

But what is a volatility controlled index?

Your answer to that question may differ based on the index of choice that you have been promoting, but for our purposes today I just wanted to stick to the basics, of how most of these indices operate. Volatility control indices have their roots in modern portfolio theory, the idea that frequent rebalancing creates stability. Stability is very important in an index universal life policy that is often promoted as the lower risk alternative to Variable Universal Life policies. We'll talk later about why that may not always be true, but for purposes right now, we will stick to how these work and why they have proven to be more reliable. The goal of a volatility based index is to generate consistent, positive, reliable returns, not maximize the returns. They strive to create the optimal risk/return balance and stay within a certain standard deviation of the underlying assets that they are comprised of. Since nobody knows for certain what will become of any investment in the future, instead of projecting where the underlying investments in the index will go based on speculation, the index instead looks at it's recent momentum as it's gauge. The index then trades on a periodic basis (Daily, monthly, quarterly, it depends on the index) and trades based on principles within it's algorithm that are based on the volatility of the underlying assets. In other words, they operate on the idea that above all else, momentum tells a powerful story and builds in rules based trading triggers to move based on what it just saw, as opposed to guessing where the investments are going. Behind the algorithm is where you get the differences of what the investments are. They may rebalance the 500 individual stocks of the S&P 500 on a periodic basis, or they may use the S&P 500 as one of the investments instead and rebalance it against other indices. Each index has it's own set of rules, and underlying investments, and may move based on a different degree of volatility, but they are all doing the same thing, which is letting yesterday's news drive today's moves. No guessing, no reading the tea leaves, no trying to decide how inflation is going to affect the next holiday retail season. This is again because the goal is not to maximize the return year over year, but rather to maximize the probability of a return, and to get the most out of the investments it tracks based on the rules that they decide to use to do so.



So why are these now the preferred default of index universal life policies?

Supply and demand has a lot to do with that, as does the volatility of the S&P 500. The S&P 500 is still the most widely used index in the market. The majority of carriers have to go to outside firms to purchase derivatives to hedge their policies, and where there is more demand, price goes up. The pricing of the underlying options are affected substantially by volatility, and the past decade has been a very volatile market, great market, but volatile nonetheless. Then there's the money that is actually used to buy the options, and until recently, we had a very low interest rate environment for a long time, which drove down the budget available by insurance companies to buy options. While volatility control indices do not create a higher budget to buy options, by their nature of being built for stability, they reduce volatility and are offered at cheaper rates. More important than that is that each carrier can go their own way, and develop their own one off deals with investment banks and fund companies, allowing them to have better pricing. As opposed to in the past all going to the same place (S&P 500 options). In essence, options cost lower, and insurance companies have more control in dictating the pricing they pay for the options, so they pass along better terms to the client than just being reliant on whatever the market dictates that they pay.



If they are all not the same, then how do we evaluate apples, oranges, grapes and pears?

While only an insurance license is required to sell an index universal life policy, it is only offered to the public by financial professionals who understand and study the nuances of the contracts. There is a lot to be evaluated in the decision of which policy to choose, and only part of that decision comes down to which index is offered. There are a variety of other factors to consider, which we'll discuss momentarily, but assume all else is equal, choosing the index really comes down to preference and the terms that are being offered. One of the biggest issues with the S&P 500 cap based environment that we are leaving is that little to no emphasis was placed on what the underlying minimum guaranteed cap was. It was easy to choose a 17% cap vs. a 12% cap, if that was all that was being evaluated, but some of the underlying guaranteed caps were as low as 3%, while others were as high as 10%. Then after a decade of low interest rates, caps fell sharply, and all of a sudden the underlying guarantees became way more important. Learning from the mistakes of our past in the industry, I think it's important to look beyond the sizzle of the high current participation rates, and look to the underlying guarantees. A look at the current market will show that for carriers who are offering similar index accounts right now the underlying minimum participation rates range from 5.00% and 100%, with very similar current participation rates. Will any one index go to 5.00% participation rate? That's unlikely, but when evaluating risk, when studying the contracts, it's very important to see who is holding the risk in the transaction. If the index is similar in both policies, and one has a 5% minimum guaranteed participation rate and the other has a 100% guaranteed minimum participation rate, that is a big client protection built in that is guaranteeing that percentage of the actual return.



What other things besides the illustration should be evaluated?

Illustrations are more of a compass than a map. They guide us to how a policy may do and we can use them to measure the performance of the contract from year to year. They are not an exact science those, and when it comes to index universal life that is especially true. There is no uniform standard cost model, or insurance COI pricing across policies. So a client the same age, putting in the same amount of money, into the same death benefit, is getting a completely different cost structure and contract from one company to the next. The illustration blurs these differences, by ultimately landing around the same place when showing future values or income, but the structure of contracts vary wildly. Some contracts have a lot of costs up front, and then lower back end costs. Others have low entry costs, but then higher costs later. Some contracts have internal bonuses that are triggered, and sometimes used abusively to mask higher charges later in the contract. There's a lot going on in these policies, but the costs show tell the story. If you can review the internal costs with as many of the other variables constant, you will see that some contracts are just significantly higher than others. AG 49 regulations removed a lot of the illustrative tricks that allowed for companies to create higher interest rate assumptions, but even at the same interest rate assumption, the policies perform differently. This is where you get into the balance of how much of the performance of the contract is being driven by the bonuses in the contract, and that brings up more questions, particularly what are these bonuses based on and are they guaranteed. What you may find is that in some of the better projected performing contracts, there are actually higher costs, and more bonuses that are driving the projections, and if those bonuses are non-guaranteed and allowed to be removed, that is a very important item to evaluate when you are selecting a policy, perhaps the most important. Carriers also allow buy ups in index features, and/or build in high asset under management fees to provide them. There are index accounts with index fees as high as 7.00% annually. While you do get an enhanced multiplier benefit for that high fee, there is virtually no index that can hurdle the fees that high over a long period of time.



At the end of the day, costs and expense charges, may be the most important thing to evaluate in these policies and often go overlooked.

So where do we go from here?

Life Brokerage constantly does due diligence on the products offered in this space and evaluate them internally before even offering them on our platform.

Here are some helpful tools to evaluate which policy and index to choose based the questions that we use to determine if we will promote the product:

1. What is the cost structure of the policy?
2. What is the performance based on?
 - o Are there additional bonuses, and how do they work?
3. What are the terms of the contract, not just the cap and participation rate, what are the underlying guarantees?
4. What does the specific index consist of and how does it operate?
5. What is the renewal rate history for the carrier in this product, or other similar products?
6. What is the COMDEX and outside ratings for the carrier?



Those questions can help narrow down your search for the policy to recommend, but ultimately, if the policy has low costs, and favorable terms with underlying guarantees for the client in the index, then your client should be able to enjoy a tax efficient, diversified protection financial instrument that provides reliable returns and can be used to help supplement their retirement, with zero downside crediting protection while protecting their family. Life Brokerage is well versed in the nuances of the individual contracts that are offered and happy to discuss any of the opportunities and if need be get the insurance companies and/or the fund companies themselves on a call with you to help you understand the contract you are offering to your clients.