

# BEST'S REVIEW

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Life

**EARLY ADOPTER:** Barbara Cooper, chief risk officer for Prudential Financial's individual life insurance business, said the company in August added protected portfolio funds to its variable universal life products to help policyholders diversify.

Kim Bjorheim for Best's Review

## Putting the 'New' in Annuities

Variable annuity writers have taken a new step in risk management by introducing investment options with hedge assets.

by Ron Panko

**T**he financial crisis was a horrible experience for people as they watched their asset values fall sharply. But it was also an amazing laboratory for risk management by writers of retirement savings products, said Ken Mungan, financial risk management practice leader at Milliman.

"It was exciting for me to see the life insurance industry use that opportunity to see how retirement savings products could be created with a strong use of risk-management principles and then be proactive in designing new products and new manufacturing processes for those products to give a more sustainable offering to the market," Mungan said.

Milliman's new contribution is the creation this year of three "protected portfolio" funds that are made up of both exchange-traded funds and hedge assets.

Variable annuity writers have added to their risks since 2002 by offering guaranteed withdrawal benefits. These benefits have grown into lifetime withdrawal benefits, which

have been driving VA sales. But when the financial crisis struck in 2008 and account values fell steeply, many insurers found themselves struggling to hedge those liabilities on their balance sheets. In response, many reduced the benefits they offered in new contracts, and writers have worked with firms like Milliman to try to contain risks.

The three new funds, a joint venture of Milliman and ValMark Advisers, are the latest development in what Mungan calls a multiyear effort to create a "sustainable manufacturing model." They embed hedging at the subaccount level rather than at the policy level, which should reduce volatility in account values.

"The company still provides a guarantee, but now it's a much less stressful offering on the balance sheet of the company, and it provides more stable quarterly earnings," he said. The new funds have also generated positive responses from customers and financial advisers, who value risk management in the fund options they own, Mungan said.

### Key Points

- ▶ **The Trend:** Variable annuity writers are showing interest in new investment options that actively hedge assets at the subaccount level.
- ▶ **The Significance:** These 'protected portfolios' reduce the risk of large account-value declines while still providing upside potential.
- ▶ **The Payoff:** Insurers will have better control over their balance sheets and more satisfied customers.

ValMark's investment advisory business manages exchange-traded fund portfolios on behalf of life insurance and investment companies, high-net-worth clients and collective trusts. It created ETF allocation portfolios in 2002 before launching five traditional ETF allocations for the variable insurance world and then partnering with Milliman to create the three so-called "protected portfolios."

Michael McClary, chief investment officer at ValMark, said Milliman thought ETFs were the perfect tool for its risk-management technique because they are index-based, and Milliman uses index-based

## Life

futures contracts as its hedging tool.

“With our portfolios, since every component of our portfolio is an index, there is very little hedge breakage,” he said. “They perform very close to what we expect. So that’s where the marriage got started. Milliman thought we were the perfect partners.”

ValMark also worked closely with i-Shares, the largest ETF provider in the world, to help design the operational component of the funds, McClary said.

McClary is manager of the funds.

“We handle the ETF side, and they do what they need to do on the hedging side,” he said. “So if there is a large deposit, we’ll be purchasing ETFs, and they will be shorting index-based futures contracts based on their methodologies and algorithms.”

Milliman looks at all of the volatility of each of the individual ETFs on a custom basis every day, and the volatility measures are up or down based on the volatility of the portfolio, said McClary. “So as the market gets more volatile, our net long exposure will decrease,” he said. “As volatility goes down, our net long exposure will increase.”

In simple terms, McClary said, ValMark’s traditional strategic allocation models are designed to drive on the expressway at a steady 65 miles per hour, and Mungan and Milliman dynamically apply the brakes and change lanes with their hedging techniques.

In the third quarter, the S&P 500 Index was down 13.87%, but the three protected portfolios were down less, McClary said.

The growth fund was down 6.49%, moderate growth was down 5.62%, and the balanced portfolio was down 4.45%.

### Early Adopter: Ohio National

In late June, Ohio National Life Insurance Co. became the first variable annuity writer to add these portfolios to their lineup.

They are available to both in-force and new business, said Stephen Murphy, senior vice president, capital management. The company plans to introduce a product and new features early next year that will be specifically designed around the funds and will provide a richer lifetime withdrawal benefit.



“What these risk-levered funds do is allow us to put a policy on the books and predict what it will cost us to hedge that policy.”

—Stephen Murphy,  
Ohio National Life Insurance Co.

The new funds were compelling to Ohio National because they benefit the insurer and are attractive to the consumer, Murphy said. And when Mungan spoke in June to the company’s wholesalers, Murphy said the “buzz that Ken’s presentation generated was incredible.”

In the first two months, about \$50 million was invested voluntarily in the funds, even though no one is required to put money into them as this time, he said. That could represent a significant percentage of new VA premium flow, Murphy said, “and it was reassuring to us that we made the right move.”

Overall, using the funds will reduce the amount of hedging

Ohio National will need to do, “and its downside protection is also going to reduce the reserve calls and capital calls that these riders can potentially have,” Murphy said.

Other companies have used a variety of ways to reduce account value volatility, he said, but those efforts have been at the policy level.

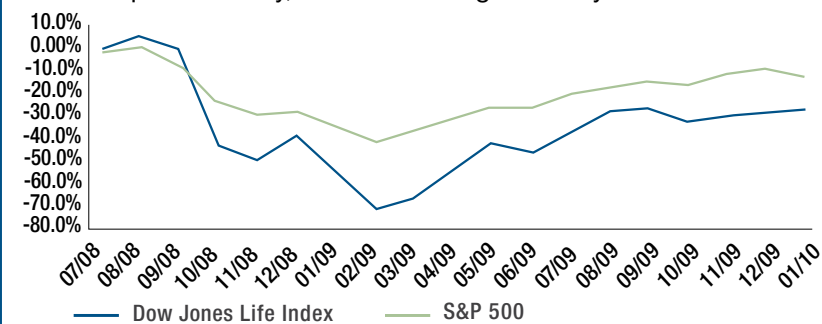
“Those methods create the risk for policyholders that they can become stranded in nonequities because they move your account value out of equities into fixed income,” Murphy said. “The question is, can you protect against a downturn and still provide a lot of upside potential? All of our analyses have showed us so far that Ken has come up with a structure that provides a lot of downside protection but still allows you to participate in much of the upside.”

### Advisers Show Interest

Indeed, a couple of other companies say they have included protected-portfolio funds not so much for their own risk-management purposes, but

### Life Insurer Returns vs. the Market

This graph illustrates how life insurers’ business models were market sensitive from the onset of the financial crisis through January 2010. At the worst point of the crisis, a life insurer index showed a 71% decline vs. a decline of 42% for the S&P 500 Index. Life insurers outperformed during the subsequent recovery, further illustrating sensitivity to markets.



Source: Milliman

rather to help policyholders manage account-value risk. Jefferson National Life Insurance Co. is in the process of adding the funds to its Monument Advisor variable annuity, and Prudential Financial has added them to its variable universal life insurance policies.

Monument Advisor is designed to be a tax-deferred electronic trading platform for fee-based advisers to proactively create and manage portfolios for clients.

The platform allows advisers to easily rebalance and transfer assets, said Laurence Greenberg, company president.

The only guarantee the company offers is an optional return-of-premium death benefit.

"The advisers want to utilize their own strategies rather than pay the insurance company to manage portfolio risk through a rider," he said. "They believe they can do that more cost-effectively than employing riders."

The annuity offers that opportunity through 330 fund options, compared to an industry average of about 40, according to Greenberg. It charges a flat fee of \$20 a month regardless of policy size, which Greenberg said averages about \$200,000.

So before adding the funds, Jefferson National already offered a wide variety of asset classes, including funds that short stock indexes.

"It's a very different take on the role a variable annuity can play with a fee-based adviser in terms of managing their clients' money," he said.

Despite the in-fund hedging, the new funds are not more expensive than existing funds in the annuity, Greenberg said.

"To us, it was an opportunity to help advisers offer that strategy," he said. Jefferson National added one of the portfolio-protected funds in May and planned to launch the other two in November.

Greenberg said requests to add the funds came from advisers.

"We don't use wholesalers. We have a centralized desk where our people talk to advisers every day and get constant feedback. All we do is serve fee-based advisers, so it is essential that we understand what they need to be successful."

Jefferson National launched Monument Advisor in 2006 and expects to have \$850 million to \$900 million of assets under management by year-end, Greenberg said.

The insurer works with more than 1,500 advisers and has about 5,000 policyholders.

### Addition to VUL

Prudential added portfolio-protected funds at the end of August to its PruLife Custom Premiere II and its VUL Protector.

"Our product area looked into them and thought they added diversification," said Barbara Cooper, chief risk officer for Prudential's individual life insurance business. "We offered them to customers because we felt that a subset would like the management style and the approach it takes to investing."

Cooper said Prudential did not add the funds as a way to manage the death benefit liability. The VUL Protector has a no-lapse guarantee, but the issuing companies, Pruco Life and Pruco Life of New Jersey, cover that risk through reinsurance, Cooper said.

According to Mungan, the three protected portfolio funds could be especially useful for investors who are in or nearing retirement and dependent on taking withdrawals from their holdings. If a significant market decline occurs while making periodic withdrawals, account values can fall so rapidly that the investors may not have enough left to participate meaningfully in rebounding prices.

"Those two events can combine in a very toxic way to deplete the account value for the customer," he said. "So having a protection strategy within a customer's portfolio

means that the sequence-of-returns problem is largely solved, and it gives them the ability...to benefit reasonably from recovery in the market."

Mungan estimated that some version of the sustainable manufacturing model probably represents about half of current variable annuity sales, "and it's growing at such a rapid rate that I believe it will become the primary manufacturing process in the VA industry in the relatively near term."

Murphy said risk management challenges for annuity writers can be explained by the way airlines hedge the costs of fuel.

"The reason an airline won't sell you a ticket for five years from now is that it can't hedge fuel costs five years from now," he said.

"If we're going to sell somebody options, which are what we're selling in our riders, and we have no ability to lock in that cost to hedge these things, that's not a sustainable design. So what these risk-levered funds do is allow us to put a policy on the books and predict what it will cost us to hedge that policy," Murphy said. **BR**

### Audio:

Listen to the entire interview with Ken Mungan at [www.ambest.com/audio](http://www.ambest.com/audio).

### Learn More



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