Episode #158: How Volatility Control Indices Work

Video Transcription

Hey there, this is Kevin. Thank you so much for watching today's Money Script Monday video. Today, what I want to talk about is how volatility control indices work. You see, one of the complicated things out there can be about buying an indexed annuity, or an IUL is how some of the indexes work. And many people on the outside, such as the competition and Wall Street demand that a consumer understand every single sub-component of an indexed annuity before they go and buy the product. Yet at the same time, the consumer might go out, and they might go buy a car and not insist that the salesperson open up the hood and explain every single moving part underneath in that engine. Nor or when they go, and they go buy a TV that they want to tear the panel off and examine every microprocessor that makes the technology work. But when it comes to insurance products, for some reason, the expectation is that a person should have an understanding of every single internal moving part inside of that contract or how that index works. And while it can't always be true, I want to explain how a volatility control index works generally. Because volatility control indexes are a great benefit to a client because it allows them to earn potentially more interest in the long run in their contract compared to a non-volatility control index.

The first thing I want to talk about is what is a volatility control index. So, I have an example. It's purely hypothetical, but this red line, let's say is the S&P 500. And the S&P 500, as you know, is an equities-based index. And over time, it goes up and it goes down. We've learned in the recent past, it can go down really, really fast. This is an example of extreme volatility. When it comes to indexed annuities or indexed IUL, volatility is not your friend when it comes to an index. It means that there's going to be restrictions on how much you can earn because you're not invested in the market directly. What insurance companies and index manufacturers have come up with is this new type of index called a volatility control index. And if we compare it to the S&P 500, let's say that one of the subcomponents of this volatility control index is the S&P 500. What you'll see is that over time, when the S&P 500 goes up, the volatility control index is going to go up too, and when it goes down, it's also going to go down. But the volatility is going to be smoothed out over time. It's not going to be as extreme. From beginning to end, it's still going to earn a competitive interest rate and have a good opportunity for growth without all those big gains and all those big losses.

That is essentially how one of these indexes work. But if you lift the hood and try to go inside and understand the complicated parts, there are some other things that you have to note on how it's going to perform. One of these things is something that they call a volatility target, it's expressed typically as a percentage, it could be 3%, it could be 5%, it could be 10%. And what it means, in the end, is that if the volatility target is 10%, it will have quite a bit of volatility. The green line would have more volatility. Whereas if the volatility target was 3%, this green line would be very smooth and linear. That is something that's not explained, or even disclosed to the consumer when they're picking an index or told how it works. And I'm going to show you in a few minutes exactly how that applies to you in the end — the other piece of how one of these indexes work is through something that we call dynamic rebalancing. The volatility control index is typically made up of two sub-component indexes. One of them is going to be equities-based, such as perhaps the S&P 500. And one of them is going to be fixed, perhaps the 10-year Treasury or U.S. Treasury benchmark. And one of them is going to be not volatile, whereas one of them is going to be extremely volatile.

Based on the volatility target of the index, there's going to be a proprietary algorithm that dynamically rebalances daily between these two positions, between equities and between fixed. And it's purely determined by the volatility of this equities-based index. Here's what this means, because it was a mouthful, is that if volatility increases, if volatility goes up, meaning that the market starts going down really, really fast, then the index is going to dynamically rebalance over here to the thick side so that the index itself does not experience this huge movement. It controls the volatility of that index. When volatility decreases, it's going to dynamically rebalance back over to the equity side and have a way a weighting that's much higher on that side. We've seen some indexes where the weightings on the equity side are as high as 90% or 95% when volatility is low.

Essentially that's how the dynamic rebalancing works. And the value of the index is just the sum of the weighted averages of these two different indexes. It's as simple as that. But what does that mean to you as the end consumer? How can you look at all these different indexes if they don't tell us the volatility controls? And we really don't know what the proprietary algorithm is that they're using to determine these dynamic rebalancing. How do we figure out which one is going to be best for you as a consumer? Well, there are some things you can do, and there are some things you can't do. And let me give you an example. Let's say there are three completely different indexes: A, B, and C. When it comes to a volatility control index, typically, you're going to have no cap to how much you earn, because the volatility is smoothed out, they're going to allow you to have no cap on the interest credit.

In fact, because its volatility's smooth, they're going to give you a participation rate of let's say 120%, 160%, or 200%. This means that if index A earned a 10% return

over a 1-year basis, they would take that 10% times it by 120%, and your index credit would be 12%. If index C earned a 5% return, then you multiply that by 200%, and your index credit would be 10% at the end of the year. So, that's how the math works. If this is the only thing we know, and we look at the three indexes, it would be easy for a consumer or an advisor to conclude that the index with the highest participation rate will be the best and give you the highest opportunity for growth. But that is simply not true. So, beware of picking indexes just based on which one has the best rate. That is because what they're not showing you is what the volatility control of these indexes are. And in my hypothetical example, the reason why the participation rates lowest on this one is that this index has the highest volatility. It has the biggest earnings potential; therefore, it gets worked out by having this lower participation rate, whereas index C has a lower volatility control, which is why it has a higher par rate.

Now, let's say that this was actually the same index. And the insurance company gave you three different options on the same index. They said you could choose one of these three, but we're going to use a different formula to determine a different volatility control. If the index is priced perfectly every single year, over the long run, all three will perform exactly the same. They're going to run the exact same rate of return over the long run. That's an example of how these mechanisms work when you go and try to pick one. Do not just simply pick the one with the highest participation rate or the best rates. Then, the consumer might say, "Well, I'm just going to go, and I'm going to look at the back testing that the index manufacturer or the insurance company is showing me." If they're going to take the algorithm, they're going to apply today's algorithm to the past ten years, let's say, and they're going to project whatever the returns would have been moving forward. That is also reckless because it is not an indication of how the index is going to perform moving forward, based on how it has performed in the past. It is not an accurate representation.

So, do not run to an illustration and say, "Well, the one on paper is projecting better than the other." Because that also is not going to be an accurate projection. So, what do you do? The bottom line is there are really two things that you can do to make sure that you pick the right one. One is you have to pick an insurance company with a good brand name, that's been in the industry, and has a good reputation. And second is you have to pick an index that has been on the market for something over one or two years. You do not want to pick a product or an index that just came out, that has really good participation rates, and has good back testing because I just told you that both of those are meaningless when it comes to projecting forward. You want to go more towards the strength of the company, their reputation, and that we can actually look at actual returns on enforced contracts to see how they have performed.

The bottom line is that as a consumer, you want to make sure that when you buy your car when you turn the key over, the engine will turn on, and that car is going to get you to the destination you want to go. When you have had a hard day and want to relax and want to go home and watch some Netflix, you want that TV turn on. In the end, you don't want to know how every piece works inside of those. But you want to make sure that it's dependable and reliable when you actually need it. And the same is true when it comes to an insurance product with a volatility control index. It's going to be impossible to know exactly how that volatility control index works because they're not going to tell you things like this proprietary algorithm. What you want to make sure is that you pick a good company with good ratings and reputation, because at the end of the day, when it comes to your retirement, you want to make sure that product is going to perform and that money is going to be there for you in the future when you need it. So, thank you so much for watching today. Thank you.