Episode 84: Understanding the Index Choices for Index Annuities

00:00
Bob French
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to Risaprofile.com/Style and sign up to take the industry's first financial personality tool for retirement planning, indexes or Indices. Wade and Alex continued their arc on annuities and unraveled the mysteries of the English language on today's episode with special guest Branisov Nikolik from the Index Standard.

00:54
Alex Murguia
Welcome to retire with style. And I'm here with my co host Wade Pfau and another special guest here, Branisnov Nikolic. And just quick trivia, two of us are in Canada, one of us is not. For this episode, if you write in, you'll get a free copy of Wade's book. You can guess who's in the US. Right, Wade? Is that right, Wade? Am I ruining the sales numbers?

01:24
Alex Murguia
Did we do that?

01:25
Wade Pfau
I think we got yeah, you should probably be asking Bri if she wants to manage that's.

01:36
Alex Murguia
The she sort of organized everything in the background. But Branisloff, thank you for joining, man. Really, really appreciate it. I think you're one of the rising stars within the industry as far as insurance annuities go. I really do think so. And so it's actually kind of cool to bring you on the show simply to get your take on the state, but more specifically on indices and the like. As we've been discussing on previous know, specifically with regards to fixed indexed annuities and Rylas, how there's an index that they effectively track. But before we get into all of that, can you tell our lovely listening audience a little bit about yourself?

02:23
Branislav Nikolic
Thank you, Wade. Thanks for having me on the podcast. As Alex mentioned, my name is Brycelamnikovic, and I've been within the Standard for last six months. So fairly with both foot on the ground. Prior to that, I was with Canx, a data analytics provider, and I've spent last ten years roughly working on annuities their allocation within a portfolio, basically optimizing the annuities themselves, anything from optimal utilization. And I had a pleasure to work with Wade and Alex in my past life, so hence the invite, I guess. But I think the topic is more of like what I do now. And I'm leading the insurance initiatives at Index standard? Index Standard been founded around three and a half, four years ago by Lawrence Black. And what we tend to do is help people understand indices that are utilized in structure products and annuities demystify what these things are.

03:39
Branislav Nikolic
See if we can break it down to the level that it's acceptable for people to just read our reports, understand our ratings, see what our forecasts are for the future and how to use this to optimally allocate within annuities. Again, I'm really honored to be here. Thanks for having.

04:01
Wade Pfau
Thanks, Brandis. I've been pointing clarification, just to be clear. So what you do with the index standard, you're evaluating other indices. You're not in the process of creating proprietary indices.

04:15
Branislav Nikolic
That's correct. So the founder of the index center, lawrence black, he was in the business of creating indices and is behind some of the very successful ones. But he thought that instead of creating more indices, we could use the expertise to evaluate ever that's in the market and see if we can add a layer of information that could be useful for the advisors, consumers, product manufacturers alike.

04:48
Alex Murguia
Yeah. And this goes to your point way that we've said in previous episodes that sometimes it's hard to make comparisons, especially when people have different indices to assess the quality of the underlying. And so I think this sheds light. But before I get into that, I have two significant questions I have to ask branislav about. All right, so is it dr. Branislav, or are you like wade? That was like ten years abd.

05:16

Branislav Nikolic
Yes and no. I defended on a may 4, but I'm yet to wear a silly hat, so it's somewhere in between. Dr. Ellen?

05:32
Alex Murguia
Yeah, you know what? Truth be told, I never attended my graduation. I never wore a hat or gown or anything. By that time, I got it.

05:40
Branislav Nikolic
I'm done. The feeling is mutual. So, yeah, the hard part is done now. It's only festivities left.

05:49
Wade Pfau
And was moshe Malevsky on your? Yeah, I know you're.

05:52
Branislav Nikolic
He was actually chairing committee, not just being on it, but chairing. And usually the role of the chair is relatively ceremonial. But everyone who knows moshe, he made sure that it wasn't that. So I had a very good examination. So proud to say that.

06:12
Wade Pfau
Well, congratulations.

06:14
Alex Murguia
Congrats by the you.

06:16
Branislav Nikolic
Thank you.

06:17
Alex Murguia
Now, the other main question, and I think after this question, I'm done with the entire interview is it pronounced IFI or IFA ms?

06:27
Branislav Nikolic
Yeah.

06:33
Wade Pfau
Well.

06:36
Alex Murguia
Look, where do you go?

06:38
Branislav Nikolic
My rendition. But I'm ESL kid myself, so I just go with whatever is in the moment. So I'll be in your team. There's no answer.

06:49
Alex Murguia
Did you see wiggins? He's like a politician, this guy. Is that what you do in your dissertation advance? Is that how you answer?

06:56
Branislav Nikolic
No.

06:56
Alex Murguia
EV or EPA? You got to give me answer, man. What team are you at?

07:02
Branislav Nikolic
I would say EV. Really?

07:06
Alex Murguia
I'm EPA.

07:07
Wade Pfau
And just for those listening, maybe it's one of the standard international indices that gets used, but that might just a good place to start. Just to level set a little bit. What even is an index? What do we mean by the idea of an index?

07:25
Branislav Nikolic
The way we like it to think about indices is that they are, again, nothing but the set of rules that would give you exposure to different types of assets, loosely speaking. So one can think about it as a portfolio with a caveat that you don't actually own what's in the index. And this really goes into when you say, I'm invested index. What does that mean? I'm invested in something that usually tracks the index. Index would be the way or the recipe that you would put things together. But usually what you're invested in is either an ETF exchange traded fund or structured note or annuity. So that's the way I like to think about this.

08:19
Wade Pfau
Classic indexes indices that are out. That's another question. Is it indexes or indices? I think I've seen it both ways.

08:30
Branislav Nikolic
Are you team indexes or team indices?

08:33
Alex Murguia
Let's just get this all out of the way.

08:35
Branislav Nikolic
I have indices but I believe that Common US editor would correct it all to indexes. So that's again, I think it's a relative preference. But we actually wrote a piece that's going to come out as a part of National Association for Fixed Annuities Education series on actual indices and we basically tried to put this into some common buckets. You have benchmark indices that started on as just a gauge of how an economy as a whole will be doing or the sector of the economy. Then you have thematic indices, something that is basically output of someone's research or someone's idea on how to put assets together. Everything leading to for example, ESG indices these days that are being utilized more and more. So Wade, I think going back to your question when we talk about indices, what are we talking about when we're strictly talking about annuity space?

09:47
Branislav Nikolic
More often than not you're either team benchmark or risk control or volatility control type index. That could be either multi asset and then have some form of the volatility control mechanism. Now I'll let you ask probably you're going to ask what's the volatility control mechanism?

10:10
Wade Pfau
Yeah, we definitely want to get into that. The benchmark indices that's like the S and P 500, that's the one we've talked about the most in past episodes. But you've got I always just said EAFE the EFA, that's a common international index. You've got like the Russell 2000 which brings in more of the small cap side than the S and P 500 gets into and so forth. And then right, we've talked about just generally the S and P 500, because that's one that most companies will offer. And so it makes it easy to say, well, if Company A has got a 12% cap on the SP 500, company B has a 10% cap on the S and P 500, that tells you a little bit about how much options budget is available. But the real interest it's with the volatility controlled wait, I would say just.

11:03
Alex Murguia
To make sure again, this is where we struggle with this argument a little bit because we've talked about certain concepts already. This is within the construct of a fixed indexed annuity and later on we'll be talking within the construct of a registered index late annuity.

11:17
Wade Pfau
Well, and whether there's even any difference really. That's probably a good question.

11:22
Alex Murguia
Yeah, fine.

11:23
Wade Pfau
But yeah, the volatility controlled indices is where a lot of the action is. And why is that? Brennan what's the motivation?

11:33
Branislav Nikolic

At a basic level, there are two key elements that affect you said a keyword option budget. And option budget is a reflection of where the interest rates are. And in the past decade we had interest rates near zero and then they were consistently very low. So usually where you get your option budget is from the rate that you can invest in your general account. If you are an insurance company, you invest your assets and you get rate of return. And for that you can buy some options to offer your fixed index annuity payouts. Now, the benchmark indices, as the name says, like benchmark, they were never meant to go into anything, they were just meant to benchmark. And as such, they're a true gauge of what's going on. So they're volatile at times and if you have a small budget to buy something that's very volatile or very risky, you cannot give much of the exposure.

12:34
Branislav Nikolic
In other words, what you were mentioning before, you said company A offers caps of ten and twelve. Have we had this conversation two years ago? Three years ago we have been talking about two and a half, two and three quarters, and talk about competitiveness. So that tells you about the responsiveness of these options that you're buying to the FIA to benchmarks. Now that's one aspect. The other aspect is volatility. So in order to reduce the price of that option, you need to tame the volatility. And this is where the volatility disease came into the game, that if you could offer an index that would perform certain actions, most commonly just shifting between, let's say cash and risky asset, you can bring down the volatility, make the option cheaper and offer more participation on such an index. Then the key is that you then expand kind of the field of who can play in that arena.

13:36
Branislav Nikolic
So we've seen a lot of asset managers that went into the arena and a lot of obviously banks who are on the other side of those deals providing these options to their shares companies to begin with.

13:49
Wade Pfau
Yeah, probably we should kind of so a 15 2nd refresher on how an FIA works because it's something we covered in past episodes. But the idea is you pay this premium, it has principal protection because the insurance company buys enough bonds so that when they earn their interest, you have principal protected. Then with the remainder, the insurance company keeps part for themselves, the rest goes into this options budget used to purchase financial derivatives such as call options on the index, which provides a payout. If the index gains in value, the price returns of the index gains in value. Now, when you get into that situation, interest rates become very important because the higher the interest rate, the less it takes to protect principal, the more that remains to purchase upside exposure to the index and then the price of the financial derivatives is very important.

14:41
Wade Pfau

There's several factors that go into that and the most important of which is the measure of implied volatility that the more volatile the index is expected to be, the more expensive those options are. And if you have to spend more on those options, the less upside exposure you get. But that's the whole idea. Then if you use a low volatility index should make the options cheaper. The low volatility index might give you a higher cap than the S and P 500, for example.

15:13
Branislav Nikolic
Usually these come only with a participation on it. Usually they're not capped. I think that's another if you want to go into the marketing realm of why they took off is that usually you can go around and say you get a participation but there is no any cap to it. Again, it's like half dozen or the other six. You can really structure this any way you want. But the key point is what you just mentioned is the lower and more importantly constant or close to constant volatility. Because the big question that is posed industry is how consistent these annuity parameters will be through time. I understand that these are today that I'm buying the annuity, but in a year's time will you be able to, what it's called, renew at the same or similar rates. And these volatility control indices because of the relatively smooth volatility structure can offer that with a higher consistency and then becomes very important at the advisor level.

16:19
Branislav Nikolic
What happens at that one year or a two year statement review? Did you get a credit in your FIA? What's going to be the profile of your payout for the next year and so forth. So I think between those two things, extremely low interest rates in the past decade and the stability of the annuity parameters, we see roughly 60% of the premium being allocated to these, call them custom or non benchmark indices in the market.

16:53
Alex Murguia
Has this been a steady increase over time or is this just it has.

16:56
Branislav Nikolic
Been steady, relatively steady increase and obviously with more players coming into the game. So at any point in time you have around 100 or so of these indices utilized in the insurance.

17:10
Wade Pfau
Yes.

17:12

Alex Murguia
And so this is where you saw.

17:14
Wade Pfau
Sorry, this may be where really what the work you're doing at the index standard comes into play because someone might think, well, if this is an indices, an index that has less volatility, maybe it has a lower expected return as well. And then if I'm thinking, well, if I have a higher participation rate on this index because it has less volatility, does that even matter? Because I'm not expecting a higher return anyway. And so what should I pick? Index A that has lower participation rate but A higher expected return or index B that has a higher participation rate, but a lower expected return. Is that where you're coming into the picture?

17:58
Branislav Nikolic
That's a perfect segue. Again, now it goes shameless plug. So what we do is that we assess indices on their own. We provide a rating and we provide a forecast rating. We look into how well the index is constructed, how transparent the rules are, and again, anything to do with the past returns. We take into account very important bit that all of these are developed with a benefit of a hindsight because you have to provide a back test. In other words, how would have this index performed in the last ten years, for example? So we look into the measures that would assess the returns in a back test versus this index went live and basically assess the index for its quality. Then the second step is that we take the capital market assumptions and basically forecast for ten years from over 35. Either investment banks, insurance companies, asset managers aggregate these, and through basically a DNA analysis of each and every index, we are able to based on these kind of now common capital market assumptions that we call Wisdom of Wall Street Forecast, what each of these indices we see doing over next ten years, we provide conservative, moderate and a strong forecast for it.

19:26
Branislav Nikolic
But where rubber really hits the road is that we combine that now with the present annuity parameters. So you have a forward looking index returns and you have annuity parameters, participations caps fees in some cases. And we are basically trying to level set and allow for this comparison between different annuities with different crediting strategies struck on different indices.

19:54
Bob French
Are you a financial professional looking to learn more about the Risa and Retirement income best practices? Well, if you are, you should join our retirement income masterclass on Monday, August 28 and Tuesday, August 29, you can sign up at risaprofile.com/advisors. That's risaprofile.com advisors.

20:16
Alex Murguia
Okay, so if I can maybe reiterate this just to make sure that I understand it. So what you folks do and your audience, I would imagine our financial profession or carriers or they're like not necessarily end consumers, correct?

20:36
Branislav Nikolic
No, we do this for the benefit of the end consumer. So to us it's important, but we can debate who the end consumer of our material is.

20:45
Alex Murguia
Yeah.

20:45
Branislav Nikolic
So I think the ultimate benefit is for the person buying the annuity because their advisor got you will be able to tell them difference between index A, index B, and help them explain the choice that they're making together ultimately.

21:02
Alex Murguia
Okay, and so to Wade's point about, okay, there's an FIA, and one of them is tracking this, the other one's tracking that. Based on what you said, you have three layers. The first layer, you're just going to quality review them. Okay. I may not be saying this right way, but okay. This index score is at a nine. This index score is at a 9.5. In terms of from a quality scale.

21:26
Branislav Nikolic
Standpoint, yeah, we made it even simpler. So we have almost like a metals. So we go from like, platinum, that's fine. Copper neutral.

21:35
Alex Murguia
Yeah.

21:35

Branislav Nikolic
And that basically gives you the categories of.

21:41
Alex Murguia
Okay, so your Ames is able to assess the Russell 2000 is not the same as the S and P 500, but for the purposes of the analysis, they both end up getting a silver medal or they both end up getting a gold medal. So you can kind of assume that they're in the zip code.

21:58
Wade Pfau
Do the benchmark indicator.

22:01
Alex Murguia
That's the first layer.

22:02
Branislav Nikolic
You're asking the right question. So what we do, we also group indices alike. So similar to how you would not rate equity fund together with a fixed income fund, we group like indices and they get ranking a categorization in their own got you.

22:26
Alex Murguia
Okay, so it's on a relative basis, but then that's the first layer. Then you sort of bring up the forecasting. And the forecasting obviously caveat, empty, all that kind of stuff. But the forecasting is a consensus based forecast is kind of what your sense of and it's almost I use this term very loosely it may not matter the accuracy because what you're looking at is on a relative basis, the wisdom of the crowds has sort of set this general forecast for this particular index. And so that helps kind of equalize, I think, comparing different indices to each other.

23:09
Branislav Nikolic
It does.

23:10
Alex Murguia
Proportionally. The inaccuracies would be the same.

23:12
Branislav Nikolic
It does. But also the important bit is that the rest of your portfolio planning or asset allocation or product allocation even, will be done with some capital market assumptions in hand. And we are trying to basically say this is what kind of is in the same units of measure you can perform. And allocate to the annuity as opposed to using the backward looking I'll give you an example that I always like using. So take the benchmark indices, whether it be Nasdaq or S and P 500, and you see Apple being the major part of that. Obviously much more in Nasdaq than S and P 500. But Apple, if you look over last ten years, had annual returns in around like 17, 18%, let's say Nasdaq had that as the last ten years. Now, if you grow Apple at that number, you will get Apple in ten years having the market cap three, four times the GDP of Germany.

24:21
Branislav Nikolic
So the question is, should you use that back test in your planning? Is it realistically to expect that Apple will continue to grow over next ten years the way it grew over last ten, and how sustainable that is, as opposed to looking into consensus of where we see, for example, technology going over next ten years that we see in these couple of market assumptions from these different providers?

24:48
Alex Murguia
No, I think sort of say, Wade, and I subscribe to that. I mean, when we did a whole arc on planning, it comes up do you use historical returns or do you use sort of forward looking returns? And you'd be foolish maybe to struggle word, but you'd be silly to just assume that, yeah, Apple is going to return 70% for the next 20 years because that's what it did the previous 20, that kind of thing. But that's the second layer. And then you add one more layer, which is then you look at the annuity structure in which that index is in and what the parameters of those are to kind of try to uniform them all out.

25:28
Branislav Nikolic
That is correct. So basically that provides that apples to apples comparison and we compute for each crediting strategy in every annuity, what we call net forecast credit. So basically it's again a simulation that takes our index forecast as its base. It layers on the annuity parameters and for each trading strategy we are able to give you something that's equivalent of a rate of return net of all caps, floors, fees, rylas, buffers, et cetera.

26:08
Alex Murguia
So Wade, do you think this satisfies your concern? Or again, satisfy the word choice here, but does this satisfy your concern in the previous episode when you said there's no way to really compare these fie from

an apples to apples comparison because they're using different indices to begin with, does this go towards maybe allaying some of those concerns?

26:31
Wade Pfau
Yeah, I mean, this can go a long way. Really what I was saying was just if you want to compare different companies and try to think about which company would I like to go with for the annuity, it's easiest to compare them with the S and P 500 because most of them have that offering and so you're able to see what they're doing with it. When you start getting into the proprietary indices, there's less transparency because it's harder to compare. But no, I think that's where you're stepping into this missing gap in the marketplace to provide a service to make such comparisons.

27:09
Branislav Nikolic
Shall I call my marketing department and say that we got just endorsement from.

27:13
Wade Pfau
Yeah, it's kind of sounded that way. Another question though, on these comparisons, this idea of volatility controlled, it means there's something dynamic going on. And you said earlier when markets becoming more volatile, it may push more into cash. You're actually simulating those rules as well when you're doing this sort of forecasting about the future performance.

27:43
Branislav Nikolic
We do our factor or DNA analysis of an index to basically see where the index is exposed. And it's almost impossible to replicate every index go forward basis. But our factor analysis gives us the average exposures that index had and we apply those on a go forward basis. So again, everything that you could think.

28:13
Alex Murguia
You'Re effectively saying this index has a beta to value of, I don't know, 75 to cache of this, to size of this, and the R square is 95. So that's good enough and we're going to replicate.

28:26
Branislav Nikolic
So basically we do two things, I think at two layers. We do a DNA type analysis which basically would say geographical or the asset class exposure and we would do finer of a blood type thing which is value growth, momentum side. And based on these two set of factors we are able to forecast these sort of go for a bit.

28:55
Alex Murguia
Now.

28:58
Branislav Nikolic
I got asked recently how you can use what we produce. Is that someone said, okay, you're giving me all these exposures, that's good for you guys who are technical. But if I'm looking for an index to give me a good protection against inflation, how do I see that in your analysis? And then you would basically then see the exposure to commodities, exposure to gold and say these were historically a good inflation buffers. So you may want to choose index that has decent exposure to these as opposed to cash or just plain treasuries.

29:37
Wade Pfau
And that is something that's out there in the annuity space with going beyond just stock type indices.

29:47
Branislav Nikolic
Absolutely. So we see categories that are multi asset and again, the progression was that you had your benchmarks, that you had the volatility control, then different versions of doing that intraday as opposed to on some fixed timescale. Then what we saw in last couple of years coming is like the commodity curve place coming into this again to try and battle the inflation and haven't seen that commodities did reasonably well over last little while. So you have more than just to your point, more than just your stocks and bonds or equity and cash. These are now like multi asset, quote unquote portfolios that have these mechanisms that will rebalance them to smooth and cushion the returns of an index itself.

30:46
Alex Murguia
And at what point if I'm a consumer, I'm listening to this and it's interesting, there's a little meta thing going on and by that I mean like okay, the FIA structure in themselves are creating that kind of buffering, know that buffer alone creates it. But then interestingly enough, the underlying index of that product does their own internal kind of volatility control from a pricing standpoint. But do you see how there's a little meta thing to that?

31:23
Branislav Nikolic
Are you over insuring? Are you overprotected where I'm going with.

31:30
Alex Murguia
That is sometimes in any industry, right? Does this provide an extra layer of fees that's necessary? I'm sure the answer is yes. But there's always this balance, right, where people just spot an opportunity, a market opportunity and go crazy with it.

31:46
Branislav Nikolic
The way I see this, and again I can give you kind of the common example that I always give is that when it comes to the FIAs, where do these go? These go to retirees. And these credits on annual basis are sometimes the money that people will take out and live off absent having any guaranteed income rider on them. So the key is how consistent you want these to be. And to me these volatility control indices provide not another layer of protection basically to double up. Obviously the FAA will protect your floor, you will not lose your money. But the key is how steady those credits will be. Will you get a positive credit of a similar amount, let's say seven out of seven years or five out of five years? In other words, if you put it in baseball terms, you can win the game in different ways.

32:40
Branislav Nikolic
The way we see the totally control indices is your lineup stock with the guys who can hit singles and doubles and you get your runs along the way. Whereas with, let's say benchmark, let's say the SFB 500, you can hit it out of park five out of seven years, but two years you may not. On average the index did fairly well, but in two years you may not get the credit again, you can win the game that way as well. It's really coming down to a preference, but I don't think the game is either or. I think it's diversification. Look into exposing yourself to more than just one thing because that's good. The only free lunch in finance is diversification. And the other one is that I think single allocations to a single index are starting to be problematic from the suitability or best interest point of view and compliance point of view that you basically have in a lot of cases, a lot of premium going towards SMP because that's the only thing that people are familiar with.

33:49
Branislav Nikolic
And we are trying to bridge that gap as well to make them familiar with something else. And if still decision is it's better to go with index ABC, so be it. But you made an informed choice as opposed to this is the only thing that sounds familiar.

34:07
Bob French
Let's take a moment to let the audience know that this show is sponsored by Retirement Researcher. You can learn more about Retirement Researcher at retirementresearcher.com and subscribe to our newsletter where you'll receive weekly actionable information for your retirement planning benefit. Retirement

Researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

34:32
Alex Murguia
No, listen, I think you're right. Even from an investment philosophy standpoint, I'm not going to quarrel with somebody putting the money in the S P. It represents how the average investor in the US at the very least chooses to allocate their capital. But how much you reflect the average investor from an income standpoint or from an standpoint probably deviates significantly. And so to that extent, that's where these sort of levers can come into place nicely.

35:02
Branislav Nikolic
The other thing that again it plays interesting is, and we did a bit of a study is that over last two, three years with the rates coming up, you see, for example, the cap rate on SMP or the participation rate on SMP. Doubled or tripled right on these proprietary indices. If you're looking for let's say 50th percentile, I mean, the percentiles are moving pretty much in the same direction, but you see that the participation index increased by 20, 30%. So we had a huge jump interest rate, yet we didn't see much of a budget in the parameters. That tells you that these are relatively stable. If interest rates start coming down, you can expect the same thing reverting back to I think it's more about consistency and steadiness of what these provide on a return side. But that said, now it's kind of.

36:05
Alex Murguia
Wade's initial statement where it was, you know, if you can get a steady return, you can get more participation, you can get more can go down, you can send down more income to the consumer if you have that predictability because people can just budget their business a lot better.

36:23
Branislav Nikolic
Another thing that with the increase interest rates we are seeing now, you see that these participation rates are starting to get to numbers that are 200 and 5300 percent. Basically you don't need your index to do much to get a decent return, right? So I think that basically the technology that was developed to squeeze something out of nothing over last ten years now is being used when you have more than nothing to offer. And I think it's just more efficient way of doing this. And again, these indices were developed to be inside of other products. They were meant to have options and pay out.

37:08
Alex Murguia
Yeah, they have more purpose. They're not indices that are just benchmarks to your point. They're not

indices that were initially just meant to see how good active managers are doing. These indices have purpose and that purpose is to provide that steady stream of income and technology and science moves forward in the way of what you're doing. That's kind of my takeaway so far.

37:30
Branislav Nikolic
I'll just correct you. You said income, I would say returns, steadier returns. I'm still in the Annuity purist hump mostly and saying that income and guarantees come from a different place. But if you choose to use these FAA returns for that purpose, this gives you the level of steadiness that doesn't exist with benchmarks.

37:55
Wade Pfau
Brendan sova more basic question about this. When a proprietary index is created, how does that work about then creating a financial derivatives market around that so that options are being traded or is it more that part is also more proprietary in nature.

38:15
Branislav Nikolic
The simple answer is that usually they come hand in hand. So you would have the index provider, usually a bank, have their trading desk provide you with the over the counter derivatives for it. If you're an asset manager, you probably would again partner with a bank who would provide you the derivatives for it. And if you're a big indexer, again you're looking for someone like a bank, but the big indexers will have more generally available components in it so they can get bids from different banks. But it's that layer. And then the argument goes that you may be a little bit more efficient if you're getting all of it at the same place.

39:04
Wade Pfau
Okay. And that's also maybe a reason why they use participation rates more than caps is because caps requires a second layer of unique derivatives that are different strike prices and everything else you need to sell as opposed to at a different price.

39:25
Branislav Nikolic
I think that it really kind of goes because again, you're selling the cold, it's really out of the money, you might as well just keep that and keep the story around uncapped, which again has got into some hot water lately. But I think that the appeal offering uncapped exposure to an index is there in itself.

39:51

Wade Pfau
And you mentioned a participation rate of like in the ballpark of 200%. Could you clarify, was that a cumulative return over a multi year term or is that like a one year term you're leveraging? If we say a participation rate is 200%, that might indicate like if the index is up 5%, you're going to get a 10% credited interest.

40:15
Branislav Nikolic
Is that what you're basically, let's say, the simplest of one year point to point. In other words, measure your performance of an index on annual basis and apply participation rate to it. If we are strictly speaking about the SP 500, you may get 70, 80, 90% participation. But if you are talking about, again, another SP derivative index that's volatile control, you may get 100 and 2151, hundred and 60. And if you're talking a bit more complicated, again, SMP branded Volatility Control index, you can get even 200%. So basically, if that index itself does 2%, you get four, if it does five, you get ten. Then we can start to stretch that over multiple years and indices that would say, oh, if you start measuring on a two years basis or three years basis, I can offer you even more in terms of multiple on what index does over that period.

41:20
Branislav Nikolic
So it's all these combinations that make this very hard to your point to compare. And this is where we try to kind of address this with the effective annual rate of return over a ten year horizon.

41:33
Alex Murguia
Okay, got you. And Bradsoft, what's the best advice you could give to advisor who's beginning to be initiated in the world of annuities when they look at an FIA contract and they're trying to assess the quality of these annuities other than use index standard for the results? And then by the default, what are some of the questions an informed consumer should be asking themselves when an advisor presents them with a few options that are based on underlying indices?

42:08
Branislav Nikolic
So I'll go straight to consumer and that will inform that advisor as well. Right. I think for me, having academia as well is like why are you proposing this to me? Is this for income or is this for accumulation? Because the story starts to diverge fundamentally in those two scenarios. If you're doing this for guaranteed income, then obviously look into contractual guarantees. These are insurance products. They're contractual guarantees. See how is contractual guarantee looking? See if there is any upside on it. Usually there is a trade off. The higher the guarantee, the less upside and vice versa. If you're looking for the accumulation, the question is I'm using this for accumulation instead of what? Over last ten years, the common story was, oh, bond funds weren't that attractive. The interest rates were low. Here you can get

more of, quote, unquote yield. The question is if you understand that this is a fixed income replacement or fixed income augmentation.

43:21
Branislav Nikolic
That's good. I think a lot of misconception is that these are products that are exposed to they're somewhat tied to equity. I mean, they're not they're exposed to a certain degree to the equity or multi asset indices. So I would ask that question, what are we doing this instead? And then once it comes to a choice, it goes back to something that Wade was saying. How do you choose the insurance company? Did you choose the insurance company because you have some other reasons? Or this is the best rated company with the ability to pay its claims that they have the renewal rate integrity and then go into the details of a contract. Is the annuity well diversified? Does it offer more than one option? How competitive are the options inside of the annuity? And ask why pick one? Why not allocate too few to diversify even those credits coming in?

44:29
Branislav Nikolic
For example, we said like one year strategy, two year strategy, a little bit of both, and then you can get maybe higher participation or higher exposure or a two year strategy. But let's say half of the money in a one year strategy will give you constant credit every year. And again, how does this fit into your entire portfolio? And to understand again that these are fixed annuities, that if you see rates of returns on rate sheets or illustrations that are in high teens, low 20s, there are questions to be asked. That has to do with a practice of illustrations and back test and just kind of doing the arithmetic with all these numbers. But be sure that the right benchmark for this type of product is maybe 70 30 portfolio, 70 in fixed income, 30 in equities. Wade, would you agree with what I said?

45:31
Branislav Nikolic
Did they miss something?

45:33
Wade Pfau
That explanation, I think it made sense.

45:38
Alex Murguia
Yeah. I just wanted to hear from somebody outside of us that you're in it as far as indices are concerned. So who better than to ask you?

45:48

Branislav Nikolic
I'll go to the obvious answer. I think using what we have to offer, I see it as ultimate cheat sheets. And basically we're taking the burden of having to know everything about every index, everything to know about every annuity, and kind of focus on the placement of that annuity concept. And that's something that kind of is more in line with what you guys are doing. Once someone is comfortable that some of the money should go into the fixed index annuity, they should not have any additional brain damage to select one and kind of research that should be summarized for them and brought to the level that they can just assume that information and go with it.

46:37
Wade Pfau
Yeah, absolutely. One other question too, because it came up a little bit earlier. So we've mostly been talking about fixed index annuities. There's also the registered index linked annuities that we've talked about in past episodes. You take some downside risk in order to get more upside exposure. But my question then is, are there different motivations in the design of indices for each of those products, or is it pretty much they're designing the same index and it can be used in either type of annuity? Could you just talk a little bit more about that?

47:09
Branislav Nikolic
So the way I see this on a sliding scale, I see Rylas closer to equities, basically equities with some downside protection. So I see them absent having the name annuity in it. I see them very far apart from the fixed index annuities that we discussed for the duration of today's conversation. That's the first one that these are not in my mind, they're not comparable. One is very close to an ETF tracking SFP 500 with some downside protection. The other one is full principal protection with some exposure to S and P 500. So that's the first one. The other one is going into the structure of the annuity in order to get a little bit more exposure to positive outcomes of the underlying index, you're basically taking some additional risk. What does it mean that you have to sell an option and that better be something valuable, so you want something risky in it to be able to buy up your positive exposure.

48:25
Branislav Nikolic
So again, to me it's a trade off exercise between how much risk you want to take for how much return. It's not zero risk for whatever return. For me, that's the cleanest delineation between the two. And then if you look into indices again I had this conversation with our common friend David Blanchett about this is that indices should not follow the same path that on the FIA side, you should have more of a consistency, whereas on the riley side, you want something that, once she takes some risk, will offer you a lot more upside. That the option that you are selling is valuable because of the volatility that's embedded in the index itself. So you want something that's very equity like.

49:17

Wade Pfau
Yeah, it's like that was Alex's question earlier about double insurance. If you have a very volatility controlled index in Aryla that might end up behaving about the same as an FIA. And then you don't have the potential for greater upside because there's also less risk built into the index.

49:36
Branislav Nikolic
Yeah, but to me, the biggest misconception is that these get to be talked about in the same sentence. I think that these belong in different paragraphs. No, I agree.

49:53
Alex Murguia
Brianna Slop I think we're close to the 50 minutes mark, which is kind of our what's the flag before the checkered flag?

50:04
Wade Pfau
Five minutes. Five minutes left in this time.

50:10
Alex Murguia
No, this has been great. This has been fantastic. I mean, I actually picked up the.

50:14
Branislav Nikolic
Way you frame certain things.

50:16
Alex Murguia
I've learned quite a bit, actually, today. I really thank, you know, from that vantage point, I think it's been fantastic. Anything that we may have missed, Brentislov, that you wish we asked you, that we forgot, or that we just didn't.

50:31
Branislav Nikolic
Think of, I think this was perfect. I truly enjoyed it. Thank you. Thanks so much for having me. And then if it was informative for you, I hope that's informative for your listeners and or viewers.

50:45
Wade Pfau
Mostly listeners. Some viewers.

50:49
Alex Murguia
Is that why emailed me before the podcast here?

50:53
Branislav Nikolic
We're going to be on video. And I was like, yes, but I.

50:55
Alex Murguia
Should do a better job of that.

50:59
Branislav Nikolic
Just curious. Look like Casual Friday from home all have a different meaning, right?

51:05
Alex Murguia
Yeah, exactly.

51:06
Wade Pfau
And don't wear pajamas.

51:08
Alex Murguia
But all right, everyone, thank you for joining us. Brazil, everyone. Again, we'd all make light of it. Thank you for devoting a little bit of the afternoon to retire Westal. It's much appreciated.

51:21
Branislav Nikolic
My absolute pleasure. Thank you so much for having me.

51:24
Wade Pfau
Thank you. Bye.

51:27
Bob French
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk, including risk of loss. Past performance does not guarantee future results.