

The Practice Management Minute...



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GIPPLE,**

CFP®, CLU®, ChFC®, is the owner of CG Financial Group, one of the fastest growing annuity, life, and long term care IMO's in the industry. Gipple's passion is to fill the educational void left by the reduction of available training and prospecting programs that exist for agents today. Gipple is personally involved with guiding and mentoring CG Financial Group agents in areas such as conducting seminars, advanced sales concepts, case design, or even joint sales meetings. Gipple believes that agents don't need "product pitching," they need mentorship, technology, and somebody to pick up the phone...

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A Simple Way To Analyze Volatility Controls

In the obfuscated land of volatility control strategies, it is hard to determine which are sizzle and which are steak. Now, it is no coincidence that almost any volatility control strategy within a given product is going to "back-test" better than that specific product's S&P 500 annual point a point strategy. This statement is especially true immediately after the carrier launches that volatility control strategy! This is no coincidence because that is the very reason that a given volatility control strategy is in the indexed annuity or IUL in the first place.

To back up a little bit, the later part of the last decade is largely when these volatility control strategies were created because of the low interest rate environment. The low interest rate environment generating only four percent caps on indexed annuities caused many carriers and index providers to get creative. So, volatility control strategies that were cheaper to hedge—because low volatility equals lower options costs—proliferated. So, the index providers created these "index" offerings, then they flew to Des Moines (the insurance capital) to pitch the indexed annuity carriers on

their new index. Some index providers worked hand in hand with the carriers on the development of certain indices that would later be housed in the carriers' indexed annuities and IULs.

Now it is not like the index providers and the carriers put together a structure of an index and then just happened to look at the back-testing and say, "That actually looks pretty good." No, the volatility control strategies were actually created because of the back-testing. I had previously used the analogy that the A-10 warthog jet was not a jet that was built and then they put a gun into it. Rather, the gun was built first and then the jet was designed around it. That is analogous to how volatility control strategies were created. Fabulous back testing was the beginning point. The low volatility asset classes and/or low volatility methodologies that performed the best in hindsight is what informed the makeup of the volatility control strategy and thus the makeup of the indexed annuity or IUL. So, after these creations, although indexed annuity caps were three to five percent, voilà! You can now illustrate an indexed annuity with double digit returns!

My problem with this is, as my old friend Jack Marrion used to believe, I believe that, over the long run, if options markets are efficient all strategies within a respective product will perform somewhat the same. That is because all of the strategies within the respective product generally have the same call option budget. (*Exceptions to this may be the strategies within IUL and indexed annuities that have multipliers, bonuses, enhancers, etc.*) Therefore, I do not do a ton of mental gymnastics when it comes to picking index strategies within one particular product.

The challenge comes when you are comparing indexed strategies from one product to another product. One volatility control strategy within one product may have a participation rate of 300 percent, but when you look at the other product, it

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may have a volatility control strategy with a 100 percent participation rate. I always get calls from agents asking about how carrier XYZ is able to have such awesome 250 or 300 percent participation rates. I then emphasize to him/her that the higher participation rate is not always the best and can be easily priced if the volatility in the underlying index was basically zero! After all, "volatility" to the upside is what can generate the growth on an indexed product! In fact, that higher participation rate volatility control strategy may have less "call option horsepower" that the carrier has applied to it.

So how can you determine how much call option horsepower the carrier has put into that volatility control strategy? Check out the level of the interest rate on the fixed account. This is a very good measurement tool.

Example: Let's say you have two indexed annuity products where you are reviewing their volatility control strategies in order to pick one for the best accumulation going forward. You would like to get a cursory feel for which annuity product has the best potential for accumulation. How can you get a feel for this? (*Hint: The answer is not to just look at the back-casting, for reasons we discussed! You can look at the back-casting, but back-casting suffers from "hindsight bias."*)

- Product A: A product with a volatility control strategy with a 200 percent participation rate and also has a fixed rate of two percent in the fixed account.

- Product B: A product with a volatility control strategy with a 100 percent participation rate and also has a fixed rate of four percent in the fixed account.

Assuming all other parts of the two products above are the same (no premium bonuses, etc.), I would likely choose Product B. I would estimate that Product B's volatility control strategy has **twice** the call option horsepower applied to it versus Product A. Of course, I would only make my decision after I familiarize myself with the various indices. I would not make my decision solely off what I lay out above, but I would weigh the above very heavily in my decision.

This method is not perfect. It's not perfect because some carriers may give teaser rates and caps in the early years and then taper off the call option budget in later years. One carrier may have a premium bonus whereas the other carrier does not. One carrier may have less surrender charges than the other, etc.

Although it may not seem like it, I do like volatility control strategies. I especially liked them when interest rates were so low that the S&P 500 strategies left a lot to be desired. Like anything else, there are good ones and there are not-so-good ones. It is important that you—the agent—know how to analyze them and also that you work with an IMO that knows how to analyze them. I hope this gives you an additional avenue for your analysis. 🌐