



INDEX EDUCATION SERIES

NAFA has created this series to promote education on how indices work and important factors to consider when investing in index-linked products.

RISK CONTROL INDICES

PAST, PRESENT AND FUTURE

LETTER FROM THE CEO

As the CEO of NAFA, the National Association for Fixed Annuities, I am pleased to introduce the third in our education series focused on understanding indices. The Index Education Series is designed to help consumers better understand index terminology, the various types of indices and how indices work within a fixed indexed annuity (FIA).

There are a variety of indices used today in fixed indexed annuity contracts. NAFA's goal for this educational series is to demonstrate what indices are and the factors to consider when choosing an FIA. We believe this information is critical in helping consumers develop a plan that provides their retirement assets the potential for appreciation, while limiting the downside, or losses, they might be exposed to in other types of financial products.

In the first part of this four-part series, we provided the basics or ABCs of Indices. In the second part, we looked at the process of creating an index: what are the "ingredients" of the index, who is the targeted audience, what tests and processes are necessary to perfect the index "recipe?" This is the third part in the Index Education Series and describes Risk Control Indices. These indices are part of a platform of a diversified index offering in a fixed indexed annuity. This provides clients with multiple tools to achieve the goals they establish with their financial professionals. I hope you will enjoy and benefit from this educational series.

Founded in 1998, NAFA is the premier trade association in the financial services industry dedicated exclusively to fixed annuities. We are committed to providing information and education regarding the value of fixed annuities and their benefits in helping Americans achieve financial and retirement security.



Charles J. DiVencenzo, Jr.
President & CEO

The Index Education Series is produced on behalf of NAFA by The Index Standard[®].

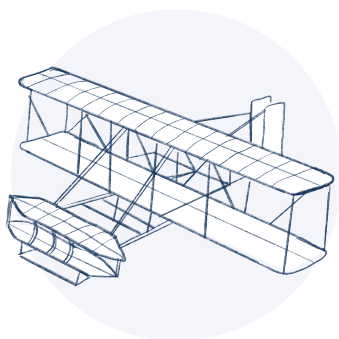
**THE INDEX
STANDARD**

ABOUT THE INDEX STANDARD[®]

The Index Standard[®] provides actionable insights and an unbiased perspective. We do this by providing ratings and performance forecasts for indices and index-linked products, along with model allocations for FIAs based on forecast annuity credits. Our solutions and research broaden understanding of complex indices and we support critical investment decisions with precise facts, clarity and comparisons.

RISK CONTROL INDICES: PAST, PRESENT AND FUTURE

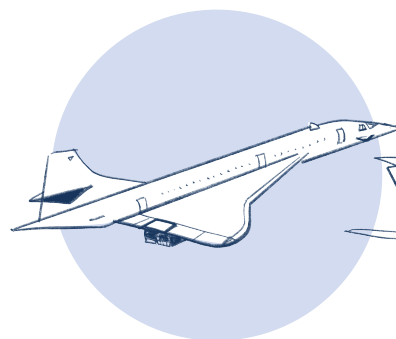
Financial markets and equity markets offer opportunities to accumulate wealth and with the possibility of high returns also come some unwanted risks. Markets appeal to our greed, fear of missing out (FOMO), but also trigger our fear of loss. The development of risk control indices attempts to provide some upside returns while cushioning performance and dealing with our fear of risk. Just as airplanes have evolved since the Kitty Hawk times, so too has the risk control technique. In this piece, we discuss the past, present and future of the risk control technique and its application in fixed indexed annuities.



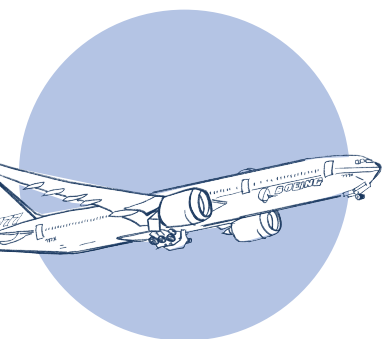
WRIGHT
FLYER
1903



DOUGLAS
DC-3
1930s



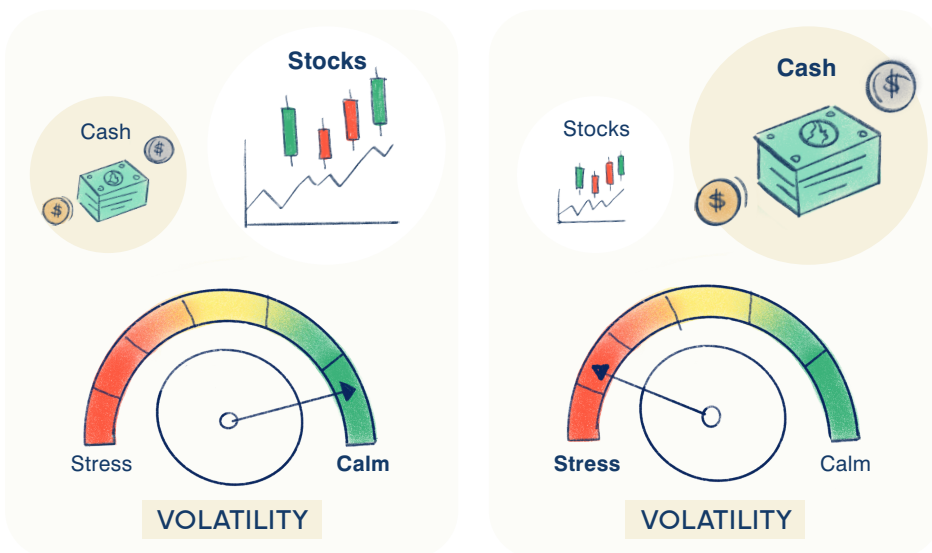
CONCORDE
1970s-2003



BOEING 777X

The risk control technique was developed in part to provide smoother returns while stabilizing prices of financial instruments necessary for the creation of insurance products. This stable pricing allows for consistent renewal rates and as a result we have seen huge growth in the use of risk control indices in FIAs.

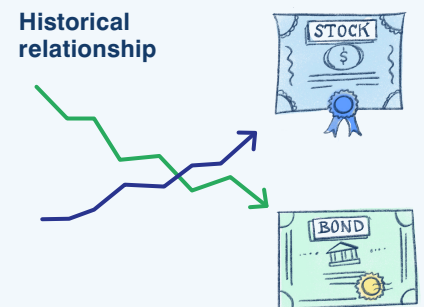
The risk control approach functions by toggling between cash and riskier assets based on market volatility. A risk-controlled index monitors fluctuations in volatility, typically measuring it by looking back over weeks or months. When it detects an increase in volatility, it reallocates some of the index's risky assets into cash. This dynamic adjustment helps to buffer the performance of the index during periods of heightened volatility, thereby smoothing returns and reducing overall risk.



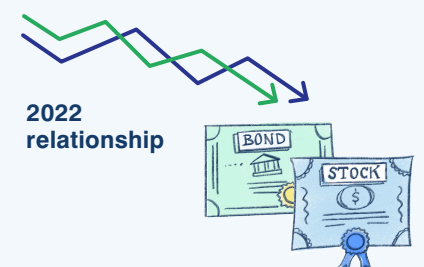
The risk control technique has demonstrated significant effectiveness and, according to research, the risk-adjusted returns are better. Risk control indices offer superior value for money when used in fixed indexed annuities, but more importantly they offer significant utility to end clients as they provide a smoother in-force policy experience.

Best Laid Plans...

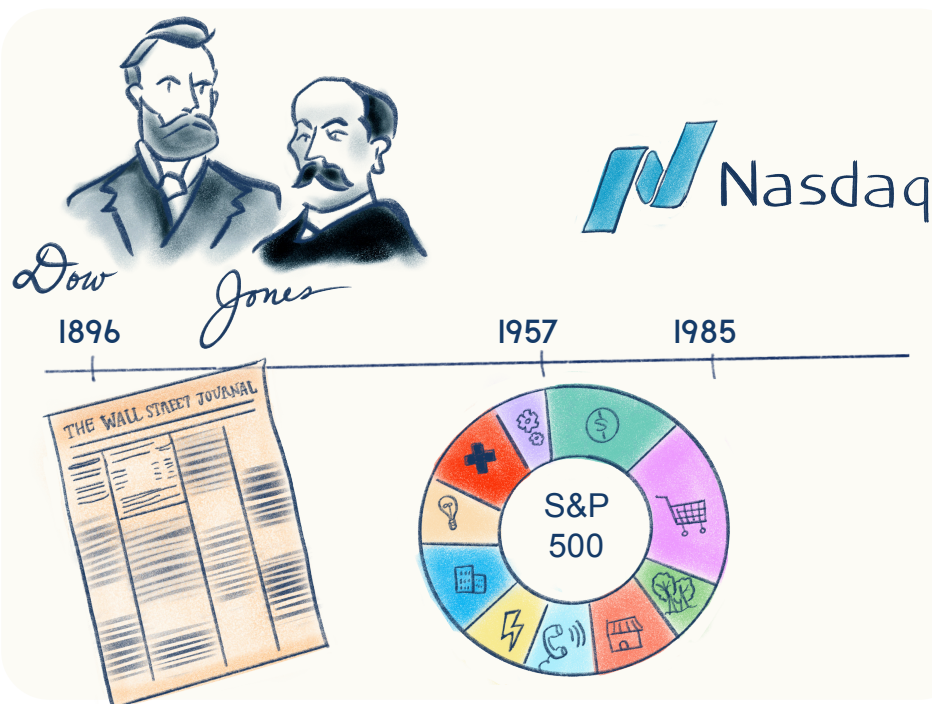
Why did so many multi-asset risk control indices underperform in 2022? No, it was not due to the risk control mechanism. Multi-asset risk control indices are primarily built of the concept of diversification and assets moving in different directions. Typically, equities and fixed income move in opposite directions offsetting each other, therefore providing better returns for the same level of risk.



For 75 years, stocks and bonds did not register a year when they both went down! However, 2022 (and some of 2023!) was very unusual in that both stocks and bonds declined together. This caused multi-asset indices to underperform as they typically hold a combination of stocks and bonds. The risk control feature worked as intended but stocks and bonds moving in the same direction drove the underperformance.

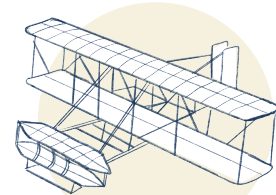


Many well-known traditional benchmark indices were developed between the 1950s (the S&P 500) and the 1980s (the NASDAQ-100). The Dow Jones Industrial Average was developed in the late 1890s, a few years before Kitty Hawk! The Dow Jones Industrial Average is still in use today, but even if we agree that it represents a widely accepted gauge of the market, it was not designed for use with options, or inside fixed indexed annuities! Relying on these traditional benchmark indices inside fixed indexed annuities poses a key question: Would you take your next holiday on a plane from the Kitty Hawk era?

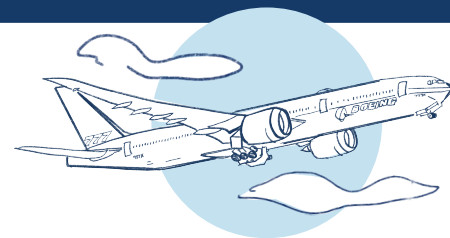


We no longer rely on ancient airplanes for modern air travel and risk control indices, like airplanes, have evolved over time. They are equipped with advanced mechanisms that enable them to deliver smoother, more reliable performance for annuities.

Over the last three decades, the risk control technique has evolved through incremental improvements, enhancing both its performance and its ability to hedge against market risks.



Sometimes the risk control technique may appear complex but so too are airplanes—most of us do not understand exact details of a modern plane but we know the benefits. Being able to convey the benefits to financial professionals or end clients is more important than the exact technical details.



Volatility is Here to Stay

Markets have experienced volatility since the era of the South Sea Bubble, but over time we have become more sophisticated in measuring it. In the late 1980s and early 1990s more stock exchange data became available to measure volatility, and better models were developed to monitor it. The VIX is the most commonly known measure of volatility and is sometimes called the “fear gauge”. The VIX index was introduced in 1993 and measures one-month implied volatility of the S&P 500 index. The VIX is now a tradable index and a commonly used measure of volatility. Today we have many different techniques to measure and forecast volatility.



Risk control indices were initially developed in Europe in the late 1990s. The technique was primarily used for structured products and gained wider popularity after being adopted by major indexing companies. The original approach, which involved monitoring volatility and toggling between risk and cash assets, proved effective but could be improved upon.

During the 2008 financial crisis, risk control indices had much lower losses than traditional benchmark indices. However, after the crisis began to abate, they lagged in capturing returns during the recovery phase, as markets typically rebounded in a low-volatility environment, with incremental daily gains. To address this, market participants introduced some leverage into risk control indices, allowing them to take advantage of low-volatility periods by increasing their exposure to risky assets. Think of this as adding improved engines to an airplane.

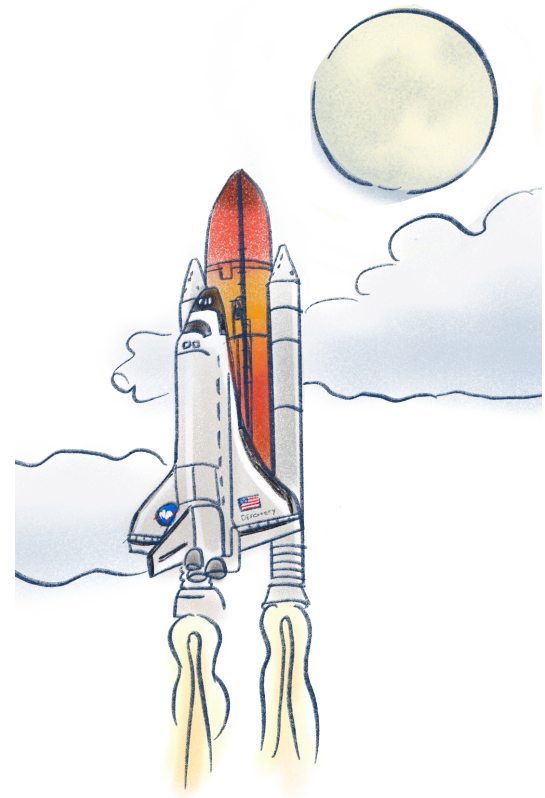
However, a notable innovation in risk control indices emerged in 2020 with the introduction of intraday risk control techniques. We think about this as giving an aircraft better systems to monitor turbulence or better brakes. This feature is becoming widely adopted, especially in fixed indexed annuities as it allows for real-time volatility monitoring throughout the trading day. By measuring the intraday fluctuations, these indices have proven to be more responsive and effective in managing risk within the context of rapidly changing market conditions.

WHAT'S NEXT?

Markets are complex and constantly evolving, and market participants are continually trying to innovate in the risk control space. The success and widespread use of risk control techniques suggests that there will be future innovations, after all we have progressed from Kitty Hawk to the Moon to Mars.

While the exact nature of these innovations is difficult to predict, it is reasonable to expect that technological advancements, including artificial intelligence, may play a significant role in refining and improving the technique. Additionally, further improvements in risk buffering and volatility control could provide even greater protection and smoother performance.

In summary, the risk control technique has been highly effective over the last three decades, as continuous improvements from the industry have made it more adaptable and efficient. As financial markets evolve, we expect that the technique will evolve delivering further benefits to end clients and users of these indices. ➡



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