S&P Dow Jones Indices

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InsuranceTalks

A Robust Rotation Strategy Designed to Reflect Equity Market Dynamics

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Insurance Talks is an interview series where insurance industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Kun Qiu is Co-Head of Derivatives Trading and Analytics at Security Benefit where his team manages a notional fixed index annuity (FIA) derivatives portfolio of more than USD 19 billion and seeks to help develop the next generation of FIA products.

S&P DJI: Security Benefit has been a leader in so-called custom indices in FIA products. How did that happen, and why was it important to Security Benefit to innovate in that way?

Kun: After the Global Financial Crisis, the industry was ripe for change in terms of smarter diversification and downside protection. We stepped up our game and became a pioneer of sorts by bringing to market a broad range of underlying index options—across asset types—in our FIA product line that the industry has followed. Later in 2014, we began a strategic focus on building a premier investment team at Security Benefit. The team has been diving deeply into the existing FIA market. We keep looking for innovative index strategies driven by historically proven academic research. We are continuously pushing our technology to achieve better hedging efficiency as well, as we seek to deliver more interest potential for our customers.

S&P DJI: What role do indices play in the information Security Benefit provides to consumers?

Kun: At Security Benefit, our products that are based on indices (like FIAs) are sold through independent, third-party financial professionals who choose to do business with us. We don't sell directly to consumers, and we have an indirect line of communication to them through the materials we create to explain how our products may be used. Consumers, along with their financial professionals, are better positioned to make the investment planning decisions for their individual situations.

We believe FIAs can serve as an important portion of a retirement plan for many consumers, one that may transfer certain risk to Security Benefit in a way designed to protect against the potential of market loss, while still allowing for the potential increase in their contract values over time.

FIAs, like all annuities, also have the benefit of tax deferral, so the contract value has the potential to increase without tax impact each year. This allows for both the additional compounding of interest and the deferral of tax payments until withdrawals are taken.

S&P DJI: 2020 was a year of notable volatility. How have those equity market dynamics affected the way Security Benefit thinks about the solutions it delivers to customers and the indices that underlie these solutions?

Kun: 2020 was indeed a challenging year, given the historically high volatility and low interest rate environment. The principal protection feature of an FIA is designed to help consumers ride out those volatile times and have the potential to eventually deliver performance in terms of interest crediting. Our general account had been positioned well during COVID-19, but that doesn't mean we ever stop trying to understand how FIA products work and how we could do better. It's what drives us. As a result, we are constantly thinking about how and when to put the latest index innovations to work.

S&P DJI: One of those index innovations Security Benefit has licensed is the S&P 500® Factor Rotator Risk Control 2.0 (RC2) 7% Index. Can you tell us what the index is designed to do and how it works?

Phil: We designed the S&P 500 Factor Rotator Daily RC2 7% Index to track the S&P 500 Factor Rotator Index and added a dynamic risk control framework using a mix of the S&P 2-Year U.S. Treasury Note Futures Index and cash to help manage volatility. Factor risk premia are well-established tools for seeking to alter risk and return, but determining which factor may be best suited for a particular point in time can be challenging since factor outperformance is cyclical. Instead of using a complicated model to determine current market conditions to try and identify the right factor, we kept it simple, using one of the most basic signals of past price performance—momentum—to identify and select which factors to rotate to.

The index tracks five S&P 500 factors: quality, enhanced value, momentum, low volatility, and high dividend. It calculates the historic risk-adjusted momentum for each of the five factors based on short-, medium-, and long-term return horizons. The two factors with the highest composite scores at that point in time are selected. The index uses a 75:25 weighting scheme, allocating three-quarters to the highest-ranking factor and the remaining quarter to the next highest factor. Calculations are tracked daily and rebalanced monthly to ensure targeting is aligned with market movements.

S&P DJI: Can you explain how the index's risk control mechanism works?

Phil: S&P DJI's Risk Control 2.0 (RC2) framework is applied with a volatility target of 7%. As market conditions change, the RC2 framework dynamically adjusts between its underlying index's mix of equities, U.S. Treasuries, and cash. When volatility goes up, the S&P 2-Year U.S. Treasury Note Futures Index weight generally increases. In more extreme volatility scenarios, the index is designed to increase its weight to cash instead of Treasuries to maintain its volatility target. When volatility goes down, the S&P 500 Factor Rotator Index weight generally increases, participating up to 150% in the equity index to capitalize on potential index outperformance. All of these adjustments are built into the rules of the index to help limit downside risk without compromising potential gains.[1]

S&P DJI: Can you talk about why Security Benefit licensed this particular index?

Kun: Like I previously mentioned, we have been consistently pushing ourselves to create better products for our customers. Inspired by the recent success of single-equity factor indices in the FIA space, we started asking ourselves how we could create a product based on an index designed to track historically proven factors. Our own academic research demonstrated that a simple, efficient, and index-based approach to factor rotation was the type of innovation we were looking to employ within an FIA structure that would offer an additional layer of hedge protection and interest credits. We selected S&P DJI because not only is S&P DJI one of the most sophisticated index sponsors in the FIA space, but it also has an excellent track record on its existing single-factor index suite. There are certain factors that appear to have driven returns in the markets, but some performed better in certain environments (e.g., COVID-19 pandemic) than others. We selected the S&P 500 Factor Rotator RC2 7% Index as the basis of our strategy because its design allows for a simple and systematic approach to factor diversification, volatility exposure, and dynamic rebalancing over time to increase the potential of longer-term success.

S&P DJI: What do you feel are unique potential benefits to this index strategy?

Kun: It's definitely the broad diversification from exposure to five different factor strategies. When you look at historical performance, these factors (momentum, value, high dividend, low volatility, and quality) tend to exhibit outperformance versus the S&P 500 in different time periods. For example, late in the business cycle, momentum has generated higher returns than the other factors, while more defensive strategies such as value or low volatility typically have led during market corrections.[2] In addition, the risk overlay provides a rotation between equity and U.S. Treasuries. As Phil mentioned, the index allocates more weight to U.S. Treasuries when markets are volatile and more to equity exposure when markets are less volatile. An index design that employs a simple, rules-based approach to factor rotation with a built-in mechanism for mitigating risk is what we were looking for when we initially discussed our objectives with S&P DJI. They had the index building blocks to make it happen, and the end result is an innovative strategy we've added to our lineup.

[1] For a full description of the index methodology, please see https://www.spglobal.com/spdji/en/documents/methodologies/methodology-sp-risk-control-2-indices.pdf.

[2] Source: S&P Dow Jones Indices LLC. Factor performance calculated by Security Benefit averaging the rolling 12-month simple return in the calendar year. Momentum outperformance occurred from 1998-2000 and 2005-2006. Low volatility outperformance occurred from 2001-2005 and 2008-2009. Value outperformance occurred from 2001-2002 and 2010.

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