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Buffers Are Now on Funds and Annuities. Is Life Insurance Next?

By Warren S. Hersch December 17, 2021

The world of investing, from annuities to funds, is increasingly becoming "structured" as people look for ways to put guardrails on the amount of risk they're willing to take.

In the latest move, Lincoln National is set to introduce a new fund within its Defined Outcome series next Monday. More will follow through May of next year.

Del Campbell, VP of variable annuity product and investments at Lincoln

The funds in the family offer upside potential to a cap and buffers against losses. The way they protect against losses is similar to indexed-linked variable annuities, a product segment that has caught fire. The funds may soon also be bolted onto variable universal life insurance, a fast-growing category.

Defined outcome funds "can absolutely make sense" in variable universal life products, given the comparable protection and tax benefits, said Del Campbell, VP of variable annuity product and investments at Lincoln.

The products had the fastest growth in the U.S. life insurance market in the third quarter, according to the Secure Retirement Institute. New annualized premiums jumped 104% from a year earlier.

Matt Kaufman, head of distribution and product development at Milliman FRM, an arm of the actuarial and consulting firm, said he sees the potential for some "crossover adoption."

So far defined outcome funds have $9 billion in assets under management, most of which is in exchange-traded funds. The total includes about $5.3 billion in 76 buffered ETFs

from Innovator Capital Management, a pioneer in the segment; much of the rest is spread across four other ETF issuers, including Allianz, according to Paul Damon, president of Keramas, a marketing and public relations consultancy for the investment management industry.

Matt Kaufman, head of distribution and product development at Milliman FRM

"The growth could be exponentially greater than what we've been seeing over the last few years, depending on which platforms approve these funds," Kaufman said. While adoption by registered investment advisors have been fueling much of the market's growth to date, "we're starting to see more and more broker-dealers take notice," he added.

Variable annuity carriers, which only recently began offering buffered funds, account for a still small portion of the overall market pie. But Kaufman expects adoption to accelerate, in part because agents and advisors have gained exposure to buffers in recent years via index-linked variable annuities.

Carriers in the Ring

Several annuity issuers are active in the market segment.

In November, Pacific Life said it would release a new variable annuity, Pacific Choice 2, where principal can grow through index-linked buffered funds offered by Invesco, according to a company filing with the Securities and Exchange Commission. Invesco fund buffers protect owners from market declines of 10% in exchange for gains that are capped when indexes rise, the Nov. 12 filing noted.

Another SEC filing in November, this one from AIG, disclosed that the New York-based insurer is planning to debut a variable product, Advanced Outcomes Annuity, that features nine index-linked strategies from Milliman. The product comes with buffers, floors, participation rates and caps on gains, and includes indexes linked to the S&P 500 and the Russell 2000.

Milliman was the most active among the fund providers this year. Of the nearly 75 buffered funds issued since January, Milliman accounted for two-thirds, according to data from Annuity Insight.com. Other providers that have debuted buffered funds this year and last, many of them tied to the S&P 500, include advisor arms of Lincoln, Nationwide, Pacific Life, Valmark and Goldman Sachs, which introduced four funds in August.

The more than half-dozen funds that Lincoln rolled out in June are offered on its Investor Advantage Pro variable annuity, a product that offers more than 125 funds. Come March, the insurer will have 12 buffered funds: eight will be linked to the S&P 500 Index — four with the 12% buffers and four with the 22% buffers — plus four Nasdaq 12% buffers.

Dan Herr, Lincoln's senior VP of annuity product management

The 22% buffer that Lincoln offers in its Ultra Buffer funds is larger than others introduced to the market over the past year, according to Jeff Hutton, an associate VP at AnnuityInsight.com, part of ISS Market Intelligence.

Campbell said that advisors can move clients' money into and out of funds to capture gains, then reset buffers and caps without incurring a penalty. This flexibility — to ratchet up or down the buffer protection as market conditions or client objectives change — makes Investor Advantage Pro a nimble platform, he said.

Dan Herr, Lincoln's senior VP of annuity product management, said the annuity should appeal to investors who want these attributes, but in a product that defers taxes on gains until income is paid. That advantage could eat into sales of buffered ETFs, which don't enjoy the same tax treatment.

Gyrating equity markets could also lift sales for variable annuity issuers active in the segment. Milliman's Kaufman said market volatility offers a "fantastic environment" for a buffer-and-cap investment strategy.

"If market volatility is high, the cap that an investor is able to achieve is going to be much greater than if volatility is lower," he said. "This is one of the only strategies I can think of that delivers risk management in a better way when markets are risky."

Retirement Plans: the Next Frontier?

Industry watchers also flag the employer market as a potentially lucrative one for variable annuities featuring buffered funds. The protected growth that these funds provide, said Herr, "certainly has an appeal for any participant in a retirement plan, especially those who are getting closer to retirement."

Milliman's Kaufman added that the products can help address a host of challenges that participants transitioning to retirement will face, including health, longevity and inflation risks. The loss of inflation-adjusted income in retirement, he said, has "forced them to be invested in the stock market, but do it in a way that's not as risky as the current approach."

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Principal Risks. The principal risks of the funds include buffered loss risk, capped upside return risk, outcome period risk, FLEX options risk, market risk, issuer risk, tracking error risk, investment objective risk, large cap company risk, passive management risk, growth stocks risk, value stocks risk, medium cap company risk, risk of investments in a particular market segment, futures risk, natural disaster/epidemic risk and liquidity risk. For a detailed list of fund risks, see the prospectus.

Unlike many other investments, the potential return an investor can receive is subject to an upside cap. If the index grows beyond the level of the cap, the fund will not experience those excess gains. The cap, net of fund expenses, is the maximum return an investor can achieve from an investment in a fund over its outcome period.

There is no guarantee that the funds will be successful in their strategy to provide buffer protection against index losses if the index has decreased at the end of an outcome period. If an investor purchases shares after the start of an outcome period, the buffer that a fund seeks to provide may not be available. The funds do not provide principal protection and an investor may experience significant losses, include the loss of the entire investment.

FLEX Options Risk. The Fund will utilize FLEX Options issued and guaranteed for settlement by the Options Clearing Corporation (OCC). In the unlikely event that the OCC becomes insolvent or is otherwise unable to meet its settlement obligations, the Fund could suffer significant losses. Additionally, FLEX Options may be less liquid than standard options. In a less liquid market for the FLEX Options, the Fund may have difficulty closing out certain FLEX Options positions at desired times and prices. The values of FLEX Options do not increase or decrease at the same rate as the reference asset and may vary due to factors other than the price of reference asset.

The funds seek to provide a buffer against the first 12% or 22% of index price decreases over each outcome period, before fund expenses (the "Buffer"). The fund, and therefore investors, will bear all index losses exceeding 12%. There is no guarantee the fund will successfully buffer against index price decreases. The Buffer is designed to have its full effect only for investors who hold fund shares for an entire outcome period. For each outcome period, fund performance is subject to an upside return cap that represents the maximum percentage return the fund can achieve during the outcome period, before expenses (the "Cap"). The Cap is set on the first day of an outcome period and may increase or decrease from one outcome period to the next. If the index experiences returns over an outcome period in excess of the Cap, the fund will not experience those excess gains.

The fund is designed to produce predetermined investment outcomes relative to the performance of an underlying security or index. The defined outcomes sought by the fund include the Buffer and Cap ("Outcomes") based upon the performance of the index over an outcome period. **There is no guarantee that the Outcomes for any outcome period will be realized. A shareholder may lose their entire investment. The fund's strategy is designed to produce the Outcomes on the last day of an outcome period for investors in the fund as of the beginning of the outcome period. It should not be expected that the Outcomes will be provided at any point prior to the end of an outcome period.** The Outcomes are measured from the fund's net asset value (the per share value of the fund's assets ("NAV") on the first day of the outcome period. The fund does not track the index except over an entire outcome period, and the fund's NAV will not increase or decrease at the same rate as the index during an outcome period.

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