S&P Dow Jones Indices

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InsuranceTalks

An Enhanced Approach to Managing Risk

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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.

S&P DJI: Following the 2008 Global Financial Crisis (GFC), many investors with longer-term time horizons and liabilities found themselves more averse to volatility. How did this give rise to the S&P Risk Control Indices?

Phil: The GFC brought significant disruption to the markets, with U.S. equities (as measured by the total return of the S&P 500®) dropping over 55% from Oct. 9, 2007, to March 9, 2009. In addition, correlations between asset classes increased, reducing potential diversification benefits normally associated with standard allocation strategies. Coming out of the crisis, there was a clear need to develop a systematic asset allocation framework that could react quickly to changing market conditions, with a particular focus on controlling volatility—and with that, S&P DJI was a pioneer in the market when we launched the first S&P Risk Control Indices in 2009.

S&P DJI: Some practitioners might ask, why manage risk when it can be avoided?

Phil: The S&P Risk Control Indices attempt to give asset class exposure to equities and cash (Risk Control 1 [RC]) or equities and Treasury bonds (Risk Control 2 [RC2]) for potential long-term return premium over short-term cash. The index series incorporates a reactionary asset allocation framework that shifts between the asset classes in order to target a specific volatility target percentage. While volatility is not precisely equivalent to risk, having a volatility target enables participants to match their appetite for risk taking. The asset allocation framework and volatility target in S&P DJI's risk control indices have historically enabled them to achieve reduced tail risk and higher risk-adjusted returns compared to standard equity exposure.

S&P DJI: How does Allianz Life approach risk when it considers the clients it serves and the products it develops to meet client needs?

Aaron: Clients turn to us for security in retirement, and they are putting their trust in us. As a result, we avoid any unnecessary risks in our business. The products we develop strive to reduce some of the most common risks associated with retirement, such as longevity, inflation and sequence of returns, by embedding risk management into a consumer's retirement plan, thereby increasing their probability of quantitatively achieving their retirement objectives. When it comes to crediting options, we recognize that risk profiles of individual clients vary. As a result, we offer a variety of different allocation options.

S&P DJI: How has the S&P Risk Control Indices framework evolved over time to meet investors' evolving needs? In particular, what gave rise to the latest variation: S&P Risk Control 2 Minimum Variance?

Phil: Our first RC indices were launched in 2009, which allocate to equities and de-risk to cash. Two years later, in an attempt to potentially further increase risk-adjusted returns by adding Treasuries, the S&P Risk Control 2 Index Series was launched. Historically, these strategies have effectively shown to limit volatility and produce relatively high risk-adjusted returns. However, to keep the volatility close to the target, they necessitate frequent rebalancing, which leads to significant turnover. In 2020, with the COVID-19 sell-off fresh in our minds, we began exploring if we could develop a next generation volatility management strategy that builds upon the RC framework while addressing some potential shortcomings; this gave rise to the Risk Control 2 Minimum Variance methodology.

S&P DJI: The S&P 500 Futures Daily Risk Control 5% Index applies the S&P Risk Control 2 Minimum Variance framework. What makes this index unique?

Phil: One of the key differentiators in this index is that it seeks to limit turnover, while still producing the risk/return profile desired by volatility-controlled strategies. Turnover is limited relative to standard risk control in two ways. First, there is a daily allocation change limit of 15% for equities and Treasuries. Second, our standard RC2 indices have two options: either allocate to equities and Treasuries, or equities and cash. In times of high market volatility, this can lead to significant turnover when an index is attempting to maintain its volatility target, potentially switching between high allocations of Treasuries and cash multiple times. In this new framework, we de-risk equities into both Treasuries and cash as needed. This framework has led turnover to be reduced by approximately half over the long term, along with higher average allocations to Treasuries versus cash compared to standard RC2. The new framework has historically produced higher absolute returns with relatively similar volatility, leading to higher risk-adjusted returns over the long term.[1]

[1] Anguiano, Cristopher and Laura Assis Iragorri, "Incorporating a Minimum Variance Framework into Risk Control 2," S&P Dow Jones Indices.

S&P DJI: Allianz Life recently licensed this index. What characteristics were appealing when considering clients' needs?

Aaron: Volatility-controlled indices in general are appealing because they are designed to offer a smoother return experience. This is important considering many clients would like to reduce volatility. Allianz Life is excited about this particular index because of its straightforward construction. With so many volatility-controlled indices available, it can be hard to keep track of all of them. The S&P 500 Futures Daily Risk Control 5% Index leverages a strategy with the S&P DJI brand name that is universally recognized, which is something our clients value.

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

Aaron: Volatility-controlled indices in general have a lower cost to hedge the index returns, meaning we can offer higher participation rates. This particular index has even lower transaction costs than our existing volatility-controlled indices, meaning that in many cases, it could offer a higher participation rate. Lastly, the structure of this index allows us to offer our unique index lock and multi-year point-to-point strategies alongside the index.