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It's Time to Give More Focus to Risk Control

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Variable life and variable universal life policies have a powerful marketing advantage over traditional life—the lure of stock market returns.

As the equity market has soared through the 1990s, individual investors have become enamored of the riches promised by compounding double-digit returns over a long time horizon, and that variables are the only insurance vehicles that can offer such largess.

The market's recent downside tremors may have made investors aware, however, that the stock market goes down as well as up. And baby boomers nearing retirement may start growing a bit more cautious in order to consolidate their gains and ensure their quality of life in the golden years.

These trends suggest that risk control may become an increasingly important marketing feature for all financial products.

Fortunately, variable policies have the ability to offer a well-designed set of investment options. As a result, variable policyholders can use one of the best risk control tools in existence—diversification.

Through sensible diversification, variable policyholders can be taught how to obtain their individual target rate of return with the minimum level of risk. This kind of analysis can be done by applying a "mean-variance

optimizer" to the investment options in a variable policy.

An "optimizer" is a financial tool, used by analysts, that seeks to maximize investment return while minimizing risk.

Professionals employ the tool to help find the fund combination that gives investors the most bang for the buck. (Of course, doing so is subject to the inevitable caveat of all investment analysis: The analysis is based on historical data and there is no guarantee that history will repeat itself. Nevertheless, analysis of this kind is a terrific tool for explaining and proving the benefit of taking advantage of the diverse investment options available in most variable life policies.)

To illustrate the potential of this type of analysis, we conducted a mean-variance optimization analysis on the three VL policies using the past three years of their actual monthly performance.

Since the number of fund options is an important element in policy design, we picked our policies to cover the range available in today's marketplace: MML Bay State Variable Life Plus has four options. Phoenix Flex Edge Variable Universal Life offers 17 funds, and Nationwide's Best of America Flexible Premium VUL offers 41 choices.

Our analysis suggests that bigger is better, as far as obtaining optimal risk reduction is concerned. As the accompanying table shows, at each of three levels of target return—8%, 14%, and 20%—the Best of America policy offered the lowest risk in its optimal portfolio, and MML Bay State had the highest risk level in its optimal portfolio. This simply results from the optimizer being able to find funds within the larger Best of America policy that have low correlations and, hence, more effective diversification.

However, there are disadvantages to

having a large lineup. A large number of funds makes choosing between a wide range of funds, without the benefit of the optimizer's perfect hindsight, a more challenging task.

Therefore, in order to see how close investors came to an optimal risk-minimizing allocation, we also estimated what the actual allocation of all investors in these policies was three years ago. In this analysis, the smaller policy, MML Bay State, came out on top.

For that policy, the clients' actual choices were quite close to the ideal, primarily because they put most of their money in the only domestic-equity option, Equity, which turned out to be the optimal investment in that policy. In the Phoenix Flex Edge contract, however, investors also put most of their money in the domestic-equity option, Growth, but they could have had lower risk with the same level of return with a blend that included the International and MultiSector Fixed Income options.

Overall, our estimates suggest that the investors in MML Bay State may have had slightly higher return and lower risk than did investors in Phoenix, even though they had a smaller, and less optimal set of investment options. In short, investors had more opportunities to make mistakes away from optimality in the larger policy.

This analysis suggest the range of challenge and opportunity facing variable insurance product designers. They have the opportunity to tailor fund lineups and marketing to emphasize the power of diversification to reduce risk.

On the other hand, if they offer huge fund lineups to enable the most diversification possible, they face the challenge of trying to educate policyholders about how to choose among the funds to create a portfolio appropriate for their risk tolerances.

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Minimum Risk at Three Levels of Target Return

Policy	No. of Options	% Risk at Target Return		
		8%	14%	20%
MML Bay State Variable Life Plus	4	0.61	1.75	2.91
Phoenix Flex Edge VUL	17	0.56	1.45	2.56
Best of America PPVUL	41	0.43	1.15	1.87

Risk is measured by standard deviation of monthly returns.
Source: *Morningstar Variable Annuities/Life, Chicago*