Understanding custom indexes

Excess return

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Over the past several years, custom index options have grown in the fixed indexed annuity ("FIA") and indexed life insurance marketplaces. Compared to a well-known benchmark like the S&P 500, custom indexes often have added features to accomplish specific goals, such as controlling volatility and targeting more consistent renewal rates for the contract holder. In this educational series, we break down common features of custom indexes and explain their purpose.

Excess return indexes

Most custom indexes offered as crediting strategies in fixed indexed annuities and indexed universal life policies ("IULs") are excess return. This piece briefly explains what excess return means and why it's used.

What is excess return?

In the index-linked insurance space, excess return means the return above a risk-free interest rate. This means that for an excess return index, the returns you see reflect the deduction of an interest rate.

The below table shows a simplified example of the impact of the cash component in an excess return index comprised of stocks, bonds and cash.[1]

Consider the following example:

Index Components:	Illustrative Allocation	Illustrative Gross Return	Illustrative Weighted Gross Return
Equities	50.00%	12.00%	6.00%
Bonds	30.00%	5.00%	1.50%
Cash	20.00%	3.00%	0.60%
Illustrative Gross Index Return			8.10%
Less: Cash Cost			(3.00%)
Illustrative Excess Return (i.e., the Reported Return of an Excess Return Index)			**5.10%**

The above table is a hypothetical example only and does not represent any specific investment product. Actual returns will vary. Additional discussion of how annuity participation rates are derived based on different types of indexes is found on the next page.

Glossary:

Credit: interest paid to the annuitant based on changes in the reference index.

Reference index: FIA performance is often linked to a major index, or a "reference index," such as the S&P 500 or a custom index option.

Participation rate: The percentage of market upside that is credited to an annuitant. For example, a 70% participation rate on a 10% market return equals a 7% credit to the annuitant.

Cap rate: A limit on how much an annuitant may receive in any given year. For example, a 5% cap limits a credit to that amount, regardless of how the reference index may have performed.

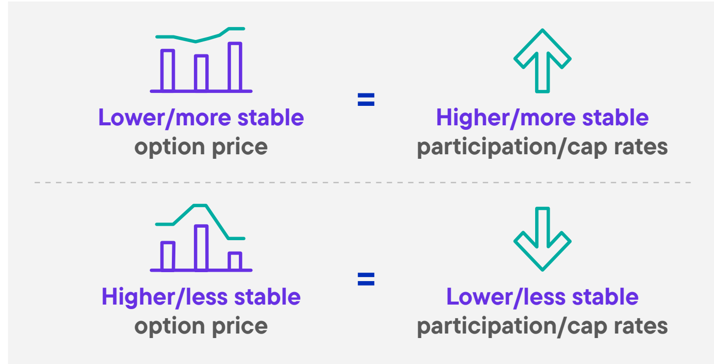
1. This purely illustrative index references total returns for equities, bonds and cash over a one-year period. The cash rate is assumed to be constant over the period. This example is meant to show the difference between a total return and an excess return by deducting the applicable cash rate from the index's total return, which is hypothetical. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

Why are excess return indexes used in the insurance space?

How are options used?

To offer upside potential and principal protection, insurance companies use call options. Options fluctuate in price; **volatility** and **interest rates** are two major factors that impact the cost of options.

Why does option pricing matter? Because it impacts the participation rates and cap rates that the insurer can offer the policyholder. Option prices and participation rates move in opposite directions.

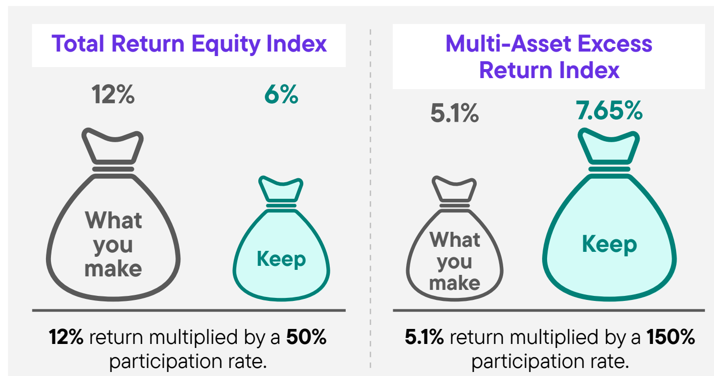


Excess return deducts the risk free rate from the index total return. This results in:

- A cheaper underlying index, and therefore, a cheaper option.
- An options price insulated from changing interest rates, which means a more stable option price.

Cheaper and more stable option prices can result in higher and more stable participation/cap rates.

So even though the underlying return of a total return equity Index might be higher, there are times a policyholder could have a better experience with an excess return index in the form of higher interest credits.



For illustrative purposes only. This example is meant to show the impact of participation rates. Numbers taken from the example on page one. This does not represent any specific investment product or participation rate. Actual participation rates and returns may vary.

WHAT ARE THE RISKS?

It is not possible to invest directly in an index. There is no assurance that products based on the Index will accurately track index performance or provide positive investment returns. Inclusion of a security within an index is not a recommendation by Franklin Templeton to buy, sell, or hold such security.

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