



Variable Annuity Asset Management: Growing Assets in a New Environment

This report is a guide for managers to gain marketshare in the variable annuity (VA) industry in the aftermath of the global market crisis. To succeed long term, asset managers and insurers must retool their strategies to balance opportunities for guaranteed retirement income solutions with the challenges of managing the ensuing risks.



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INSIDE LOOK:

Key Findings:

- In selecting a VA company for their clients, 75% of advisors rate investment options as highly important criteria.
- A top asset manager screen used by insurers post-crisis is the hedgeability of the fund.
- The 10 largest equity managers control less than 50% of the market, indicating there is room for smaller managers to expand.
- The strongest opportunities for asset managers are through unaffiliated subadvisory relationships.
- More than 85% of insurers view the use of index funds as at least equally effective as benefit reductions and fee increases for controlling the risks of living benefits.

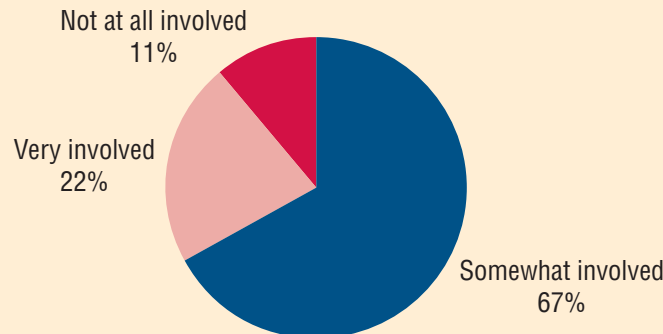
Exclusive data in this report:

- Insurer and asset manager assessment of trends in fund styles, structures, and pricing
- Role of investment consultants in asset allocation and due diligence
- Asset manager concerns regarding passively managed subaccounts
- Organization of insurers' and asset managers' client relationship groups
- Break-even levels for variable annuity subadvisory profitability

Sample Report Exhibit:

Involvement of Product Development Actuaries in Subaccount Selection Process, Insurer Experience, 2009

Nearly 90% of insurance firms reported at least some involvement of product development actuaries in the subaccount vetting process. This is done to assess the hedgeability of funds under consideration.



Sources: Cerulli Associates

This report helps asset managers:

- Formulate strategies based upon the renewed attention insurers place on risk management
- Find and evaluate the opportunities for actively managed VA subaccounts
- Identify key drivers for third-party asset management of VAs over the long term
- Position funds to fit into a fund of fund or asset allocation model

This report helps insurers and distributors:

- Assess opportunities for traditional and emerging fund styles
- Explore new approaches for VA wholesaling that incorporate the expertise of the asset manager
- Forge stronger relationships with VA asset managers to drive future growth

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Table of contents, exhibit list, user examples, and sample pages are attached

REPORT ROADMAP

- What asset managers need to know about the variable annuity industry
- VA asset management product development and delivery
- Maximizing distribution reach



Variable Annuity Asset Management: Growing Assets in a New Environment

USER SCENARIOS:

The following are examples of how this report can be applied to business planning and strategic decision-making:

Scenario 1: An asset manager currently has several funds on a variable annuity platform and would like to offer an additional strategy. They are in early stages of product development and want to get a better idea of their options. *Variable Annuity Asset Management: Growing Assets in a New Environment* answers the following questions:

- What strategies work best for active management in a variable annuity? (Chapters 3, 5)
- What attributes are most important for VA providers when assessing asset managers? (Chapters 2, 7)
- What are best practices in approaching due diligence teams? (Chapters 2, 6)

Scenario 2: An asset manager is concerned about losing its variable annuity subadvisory mandates to firms that can provide passively managed or lower cost investment options. *Variable Annuity Asset Management: Growing Assets in a New Environment* answers the following questions:

- What opportunities will be effective for active managers to increase their assets amid these pressures? (Chapters 1, 3, 5)
- How might an asset manager make its fund offerings more hedgeable? (Chapters 2, 4)
- How might relationship management serve as a conservation mechanism? (Chapters 7, 8)

Scenario 3: An insurance company is reevaluating the investment options it offers through its variable annuities and needs to balance living benefit risk management with offering a competitive product. *Variable Annuity Asset Management: Growing Assets in a New Environment* answers the following questions:

- How are other insurers using the asset management function to mitigate living benefit risks? (Chapters 2, 3, 4)
- To what extent should passively managed strategies be employed? (Chapters 2, 3, 4)
- In what ways can asset managers assist in the VA wholesaling function? (Chapter 8)

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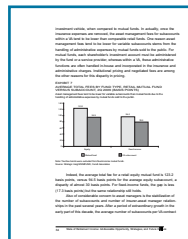
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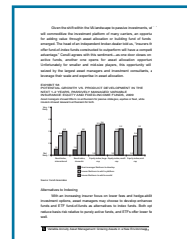
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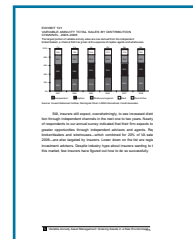
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REPORT SCOPE

Variable Annuity Asset Management: Growing Assets in a New Environment examines the outlook for the VA asset management function in the aftermath of the global market crisis that severely impacted the VA industry as a whole. To succeed long-term, asset managers must let go of long-established practices and retool their strategies to help insurers balance opportunities for guaranteed retirement income solutions with the challenges for managing the ensuing risks. The report focuses on: the connection between variable annuity product development and asset management; the future of the structures and investment styles of variable annuity funds, and maximizing the reach of asset managers through relationships with insurance companies and distribution firms. This study is the most recent in **The Cerulli Report™** series that leverages Cerulli Associates' ongoing research of the retail annuity and insurance marketplaces.

Some of the key questions addressed in this report include:

- What are the key growth drivers for third-party asset management of variable annuities, and how is this growth sustainable over the long-term?
- What are the implications of living benefit risk management, or de-risking, on asset managers?
- Will a shift from active to passive management be warranted long term?
- How has the outlook for specific variable annuity investment options changed in the past several years, and which are expected to be successful in the years ahead?
- How are asset managers incorporating ETFs and alternative asset classes and strategies into VA subaccounts, and what are the expectations for these types of offerings?
- What are insurers' greatest challenges in working with VA subadvisors, and vice-versa?
- What is the role of investment consultants in asset allocation and due diligence?
- During the next one to three years, what will be the most significant factors impacting a variable annuity subadvisor's profit margin?
- How do new approaches for VA wholesaling impact the asset manager?
- How do the viewpoints of asset managers and insurance companies differ with respect to current and future product trends and pricing?

METHODOLOGY

This **Cerulli Report™**, *Variable Annuity Asset Management: Growing Assets in a New Environment*, is the result of detailed market analysis conducted by Cerulli Associates (CA). Our research draws upon our own market insight and proprietary data, as well as our analysis of third-party information sources.

Quantitative Surveys

Proprietary surveys of executives from insurance companies and asset management firms in the variable annuity industry served as the quantitative foundation of this report. Participants were asked to provide us with their views on various aspects of variable annuity asset management, including manager selection and monitoring, organizational structures, fees, profitability, and the implications of VA product management. In many cases, CA analysts cross-referenced responses from insurance companies and asset managers to provide comparative information and to signify gaps that need to be addressed.

Also included are the results of CA's proprietary survey of financial advisors that pertain to variable annuity asset management. This is a portion of a larger survey that CA conducts through both our internal efforts and partnerships with the Financial Planning Association (FPA) and the Investment Management Consultants Association (IMCA). CA has been conducting proprietary advisor surveys annually since 2001, covering all major channels and registered investment advisors.

CA delivers these surveys through our proprietary data-gathering engine at www.cerullisurveys.com.

Qualitative Interviews

As a major part of our research initiative for this report, CA analysts interviewed more than 30 executives from insurance companies, asset management firms, distribution firms, and service providers. Our interviews included in-depth discussions on issues such as the competitive landscape for variable annuity asset managers, insurance company risk management associated with living benefit guarantees, opportunities for VA asset management firms in the wake of the severe market downturn, and the impact of the growing use of passively managed subaccounts on asset managers and

VA manufacturers. To ensure representation from all segments of the marketplace, we targeted firms of various sizes and levels of activity in the variable annuity industry.

It is the policy of Cerulli Associates to conduct interviews for background purposes only and not for attribution. Firms mentioned in this report, including case studies, are not necessarily those that participated in our research interviews.

*As with all **Cerulli Reports™**, additional information in this report was obtained from third-party public and non-confidential sources that Cerulli Associates believes to be reliable and has made every reasonable attempt to verify; however, CA does not guarantee its accuracy or completion.*

SAMPLE SECTION
from
THE CERULLI REPORT

**VARIABLE ANNUITY ASSET MANAGEMENT:
GROWING ASSETS IN A NEW ENVIRONMENT**

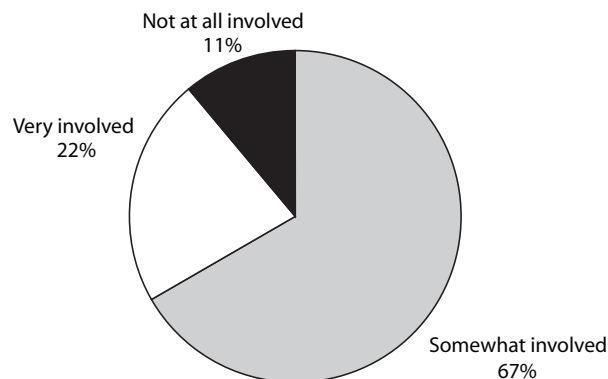
Insurance executives agree with this observation. One insurance executive, whose responsibilities include fund selection for the variable annuity platforms, told us that it is critical that fund companies are able to discuss the fund’s features, specifically how it mimics or tracks to an index, so that the insurer can better provide a hedge against volatility.

Fund hedgeability has manifested in a number of ways. Most prominent is the rise of passively managed investment options, a trend that we allude to a number of times in this report, including an entire chapter devoted to the topic. Yet, this is not necessarily bad news for firms that offer actively managed subaccounts, as insurance companies are utilizing internal expertise on how to incorporate actively managed funds while retaining hedgeability.

A growing number of firms are reporting an evolution in the role of the product actuary (also referred to as pricing actuary). These professionals utilize mathematical models to assess the risk inherent in the insurance-based features of the VA, and price the products from both risk management and profitability perspectives. Lately, product actuaries have become more involved in the selection of the underlying funds for standalone options or asset allocation models by providing their assessment of the ability to hedge the fund choices under consideration. Nearly 90% of insurance firms surveyed by Cerulli in second quarter 2009 reported at least some involvement of product development actuaries in subaccount selection, with two-thirds reporting “somewhat involved.”

**EXHIBIT 19
INVOLVEMENT OF PRODUCT DEVELOPMENT ACTUARIES IN
SUBACCOUNT SELECTION PROCESS, INSURER EXPERIENCE,
2009**

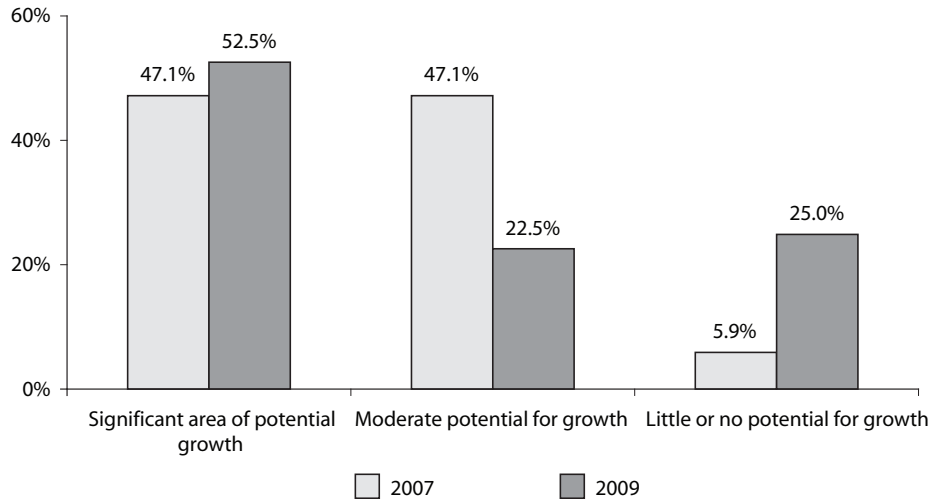
Nearly 90% of insurance firms reported at least some involvement of product development actuaries in the subaccount vetting process. This is done to assess the hedgeability of funds under consideration.



Source: Cerulli Associates

EXHIBIT 64
VARIABLE ANNUITY SUBADVISORY GROWTH
OPPORTUNITIES, INDUSTRY PERSPECTIVE, 2007 VS. 2009

Growth expectations for variable annuity subadvisory remain high, although much of this is expected to come via changes in mandates than through further adoption of the subadvisory function by insurers.



Source: Cerulli Associates

Before proceeding, we need to clarify the distinction between unaffiliated and affiliated subadvisory relationships. Cerulli defines unaffiliated relationships as those in which the subadvisor and sponsor have no broader corporate or financial relationship beyond the fee paid for subadvisory services. A familiar example of an unaffiliated subadvisory relationship is the one between Hartford (the sponsor) and Wellington (subadvisor).

On the other hand, affiliated relationships are those in which there is a structured financial relationship between the subadvisor and the sponsor. Cerulli contends that if the sponsor (or its parent) has as little as a 5% stake in the subadvisor, the dynamics of the financial relationship are influenced enough to warrant its description as an affiliated relationship. One example of an affiliated subadvisory relationship is between AXA Equitable (the insurer/sponsor) and AllianceBernstein (subadvisor), who share the same parent company. Also falling under the umbrella of affiliated relationships are those in which the asset manager hired as advisor/sponsor outsources to a sister firm. This is a rarer circumstance, and most often applies to global mandates offered through the more familiar domestic asset manager.

As a significant proportion of unaffiliated subadvised assets are in equity funds (see **Chapter Three**), their values took a huge hit during 2008,