Comparing return distributions of equity linked retirement provision plans with different capital guarantee mechanisms and fee structures

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In Germany, a retirement plan, called Riester-Rente, is supported by the state with cash payments and tax benefits.

Those retirement plans have to preserve the invested capital.

Since investors want to be invested in the equity market there is an increasing demand for guarantee concepts for long term equity investments.
Outline

- Which different return distributions are generated by the different strategies in a reasonable model?
- How big is the risk of failing to generate the guarantee if we incorporate jumps and allow only for discrete trading?
- What is the impact of different fee structures on the return distribution?

Direction

We simulate the return distribution of different strategies in a displaced double-exponential jump diffusion model parametrized to resemble the daily log returns of the MSCI World index for the last thirty years [3]
Jump risk

CPPI Jump

value

time in years
Outline

1. Model
2. Products
3. Payments to the contract and cost structures
4. Results
Outline

1. Model
2. Products
3. Payments to the contract and cost structures
4. Results
The model equation:

\[
\frac{dS_t}{S_t} = \mu \, dt + \sigma \, dW_t + d\left(\sum_{j=1}^{N_t} (V_j - 1)\right)
\]

\[
S_T = S_t \exp\left[\left(\mu - \frac{\sigma^2}{2} - \delta\right) \tau + \sigma W_{T-t} \right] \prod_{j=1}^{N_{T-t}} V_j
\]
Model equation equity

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\]

\((W_t)\) standard Brownian motion,

\((N_t)\) Poisson process with intensity \(\lambda > 0\)

\(V_j\) i.i.d. \(V_j \sim e^Y\): \(Y\) represents the relative jump size with a minimal jump of \(\kappa\), therefore leading to jumps of \(Y\) in the range \((-\infty, -\kappa] \cup [\kappa, +\infty)\),

\(\delta\) drift adjustment \(\Rightarrow S_t\) has the desired drift \(\mu\)
Model equation equity

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\[
\frac{dS_t}{S_{t-}} = \mu \, dt + \sigma \, dW_t + d \left( \sum_{j=1}^{N_t} (V_j - 1) \right)
\]

\[
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The processes \((W_t), (N_t)\), and the random variables \(V_j\) are all independent.
We chose the jumps $Y$ to be exponentially distributed outside $(-\kappa, +\kappa)$.

Figure: Displaced Double-Exponential density of $Y$ with parameters $\kappa = 2.31\%$, $\eta_1 = \eta_2 = \eta = 1/1.121\%$, $p = 0.5$
Drift adjustment as in Kou [4]:

\[
\delta = E[e^Y - 1] = \lambda \left( p \eta_1 \frac{e^{+\kappa}}{\eta_1 - 1} + (1 - p) \eta_2 \frac{e^{-\kappa}}{\eta_2 + 1} - 1 \right).
\]

We use \( \eta = \eta_1 = \eta_2 \) and \( p = 0.5 \).
Moments

First moment:

\[ E \left[ \sum_{k=1}^{N_t} U_k (\kappa + H_k) \right] \]

\[ = \sum_{n=0}^{\infty} E \left[ \sum_{k=1}^{n} U_k (\kappa + H_k) \right] \cdot P[N_t = n] \]

\[ = \sum_{n=0}^{\infty} n \cdot 0 \cdot P[N_t = n] \]

\[ = 0 \]
Moments

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= 0
\]

\(H_k\): independent exponentially distributed with expectation \(h = \frac{1}{\eta}\)
Moments

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\]

\[
= 0
\]

\(H_k\): independent exponentially distributed with expectation \( h = \frac{1}{\eta}\)

\(U_k\): +1 and −1 with probability \( \frac{1}{2} \)
Second moment:

\[
E \left[ \sum_{k=1}^{N_t} U_k (\kappa + H_k) \right]^2 \\
= \sum_{n=0}^{\infty} E \left[ \sum_{k=1}^{n} U_k (\kappa + H_k) \right]^2 \cdot P[N_t = n] \\
= \lambda t ((\kappa + h)^2 + h^2)
\]
Variance:

\[
\text{var} \left[ \sum_{k=1}^{N_t} U_k (\kappa + H_k) \right] = E \left[ \sum_{k=1}^{N_t} U_k (\kappa + H_k) \right]^2 - \left( E \left[ \sum_{k=1}^{N_t} U_k (\kappa + H_k) \right] \right)^2 = \lambda t ((\kappa + h)^2 + h^2)
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\]

Volatility of the DDE-process:

\[
\sqrt{\frac{1}{t} \text{Var} \left[ \ln \frac{S_t}{S_0} \right]} = \sqrt{\sigma^2 + \lambda((\kappa + h)^2 + h^2)}
\]
Parameter estimation

Parameter estimation

- **data:** MSCI Daily TR (Total Return) Gross (gross dividends reinvested) in USD January 1 1980 to October 2 2009.

- **prices:** $x_0, x_1, \ldots, x_N$
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- log-returns:

\[ r_i \triangleq \ln \frac{x_i}{x_{i-1}}, \quad i = 0, 1, \ldots, N \]  

\[ \hat{\sigma}^2_{\text{tot}} = \frac{N}{N-1} \left( \frac{1}{N} \sum_{i=1}^{N} r_i^2 - \frac{1}{N} \sum_{i=1}^{N} r_i^2 \right) \]
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    r_i \triangleq \ln \frac{x_i}{x_{i-1}}, \quad i = 0, 1, \ldots, N
\]

(1)

- estimate for the daily log return:

\[
    \bar{r} = \frac{1}{N} \sum_{i=1}^{N} r_i
\]

(2)

\[
    \hat{\sigma}^2_{\text{tot}} = \frac{N}{N-1} \left( \sum_{i=1}^{N} r_i^2 - \frac{N}{N} \bar{r}^2 \right)
\]

(3)
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  \]  
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- estimate for the daily log return:
  \[
  \bar{r} = \frac{1}{N} \sum_{i=1}^{N} r_i
  \]  
(2)
- estimate for the total volatility \( \hat{\sigma}_{tot} \):
  \[
  \hat{\sigma}_{tot}^2 = \frac{\# \text{Prices per year}}{N - 1} \left( \sum_{i=1}^{N} r_i^2 - N \bar{r}^2 \right)
  \]  
(3)

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- If $u$ is too low, almost no jumps occur.

Of course, this level is subjective. We have chosen $u = 1\%$ because in this case only daily changes of more than 2% are considered to be a jump. Changes of less than 2% can be explained with the diffusion part with sufficiently high probability.
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- The number of jumps divided by the total number of observations yields an estimate for the jump frequency. Annualizing this frequency we can estimate $\lambda$ to be 5.21.
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- The number of jumps divided by the total number of observations yields an estimate for the jump frequency. Annualizing this frequency we can estimate $\lambda$ to be 5.21.
- Finally we have to correct the estimator for the volatility according to Equation (1) since the volatility consists of the jump part and the diffusion part.
Parameter estimation

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total volatility $\hat{\sigma}_{tot}$</td>
<td>14.3 %</td>
</tr>
<tr>
<td>Volatility of the diffusion part $\hat{\sigma}$</td>
<td>11.69%</td>
</tr>
<tr>
<td>Jump intensity $\lambda$</td>
<td>5.209</td>
</tr>
<tr>
<td>Minimum jump size $\kappa$</td>
<td>2.31%</td>
</tr>
<tr>
<td>Expected jump size $h$ above minimum jump size</td>
<td>1.21%</td>
</tr>
<tr>
<td>Drift adjustment $\delta$</td>
<td>0.339%</td>
</tr>
</tbody>
</table>

Table: Estimated parameters for the DDE-process.
Interest rate model

Zero bond curve

To calculate the current value of the future liability (floor) and the performance of the riskless investments, we model the short rate by a Hull-White Extended Vasicek Model. The model is calibrated to the zero bond curve as of October 1, 2009. The curve is extracted from the money market and swap rate quotes on Reuters.

The model equation:

\[ dr_t = [\theta_t - ar_t] dt + \sigma dW_t \]

with constants \( a \) and \( \sigma \) and time dependent \( \theta_t \) chosen to exactly fit the term structure of interest rates.
Outline

1. Model
2. Products
3. Payments to the contract and cost structures
4. Results
Classical insurance strategy

- In this strategy a large proportion of the invested capital is held in the actuarial reserve fund to fully generate the guarantee.
- Only the remaining capital is invested in products with a higher equity proportion.
- The actuarial reserve fund is assumed to be riskless and accrues the interest implied by the current zero bond curve.
- It guarantees a minimum yearly interest rate of 2.25%.
- We assume that the calculation of the amount needed to meet the future liability is based on the guaranteed interest rate of 2.25%.
Classical insurance strategy

Figure: Simulated path for a classical insurance strategy and 10 year investment horizon
Classical insurance strategy

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Constant proportion portfolio insurance

- In contrast to the traditional strategy the amount necessary to generate the guarantee is not fully invested in the riskless products.
- The amount invested in the more risky equity products is leveraged for a higher equity exposure.
- Continuous monitoring ensures that the guarantee is not at risk, since the equity proportion is reduced with the portfolio value becoming closer to the floor.
- If the process allows for jumps or if trading is done only at discrete time points we are again imposed to gap risk.

With $F$ being the floor of the future obligations, $NAV$ the net asset value of the fund and $a$ the leverage factor, the rebalancing equation for the risky asset $R$ is

$$ R = \max (a (NAV - F), NAV) . $$

(4)
Constant proportion portfolio insurance

Figure: Simulated CPPI path with leverage factor 3 and 10 years investment horizon
Constant proportion portfolio insurance

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Stop loss strategy

- 100% of the equity amount is held in the risky fund until the floor is reached. In this case all the investment is moved to the fixed income fund to generate the guarantee at maturity.
- The Strategy is riskless as the CPPI strategy in a continuous model. In a model with jumps or if trading is only at discrete time points again we are imposed to gap risk.
- We neglect liquidity issues here which actually forces the insurer to liquidate the risky asset before it reaches the floor level.
Stop loss strategy

Figure: Simulated stop-loss path with 10 years investment horizon
Outline

1. Model
2. Products
3. Payments to the contract and cost structures
4. Results
We consider a typical payment plan for a Riester-Rente with an horizon of 20 years and a monthly payment of 100 Euro (sum of own payments and state payments).
Payments to the contract

- We consider a typical payment plan for a Riester-Rente with an horizon of 20 years and a monthly payment of 100 Euro (sum of own payments and state payments).
- We further assume that the investor has one child born after January 1, 2008 and earns 30,000 Euro per year. In this case the insurant receives 454 Euro from the state per year, so he actually only has to pay 746 Euro per year to reach 1,200 Euro per year. This is a very high support rate of 37%.
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- For comparison, if we take an investor without children, earning 52,500 Euro per year, the support rate would only be maximal 7.3%. 
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For comparison, if we take an investor without children, earning 52,500 Euro per year, the support rate would only be maximal 7.3%.

We consider different cost structures ($\alpha$-cost, $\beta$-cost and capital management cost), all of them having the same current value but being differently distributed over time.
Outline

1. Model
2. Products
3. Payments to the contract and cost structures
4. Results
Return distribution standard scenario (6% drift)

Figure: Return distribution of the different strategies. We list the capital available at retirement (in units of 1,000 EUR) on the x-axes.
## Results

Table: Expected capital at retirement.

<table>
<thead>
<tr>
<th>Product</th>
<th>expected capital (constant rates)</th>
<th>exposure (constant rates)</th>
<th>expected capital (stochastic rates)</th>
<th>exposure (stochastic rates)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPPI leverage factor 1,5</td>
<td>46,187</td>
<td>74.86%</td>
<td>45,731</td>
<td>74.17%</td>
</tr>
<tr>
<td>CPPI leverage factor 2</td>
<td>47,368</td>
<td>88.49%</td>
<td>46,927</td>
<td>87.41%</td>
</tr>
<tr>
<td>CPPI leverage factor 3</td>
<td>47,881</td>
<td>94.22%</td>
<td>47,618</td>
<td>93.51%</td>
</tr>
<tr>
<td>CPPI leverage factor 4</td>
<td>48,007</td>
<td>95.66%</td>
<td>47,840</td>
<td>95.13%</td>
</tr>
<tr>
<td>Stop Loss</td>
<td>48,190</td>
<td>97.12%</td>
<td>48,159</td>
<td>96.57%</td>
</tr>
<tr>
<td>Actuarial reserve fund</td>
<td>42,602</td>
<td>31.59%</td>
<td>44,294</td>
<td>31.50%</td>
</tr>
</tbody>
</table>

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Return distributions of equity linked retirement plans
## Impact of jumps

<table>
<thead>
<tr>
<th>Product</th>
<th>number of paths with gap (IR constant)</th>
<th>average realized gap (IR constant)</th>
<th>number of paths with gap (IR stochastic)</th>
<th>average realized gap (IR stochastic)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actuarial reserve</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>CPPI, factor 1.5</td>
<td>0</td>
<td>0</td>
<td>8</td>
<td>346</td>
</tr>
<tr>
<td>CPPI, factor 2</td>
<td>0</td>
<td>0</td>
<td>52</td>
<td>371</td>
</tr>
<tr>
<td>CPPI, factor 3</td>
<td>0</td>
<td>0</td>
<td>489</td>
<td>321</td>
</tr>
<tr>
<td>CPPI, factor 4</td>
<td>0</td>
<td>0</td>
<td>1,664</td>
<td>306</td>
</tr>
<tr>
<td>Stop Loss</td>
<td>18,642</td>
<td>223</td>
<td>18,902</td>
<td>441</td>
</tr>
</tbody>
</table>

**Table:** Shortfalls for 100,000 simulations.
Bibliography

The pricing of Options and Corporate Liabilities, *Journal of Political Economy*, (81)


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