

Annuities May Be Simple, But...

BY JEREMY ALEXANDER

Fixed annuities remain an important investment alternative for clients nearing or in retirement, even when the stock market is up—because seniors need a more conservative portfolio for income and safety of capital.

But all fixed annuities are not created equal, so producers who work with seniors, should make careful selection among the many options available. Here are some factors to consider, based on scrutiny of 282 annuities, representing a total of 662 rate variations, as tracked by Beacon Research Publications in July 1998.

Interest Rates: Insurers offer a surprisingly wide range of interest rates on two types of fixed annuities.

1) "Certificate" annuities yield a fixed interest rate for the same period that the invested funds are subject to withdrawal charges. Chart 1, on page 7, reflects 136 rates from certificate-type annuities; it shows that the average base rates in July 1998 range from a low of 4.3 percent, for one-year term products to a high of 5.3 percent for eight-year term products. Policies with the longest terms (10 years) averaged a 5 percent base rate.

2) Fixed annuities of the "standard" type, which offer surrender charge periods that exceed the term of their interest rate guarantees, showed similarly broad interest rate variations in July. As Chart 2 illustrates, 526 of the 662 rates we profiled fell into the standard category. The average effective base rates by surrender period, ranged from a low of 4.3 percent, for policies with three-year surrender periods to a high of 5.6 percent for policies with eight-year surrender periods. Policies with the longest surrender periods (10 years) averaged a base rate of 4.8 percent.

Payout Options. To help clients who want to maximize a guaranteed income stream or provide for survivors, agents should check the interest rate used to calculate annuity payouts. Also note if there are annuitization bonuses or higher annuitization rates than are available on newly purchased immediate annuities and examine the payout options, too. Given the clients needs ask for what period and under what conditions the payments should extend. And read the fine print to see

if the policy requires a minimum value in order to annuitize.

Interest Rate Risk. The best choice of a fixed annuity depends partly on the direction in which you and your client expect interest rates to go.

Here, you could use shorter maturities in a rising interest rate environment, and longer ones when interest rates are falling (assuming a normal yield curve).

Interest rate direction should be considered when selecting a standard contract.

seven years, but there is wide variation, with some periods running as short as three months and others extending indefinitely by way of a permanent back-end fee. The lower the surrender charges and the shorter the surrender charge period, the more liquidity the product offers.

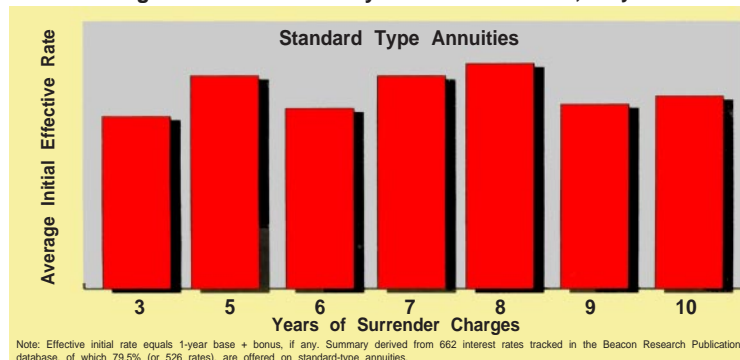
Withdrawals. Many retired clients will appreciate being able to withdraw funds without incurring a surrender charge. Typically, they can withdraw 10 percent annually without penalty. But cumulative withdrawal privileges are even more favorable. For example, a contract may permit free withdrawal of 20 percent in year two, if nothing is withdrawn in year one; a 30 percent penalty-free withdrawal in year three, after two years of no withdrawals; etc.

Nearly half of all fixed annuities also offer systematic withdrawal, which allows owners to receive periodic interest payments automatically at no charge. Of the 282 contracts we tracked in July 1998, the availability of various withdrawal privileges was as follows: 83.4 percent allow annual free withdrawal; 60 percent, systematic withdrawal; 18.8 percent, annual withdrawal of interest earned; and 8.1 percent, cumulative withdrawal.

Waivers. Many contracts waive all surrender charges in the event of various emergencies. Some will do so only if the situation continues for an "elimination period" of 30 days to a year. The fewer such conditions and the more events covered, the more attractive waiver provisions become. Chart 3 shows the types of waivers we found in 282 fixed annuities, as of July 1998. The three most prevalent were waivers upon death (35 percent), annuitization (24.5 percent), and nursing home confinement (18.5 percent). Some waivers have restrictions based on age or pre-existing conditions. Most vary by state. So check the fine print.

Theoretically, fixed annuities are rather simple investments. Most of us believe they are easy to understand. But we still need to pay careful attention to the availability and quality of the various features in order to select superior contracts for older clients. NU

Chart 2
Average Effective Rates by Surrender Period, July 1998



Source: Beacon Research Publications, Inc., Evanston, Ill.

Consider: Of the 282 annuities we profiled, some 11 percent shift some interest rate risk to the annuity owner through a market value adjustment. Because MVAs can provide a bonus if interest rates fall, or a reduced value if rates increase, when funds

are withdrawn, agents offering MVAs need to gauge client interest expectations. In a "portfolio" strategy, old premiums are combined with new ones and invested at current rates, providing an overall yield. An annuity backed by a portfolio strategy is a good choice if rates are expected to rise, because its yield is sensitive to the current interest rate environment.

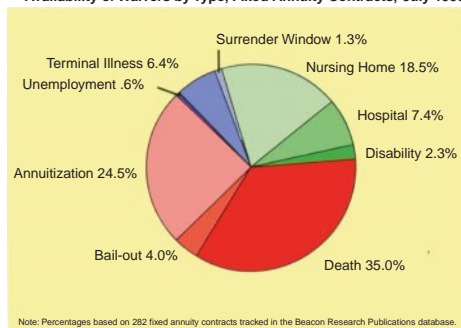
Conversely, a "block rate" strategy keeps premium pools separate. Each pool is invested at a specific rate. After a given amount of premium is received, the old block is closed and a new one is opened, often providing a different yield. Annuities backed by a block are less sensitive to changing conditions, making them a good choice if lower interest rates are anticipated. (Note: Of the 282 contracts in our database, as of July 1998, 72 percent of all fixed rate standard contracts were invested at block rates.)

A final point about interest rate risk: Some 4 percent of all standard contracts include bailout waivers. A generous waiver can substantially reduce interest rate risk. If the offered renewal rate is less than a specified yield, a bail-out waiver will permit clients to liquidate, without surrender charge or market value adjustment.

Liquidity. Many retired clients will want to have access to fixed annuity funds during the surrender charge period, to have a source of money in event of illness, death etc. Products vary widely in liquidity provisions, so checkout the details. In general, liquidity is affected by surrender charges, withdrawals, and waivers.

Surrender Charges. Almost all annuities have a surrender charge schedule. As of this writing, the average duration is

Chart 3
Availability of Waivers by Type, Fixed Annuity Contracts, July 1998



Source: Beacon Research Publications, Inc., Evanston, Ill.

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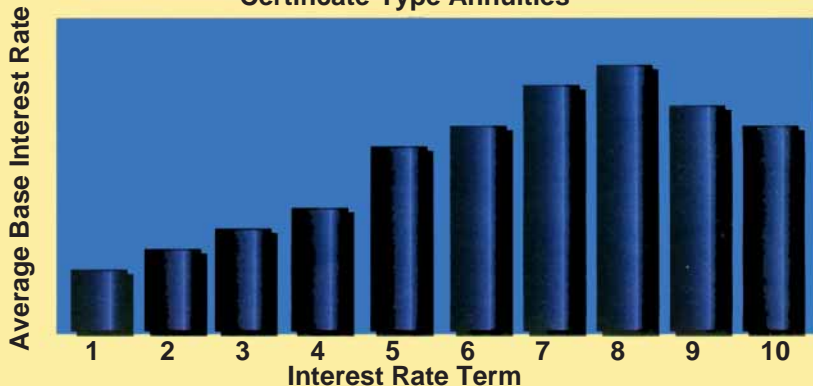
In periods of uncertainty, consider "laddering" several "certificate" annuities of different maturities, to hedge the interest rates. For example, suggest the client contribute 20 percent of the funds to annuities maturing in one, two, three, four and five years. Then, if interest rates rise, one-fifth of the capital can be reinvested each year at the future, higher of two investment strategies to back such products. If interest rates fall, the client will have secured a higher average yield than will be available later.

Certificate annuities may also be appropriate when there is less uncertainty.

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Chart 1

Average Base Interest Rate by Rate Term, July 1998 Certificate-Type Annuities



Note: Summary derived from 662 interest rates tracked in the Beacon Research Publications database, of which 20.5% (or 136 rates) are offered on certificate-type annuities.

Source: Beacon Research Publications, Inc., Evanston, Ill.

The interest rates currently being credited by certificate-type fixed annuities show a surprisingly wide range, says Beacon Research Publications, Inc. See page 14.