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ANNUTIES

In Fixed Annuities, Don't Ignore Value Just For The Rate

BY JIM TEAGUE

WITH SHORT-TERM Treasuries and bank certificates of deposit offering rates only slightly above sea level, the 3.5% to 6% guaranteed returns offered by today's fixed annuities have been very attractive.

Further, since there is no tax on interest until annuity proceeds are distributed, the tax-adjusted return for fixed annuities is more like 4.5% to 7.5%. That's not bad in today's scary investment environment.

But there is more to fixed annuities than rate; there is value. How to determine this value is the subject here.

Historically, comparison shopping for FAs has been limited to a quick look at new money rates and on broker compensation.

The focus on rates is understandable since FA provisions are pretty similar across the industry. Most have 10% free withdrawals and waiver of surrender charges for nursing home confinement and terminal illness, for instance. While fixed indexed annuities offer a little more variety—different indexes, participation schedules and multiple fund accounts, for instance—when it comes to distinguishing one five-year, guaranteed-rate FA from another, rate is usually the top factor.

However, because annuity crediting rates are a function of the performance of the general account assets of FA carriers, looking at the rate without looking behind the curtain to see what supports the rate could prove to be a costly mistake.

General account investment portfolios generally consist of corporate bonds, government securities, commercial mortgages and a handful of other very conservative investments. In recent months, much has been written about the beating insurers have taken on their bond portfolios. Some big insurers have written billions of previously highly-rated bonds off their books, and they all have internal watch lists of dozens more bond issues that may join the ranks of fallen angels before the sagging economy flushes out all the losers.

Many analysts believe the next shoe to drop in the sub-prime stumble may be commercial mortgages. That's important to annuity professionals because a number of big insurers have sizeable commercial mortgage portfolios; these could suffer significant increases in defaults as tenants are unable to pay their rent and property values continue to tumble. What looked like a good loan at 65% loan-to-value at mortgage issued two years ago doesn't look nearly as solid when loan-to-value goes up to over 100% with falling property values.

KEY FACTORS

MEASURING FIXED ANNUITY VALUE

- **Length of time** the carrier has been in the annuity business
- **Number of years** the carrier has been rated at the top
- **Renewal rate** history for the carrier's fixed annuities
- **Make-up of the** carrier's current general account investment portfolio
- **Information on the expected** performance of the carrier's portfolio assets
- **Non-annuity lines** of business at the carrier that may be having problems
- **Over-all financial condition** for the carrier and holding company

Source: Jim Teague, The Standard, Portland, Ore.

What is the message for fixed annuity brokers? In the Wizard of Oz, Dorothy had to look behind the curtain to figure out that the Wizard wasn't exactly as advertised. Brokers need to do the same to help customers determine which FA provider offers the best value, not just the best price. Here are some determining factors:

▶ Length of time the carrier has been in the annuity business. Some carriers have entered the annuity marketplace fairly recently and may be less willing to support the annuity business line as spreads have narrowed and profitability has been squeezed.

▶ Number of years the carrier has received a top rating from A.M. Best, Oldwick, N.J. Best's publishes a list of carriers that have received their top rating for the past 50 and 75 years.

▶ Renewal rate history for fixed annuities. Consumer-friendly carriers publish the renewal rate histories for most of their fixed annuity products. This information will give an idea of the renewal treatment the customer can expect as the policy ages.

▶ Make-up of current general account investment portfolio. Know what the carrier is buying to support the customer's annuity rate. If the carrier is buying primarily corporate bonds, find out the portfolio's average overall rating. If it is less than A-rated, ask more questions.

▶ As much information as possible on the expected performance of portfolio assets. Try to get a copy of the carrier's bond watch list, recent 10-Q or financial statements, and, if they issue or purchase commercial mortgages, ask to see a report on the mortgage portfolio performance and look for a low historical default rate.

▶ Non-annuity lines of business that may be having problems. Most carriers have multiple lines of business. Even though the fixed annuity line might be performing adequately, make sure there are not significant financial problems elsewhere in the system.

▶ Over-all financial condition for the carrier and holding company, if one exists. Look for recent downgrades by any of rating agencies.

In today's economy, value is critical. One way FA advisors can provide value is to complete the due diligence on carriers they represent before making a recommendation. Rate will always be important, but true value includes many factors beyond just the first-year rate. NU

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