It's Not Your Father's Fixed Annuity!
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One of the hottest new fixed annuities now raises questions about suitability. The 'total return' fixed annuity has exploded with recent product introductions from five major annuity players. Since interest rates have risen dramatically this last year and commensurately the prices of bonds have fallen, many clients and producers have started to ask questions about these accounts.

At the fall '98 meeting of the National Association of Insurance Commissioners, regulators continued to express their concerns about the marketing of equity indexed annuities. During that meeting one of the leaders of the NAIC's Annuity Regulation effort observed that he had seen the future of fixed annuities.

As exciting as the EIA may be to the fixed annuity industry, it is already old technology. A new hybrid technology represents the future. This hybrid, called a "total return annuity," has the postitive characteristics of a variable annuity, but it retains the strengths of the traditional fixed contract. It links the clients' interest rates to the 'total return' of the insurance company's general account assets, but is still provides guarantees fo principal and interest.

News of the product has spread like wildfire amount agency groups, with many wanting to know if they are real, how they work, and what their future might be. This article will examine those questions.

The concept, which began taking roots as early as six years ago, was bult around the idea of crediting the client with the total return (including interest and capital gains) from the insurance company's general account investments minus a fixed administrative fee.

This differs from the traditional method because the returns are not limited to yield on the investments, but also include the capital gains. It also differs from the traditional approach by capping the insurance company profits through the fixed administrative fees.

Some people are calling these new plans 'bond index annuities'. This label is probably mis-leading since the clients' interest is not directly indexed to bonds. These annuities promise returns ***similar to*** the returns from the Merrill Lynch Convertible Bond Index, Lehman Brothers Government/ Corporate bond Index, or the Merrill Lynch High Yield Bond Index. Notice that there is no direct linkage to that index like there is with an equity-indexed annuity that is linked to the S&P 500 or the Dow. This lack of direct linkage allows these products to generate current interest and minimum guaranteed interest from the same assets. There are no bond index options purchased by the insurance company.

It is the insurance company's general account assets that back the guarantees. And it is the insurance company's general assets from which the client's total return is derived. The insurance company may choose to segment their general account assets into categories like investment grade, convertible or high yield. But the approach that offered the greatest appeal to the regulators was a blend of these bond categories; since some regulators dictate what categories of bond investments are acceptable for the insurance company.

Since, these are fixed annuities guaranteed by the general account assets of the insurance company. Really these are ***'total return'*** annuities. The clients are guaranteed to receive the ***total return*** from the underlying assets.

The clients are further guaranteed that the maximum charge kept by the insurance company from that total return is limited to an annual administrative charge of 2 1/2% to 3%.

Finally, in the best of these products, the clients are guaranteed that the underlying assets will match the strategy or investment objective such as "long-term retirement strategies." This is a very important consideration since a company could manipulate the assets backing a ***'total return'*** annuity so that client returns were hurt.

Let's look at how they have performed?

Assuming the company only did as well as the Lehman Brothers' Government Corporate Bond Index and most companies can do better, the client would have netted 7.51% in 1997 and 7.24% in 1998. How did the average SPDA do according to AM Best? The answer was 5.74% in 1997 and 5.25% in 1998. That's 180 to 200 basis points a year more for the client with the total return, with no additional market risk. So it worked for the client. One caveat: It's not necessary to 'over-promise' to the client. If the client is expecting 6% to 8% a year and the delivers then you have satisfied clients. Many producers will 'promise' 8% to 10% a year only to find their clients are disappointed with 7% returns. Even though 7% is better than the average CD and better than the average SPDA.

There are those who have said that with these ***'total return'*** annuities you don't know what you've really earned until you withdraw the money. This seems odd to us because every day billions of dollars are invested into the stock and bond markets and those millions of people know that their profits and/or losses are never locked in until they sell. This concern is not a big obstacle to 'total return' annuity sales, especially since the clients may make more with a total return annuity than with many annual reset equity index products.

Where should the producers consider using a product like this?

This product works well as a CD alternative. Current CD rates hover around 5% and are fully taxable which may add to a clients' taxable Social Security problem. The 'total return approach' has generated better returns since 1981 than One-Year CDs, 9.04% net, per year (Lehman's Government Corporate) versus 6.54% for CDs.

The 'total return also works well as a bond mutual fund alternative. During the first quarter of '99, over $47 billion went to taxable bond mutual funds. So far this year, most of those bond mutual funds have seen their net asset values decline. If the clients had placed that money into a 'total return' annuity instead they would have at least known that non matter what happens, their principal and minimum interest were guaranteed. That's a huge market for a product that delivers bond fund returns with guarantees of principal and interest. Plus, tax deferral!

Total Return Checklist

(Things to look for)

- Good Financial Ratings for the Company
- Accessiblity to Account Values through withdrawals, annuitization, including certain types of surrender charge waisvers and death benefits.
- Caps on administrative and investment fees.
- Guarantees that assets will match investment strategies.
- Choices of strategies.

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