Which Fixed Annuities Are Best For Renewal Rates?

BY DANNY FISHER

THERE SEEMS TO BE A LOT OF confusion about how different fixed annuities (FAs) credit renewal rates. The following should help explain the 2 basic approaches.

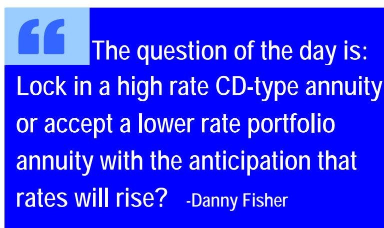
CD TYPE ANNUITIES

These FAs basically work like certificates of deposits do in banks. For example, XYZ Annuity offers to pay 5% guaranteed for 5 years or 6% guaranteed for 6 years. When the selected period ends, the client can surrender the policy for its accumulated value.

Two sub-categories are:

▸ ***Penalties Expire Forever:*** With some CD-types, after the initial guaranteed rate period ends, surrender penalties expire forever. Future renewal rates are based on a portfolio rate, as explained below.

▸ ***Forced Renewal:*** With other CD types, at the end of the initial guaranteed rate period, the owner has a window, typically 30 days, to surrender the contract. If the annuity is not surrendered, it will automatically renew for a new period with a new set of surrender penalties, exactly the way bank CDs do.



CD-type annuities may also be called multi-year guarantee (MYG) contracts.

PORTFOLIO-TYPE ANNUITIES

This type of FA normally has a rate guaranteed for a portion of the length of the contract. As an example, the ABC annuity offers 6% guaranteed for 1 year, but the surrender penalties last for 7 years. After year 1, the renewal rate is based on what the insurer earns in that portfolio of funds. Renewal rates will float up or down but can never go below the contractual minimum guaranteed rate.

The basic sub-categories are:

▸ ***Indexed Rates:*** The policy guarantees renewal rates will be based on an outside index, such as Treasury Bonds or some Lehman Brothers Bond Index, etc.

▸ ***Trust Me:*** The insurer essentially says "give us your money. After the first year, trust us to be fair with you. We'll invest the money, take what we want for a profit spread and pay you the rest."

TYPE OF FIXED ANNUITIES

CD-Type Annuities	Portfolio-Type Annuities
▸ Penalties expire forever	▸ Index Rates
	▸ Trust Me
▸ Forced Renewal	▸ Guaranteed Spread

Source: Danny Fisher, Fisher Annuity Index, Dallas, Texas

▸ ***Guaranteed Spread:*** The insurer guarantees that the renewal rate will be a stated percentage less than the gross amount earned in the portfolio. For example, the annuity guarantees the insurer will earn 2% and the balance is credited to the annuity.

Note: The Trust Me and Guaranteed Spread Portfolios may be based on a portfolio using a specific group of funds or an overall fund unique in each product.

Renewal rates for products using a specific group of funds will be based upon the money invested at a certain rate or during a certain period of time. Naturally, different groups of funds will have different renewal rates.

By contrast, an annuity with a product fund portfolio provides that all funds earn the same rate, regardless of when deposited. The rate will lag the market. During period of falling rates, the renewal rates in these products may be higher than new money rates for multi-option portfolio annuities.

Conversely, new money rates rise much faster in bundle annuities than product-fund annuities.

Agents and clients often ask me for an annuity where they can invest money at today's rates and if rates go up in the future, they will earn the rate offered on new money. (It is implied they are talking about an annuity using a specific-group-of-funds portfolio.) When I tell them there is no annuity—or any other investment—that works that way, they say, "Well, so-and-so said he had one that does." When I say that type would be financial suicide for the issuing company, they hang up on me.

Here's why that scenario is impossible for a specific-group-of-funds annuity:

When an insurer receives $1,000,000 in premium, it invests the money basically to match the duration of the penalty period. Simply stated, if it's a 7-year contract, the money is invested for 7 years. Assuming the company earns 8% and credits 6% to the annuity, the company earns $80,000 in interest and credits $60,000 to the annuities.

Next year, rates go up and the company can earn 9% and pay 7% on new money. But, it cannot credit the new 7% on old money, because the old $1,000,000 is still earning 8%. Therefore, the company only has $80,000 of old interest earnings to reinvest at the new rate of 9%. Theoretically, the old annuity should earn about 6.07% in year 2. Therefore, it is possible for renewal rates to increase, but it will happen very slowly.

Remember, if the policy uses a product fund portfolio, everyone in that particular annuity will earn the same rate.

So, which is the best type annuity? It depends. I prefer the CD-types because my clients knows exactly what they will earn and that's easier to explain than "maybe" returns. Other professionals prefer portfolio rates of varying ilk.

Whatever the recommendation, remember this era has been the lowest rate environment in decades. Everyone knows rates will rise—but not when or how high. So, the question of the day is: Lock in a high rate CD-type annuity or accept a lower rate portfolio annuity with the anticipation that rates will rise? NU

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