How annuities can beef up retirement cash flow

Laddering annuities means you have peace of mind without missing out on rising interest rates

by Jonathan Chevreau
December 14th, 2017

Many fixed-income investors are acquainted with the concept of "laddering," whether it be ladders of guaranteed investment certificates (GICs), or bonds with different maturities. Maturity dates are staggered over (typically) one to five years, so each year some money comes due and can be reinvested at prevailing interest rates. This minimizes the likelihood of investing the whole amount at what may turn out to be rock-bottom interest rates, only to watch helplessly as rates steadily rise over time. Buyer's remorse results: "Why didn't I wait to invest?"

The same applies when it comes time for retirees or near-retirees to annuitize. At the end of the year you turn 71 you must decide whether to convert your RRSP into a RRIF, cash out and pay tax (few do this), or thirdly to annuitize.

Mind you, as Warren Baldwin, a senior vice president with T.E. Wealth points out, the analogy is not perfect, since GICs mature and annuities do not. Even so, annuity returns are also affected by low interest rates today. This interest-rate risk may explain why annuities are relatively unpopular, despite providing longevity insurance that guarantees you won't outlive your money.

Fortunately, annuitization isn't an all-or-nothing decision. You can convert some of your RRSP to a RRIF and some to a registered annuity. You can take a leaf from the GIC laddering concept and buy annuities gradually over five, ten or even more years. Patrick McKeough, publisher of the TSINetwork.ca agrees laddering annuities can reduce the potential downside: "You could buy one annuity a year for the next five years. That way, your returns will increase if interest rates rise, as is likely."

Finance professor and author Moshe Milevsky agrees with taking "a staggering or laddering or dollar-cost averaging approach" to buying life annuities, "both for financial reasons and more importantly for psychological reasons." This lets retirees "get used to their pension" before fully committing to what is an irreversible decision.

Warren MacKenzie, head of financial planning for Toronto-based Optimize Wealth Management, says retirees are generally happier when the income necessary for basic necessities is guaranteed. "For retirees one of the most important things is to have financial peace of mind,"

MacKenzie says, “Even if an investment portfolio invested in large-cap bank stocks could deliver a higher cash flow (as has occurred in the past), the investor should choose the annuity if this will deliver greater financial peace of mind.”

If you plan to take the annuity route, “a laddering approach makes perfect sense,” MacKenzie says. But instead of staggering their purchase over just a five-year period, someone in their 60s might consider staggering them over a 10- or 15-year period,” he says. Once you have annuitized enough to guarantee a basic income, you should feel more comfortable investing the rest of your capital in the traditional manner (in a RRIF), with a higher weighting to equities.

Not sure how much to annuitize? Consider first how much annuity-like retirement income you *already* have, or expect to have: such as an employer-sponsored Defined Benefit pension or CPP and OAS. Some investors may have a high component of annuity-like income without realizing it, says Adrian Mastracci, portfolio manager with Vancouver-based Lycos Asset Management Inc. Many families may already have five or six such sources of annuity-like income. He likes the flexibility of a RRIF to handle large expenditures in later years: where he does like annuities is for big-spending clients who might otherwise be tempted to break into capital.

Lack of liquidity and flexibility is one reason Warren Baldwin isn’t a big fan of annuities. This can be mitigated by adding a guarantee period or a joint-and-survivor beneficiary but these reduce annuity income. In a market swoon, Baldwin prefers more fixed-income liquidity. With a GIC or bond maturing every year, an investor has a lump sum of cash if a major expense arises.

Baldwin also views the lack of estate value of annuities negatively. However, Toronto-based financial planner Rona Birenbaum says annuity buyers can solve this by purchasing a permanent life insurance policy representing all or some of the capital amount used to purchase the annuity. The estate/beneficiary is paid by the insurance when the annuity stops at death. Investor health matters. Substandard health may result in life insurance premiums too high for the strategy to make sense overall.

Most annuities purchased in Canada are immediate: income payments begin immediately after purchase. Birenbaum says deferred annuities are less popular. With these, there is an initial accumulation phase with no payout and a later withdrawal phase where payments commence. The permanence of this purchase before the income is needed and the lack of liquidity makes it a less attractive annuity option, she says.

So how much monthly cash flow could you expect for each $100,000 of capital? The older you are before you start receiving income from annuities, the higher the payout. But the effective annuity rate is also based on factors like current interest rates, mortality rates and optional extra features like inflation indexing, guarantee periods or joint-and-survivor benefits. “The more bells and whistles, the lower the monthly income,” says Birenbaum, who is the founder of the financial planning firm, Caring for Clients.

Investors also need to be cognizant of differing tax treatment of annuities. Payouts from registered annuities (held in RRIFs, for example) are fully taxed, while non-registered “prescribed” annuities are relatively more attractive on an after-tax basis. That’s because only a

portion of the monthly payment is taxable. In the examples below supplied by Birenbaum, we look at various options for 70-year olds wishing to annuitize $100,000 in single-life, prescribed non-registered and also registered annuities.

Birenbaum says a 70-year old male purchasing $100,000 in a single life, prescribed non-registered annuity with no guarantee or indexing would get $598.61 a month, of which only $92.96 is taxable, according to an RBC quote. A registered annuity with the same terms would pay $624.26 via BMO.

Add in a 10-year guarantee for the same retiree and the payout is $581.34, of which $107.65 is taxable (Sun Life). A registered annuity with the same terms would pay $600.84 at Equitable Life. If you add both the guarantee and inflation indexing at 2%, the payout falls to $487.42 a month. At Equitable, the registered annuity with those terms would pay out $497.25 a month.

Because women have longer life expectancies, payouts for females are slightly lower. For a 70-year old female, for $100,000 in the bare bones single life prescribed non-registered annuity would pay out $535.16 per month at Desjardins, only $16.84 of it taxable. For registered funds, BMO pays $549.92.

With a 10-year guarantee the payout would fall to $531.86, $88.05 of it taxable. The registered version at Equitable would pay $547.63. With inflation indexing at 2%, the payout would be $433.06 per month, fully taxable at Sun Life. The registered version at Equitable would pay $445.23.

These are all at the interest rates prevailing late in 2017: the Bank of Canada stayed pat on December 6th but is expected to hike rates two or three times over 2018. If you partly annuitize now and add more a year from now you can expect still higher payouts: remember the laddering strategy with which we began this article!

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