The super-safe supplement to bonds

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Retirees who cut back on bonds in their portfolio could be adding trouble.

Popular bond alternatives like dividend-paying common shares offer the potential for higher returns, but also an increased risk of losing money. Overlooked by almost everyone is the bond substitute with modestly higher returns and less risk.

Take some bonds out of your retirement investments and add an annuity. You'll be completely insulated from stock and bond market declines, and you'll reduce the danger of outliving your money.

Mention life annuities to investors and advisers and you often get a simplistic two-pronged critique. One point is that it's a bad time to buy annuities because interest rates are low, and another is that your money is locked up. Once purchased, there's no cashing out of an annuity.

On low interest rates, let's face facts. Rates aren't going to shoot up dramatically any time soon. On liquidity, let's get real. "The number of people who ever take out $100,000 in cash from their RRIFs [registered retirement income funds] in their lifetime is non-existent," said John Nicola, CEO of Nicola Wealth Management in Vancouver.

Retirement investing for most people is primarily about generating a reliable flow of income. That's exactly the mission of annuities – you turn a chunk of money over to an insurance company, which commits to paying you a set amount every month, every six months or annually until you die.

Pouring all your registered retirement savings into an annuity is too confining, partly because of the lack of liquidity. Annuities also leave nothing for your estate when you die, unless you accept lower payouts in exchange for some level of continued benefits after death. These limitations explain why Mr. Nicola suggests using annuities as only a partial bond substitute. "Annuities are part of the solution," he said. "They're not *the* solution."

Why we hold bonds in a portfolio: to provide income and stability by hedging against stock market declines. Annuities do both of these things, with one additional advantage. Whereas bonds and bond funds will fall in price when interest rates rise, annuities remain unaffected. In a way, annuities are like permanent, super-safe, illiquid bonds.

When Mr. Nicola's firm uses annuities for clients, they're given roughly a 25-per-cent weighting in a retirement portfolio's fixed-income allocation alongside such things as domestic and foreign bonds, high-yield bonds and preferred shares. He says annuities can be purchased in amounts as small as $25,000.

Mr. Nicola's numbers show that at age 65, a male would receive annual income of $7,264 from $100,000 invested in a life annuity where benefits are paid out over the lifetime of the purchaser and stop when he or she dies with no assets going to the estate. He calculates that as being equivalent to an interest rate of 4.4 per cent if the purchaser lives a typical expectancy for someone of that age (to 86.6 years, by one insurer's estimate). The rate rises to 5.2 per cent if the person lives to age 90. For comparison's sake, a 10-year Government of Canada bond yields about 2.3 per cent yield.

Combining an annuity with a registered retirement income fund makes particular sense in light of the fact that RRIF-holders must draw down their accounts over time to meet minimum annual withdrawal requirements. Investment gains may offset the drain on your RRIF assets to some extent, but this gets increasingly difficult as you age. The minimum withdrawal rate at age 80 is 8.75 per cent; at 85, it's 10.33 per cent.

Annuities cannot be depleted while you're alive, Mr. Nicola says. "So, really what you're buying is longevity insurance. For some of your assets, especially on a registered basis, that's a very rational decision."

Now for some caveats on using annuities in retirement portfolios:

1. Your expected lifespan matters

Money paid into annuities by people who die prematurely subsidizes those who live long lives. Obviously, you want to have some degree of confidence that you will live long after you buy an annuity. David Chalmers, a financial adviser at Nicola Wealth Management, says this is how his firm approaches the health issue: "We would generally ask the question, 'On a scale of one to 10, with one being bad and 10 being good, how would you describe your health?' If the response is the number six or lower, we would most probably not consider the annuity as a viable strategy."

2. Liquidity

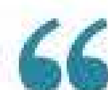
It's worth restating that money invested in an annuity can't be retrieved. "Once the capital has been deployed, it has been exchanged for an income," Mr. Chalmers said via e-mail. "One cannot get a lump sum of cash (just as one cannot trade one's Old Age Security for a lump sum of cash)."

3. The role of interest rates

Annuities bought today would not benefit from higher rates in the future. "Once the amount of the annuity income has been established, it is fixed for life," Mr. Chalmers said. Note: Indexed annuities bump up your payments annually to offset inflation, but you receive less cash per payment than you would with an un-indexed annuity.

One more caveat covers logistics. You can't conveniently add an annuity to your existing RRIF so as to keep all your retirement investments in one place. The procedure as explained by Mr. Nicola is to initiate a transfer of cash from your RRIF to an annuity set up through a life insurance company. There are no tax considerations because the money is considered as moving from one registered investment to another.

Be sure to compare annuity rates from company to company because they vary significantly and change frequently. Financial strength is a point of differentiation in choosing an insurer, but annuity holders are protected if a company folds through a customer protection plan called Assuris. Annuities are protected for up to $2,000 per month or 85 per cent of your monthly benefit, whichever figure is higher.



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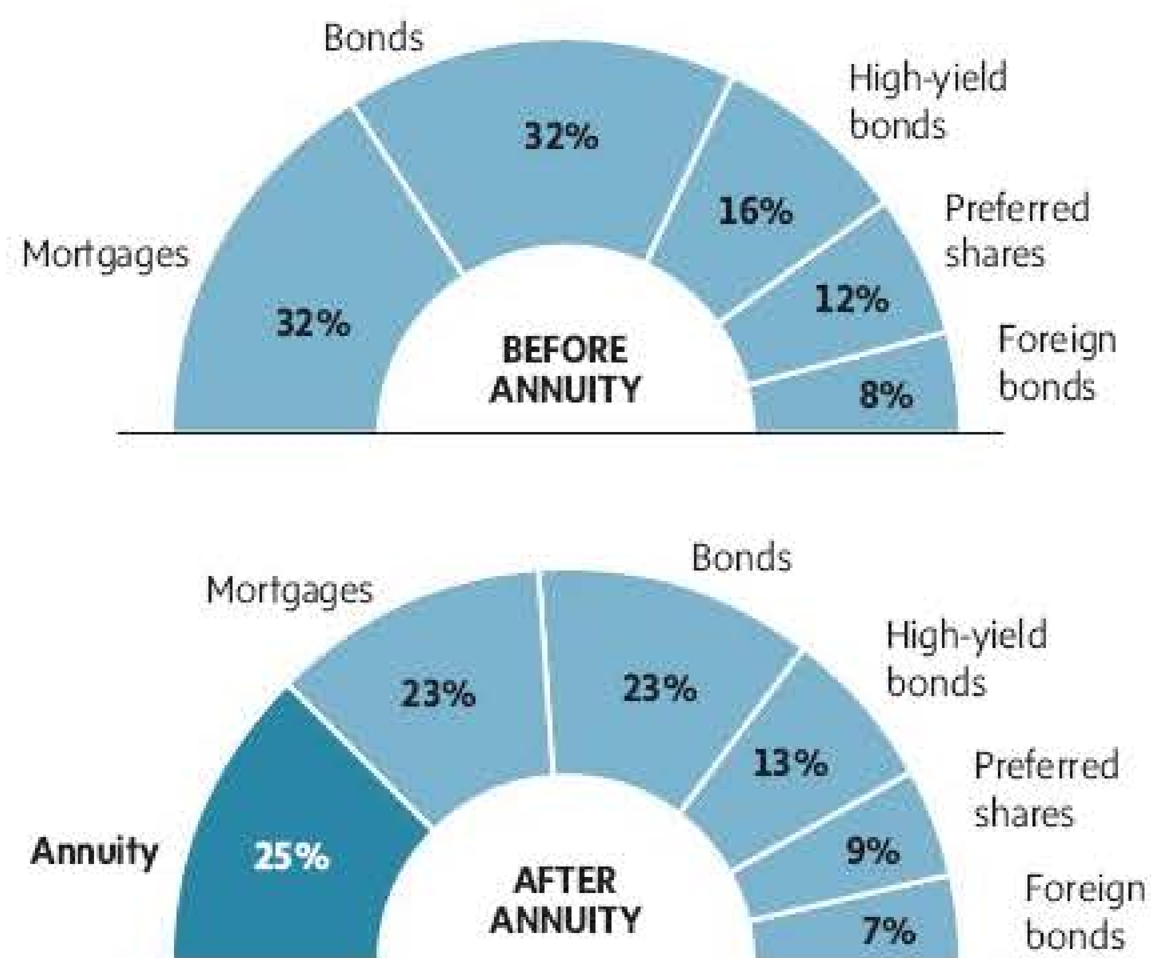
>
> **John Nicola**
> *CEO, Nicola Wealth Management*

A CUSHION FOR HARD TIMES

How to work annuities into your retirement investments

Here's a traditional selection of fixed-income investments used by the firm Nicola Wealth Management for retirees compared with a fixed-income allocation that incorporates an annuity.



How having an annuity pays off

Replacing a portion of the bond holdings in your RRIF with an annuity gives you a stream of income that lasts as long as you live. Here's an example of the annual payout you'd get from a $100,000 investment in an annuity purchased at various ages. Returns shown here are the annuity equivalent to the yield on a bond. Life expectancy data come from Canada Life.

	MALE			FEMALE		
AGE	65	70	75	65	70	75
LIFE EXPECTANCY	86.6	88	90	89	90	91.3
ANNUITY INCOMES*	$7,264	$8,524	$10,305	$6,522	$7,481	$8,887
RETURN TO LIFE EXPECTANCY	4.4%	4.9%	6.0%	4.0%	4.2%	4.7%
RETURN TO AGE 90	5.2%	5.7%	6.0%	4.2%	4.2%	3.8%

*$100,000 investment

JOHN SOPINSKI/THE GLOBE AND MAIL » SOURCE: NICOLA WEALTH MANAGEMENT

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