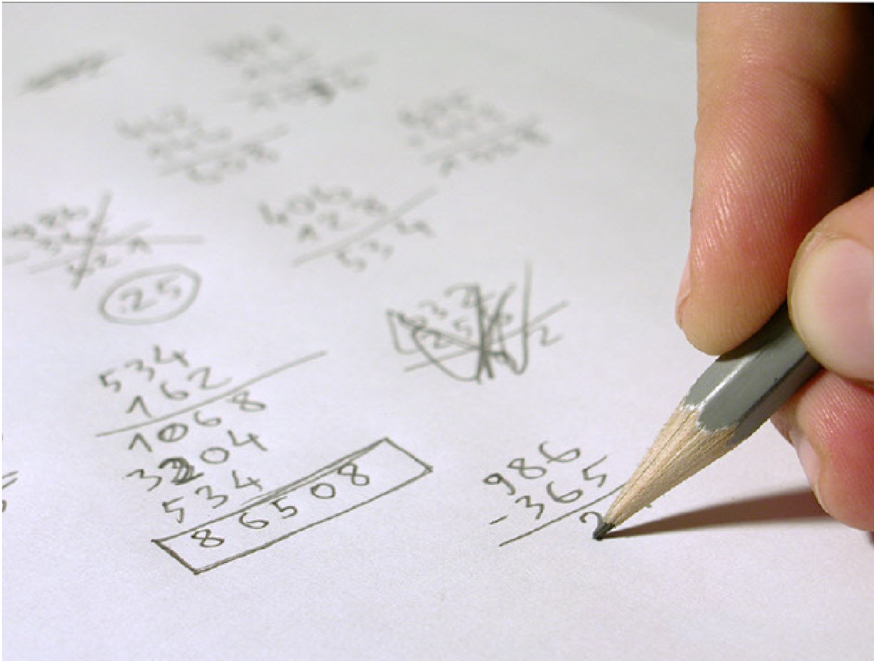
Doing the math on annuities



Even without an old-fashioned defined benefit pension plan, you too can pensionize your nest egg through a life annuity. Fotolia

Jonathan Chevreau, Financial Post · Wednesday, Jun. 9, 2010

One hazard of remaining in the workforce in one's late 50s is envying contemporaries already drawing full pensions from former employers. Last week a neighbour informed me he was retiring at age 52 through a combination of severance package and 30 years with the same employer.

Five years his senior, yours truly continues to write the column you're now reading. This set me to thinking about annuities I've covered in recent columns. Even without an old-fashioned defined benefit pension plan like my now-retired friend enjoys, you too can pensionize your nest egg through a life annuity.

Because of the Pension Adjustment provision allowed by the Canada Revenue Agency, those with small or nonexistent pension plans have more RRSP contribution room. The money in those RRSPs can be annuitized at any age, as can non-registered investments. So, you can give yourself the kind of guaranteed monthly income for life your pensioned neighbours enjoy.

What you will soon discover is, it would take $1-million to $2-million of capital to create an annuity income comparable to what those pensioners are receiving.

After a column last week introducing annuities as a way to be paid for life, I heard from Ivon T. Hughes, president of Montreal-based The Hughes Trustco Group, who also runs the website www.lifeannuities.com.Regarding one source's recommendation that clients wait until later in life, 77 or 78, before buying annuities, he had this to say: "How long are these people going to live? People wait and wait for a quarter-point interest rise to realize that they've missed a whole year of payments." So, when should they annuitize? "When it makes sense," Hughes replied. Some wait till their early 70s, some before 60.

His argument resembles the one about taking Canada Pension Plan benefits early: By waiting till age 65, CPP payments are 30% higher than if you take them early at age 60. However, that's 60 cheques you're giving up that the early retiree will be enjoying. If you both die at 65, the early retiree has the last laugh.

Hughes kindly ran some numbers for me and my wife for a joint annuity policy, meaning one of us keeps getting paid upon the death of the other. For a guarantee period of 10 years (money goes to our heirs if we both die before 10 years), each $100,000 of capital derived from our RRSPs would generate monthly income ranging from $423 (Standard Life's annuity plan) to $484 (Manulife Investments). That works out to between $5,076 and $5,808 a year, or annualized returns of more than 5%.

As Clay Gillespie of Vancouver-based Rogers Group Financial notes, that's 0.5% to 1% more than you'd get from bond interest or stock dividends. And with registered annuities, there is no tax hit when you withdraw the capital from an RRSP. Instead, you're taxed as you receive the monthly payments.

Annuities in non-registered plans provide similar amounts of monthly income but are more tax-effective because half the payments are considered non-taxable "return of capital." On the $100,000 base example, the monthly taxable portion ranges from $164 from Standard Life to $217 for Manulife.

Investors have to decide if these payouts compare favourably with bonds or dividends. Hughes says bonds and dividends are less secure and do not have the life guarantee of an annuity.

But you are forfeiting the capital with annuities and as time marches on, your purchasing power will be eroded by inflation unless you pay a premiumfor inflation-indexed annuities. Also, the decision to annuitize is irreversible.

As for me, if you're still reading future editions of this column, you can assume I decided to delay annuitizing.

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