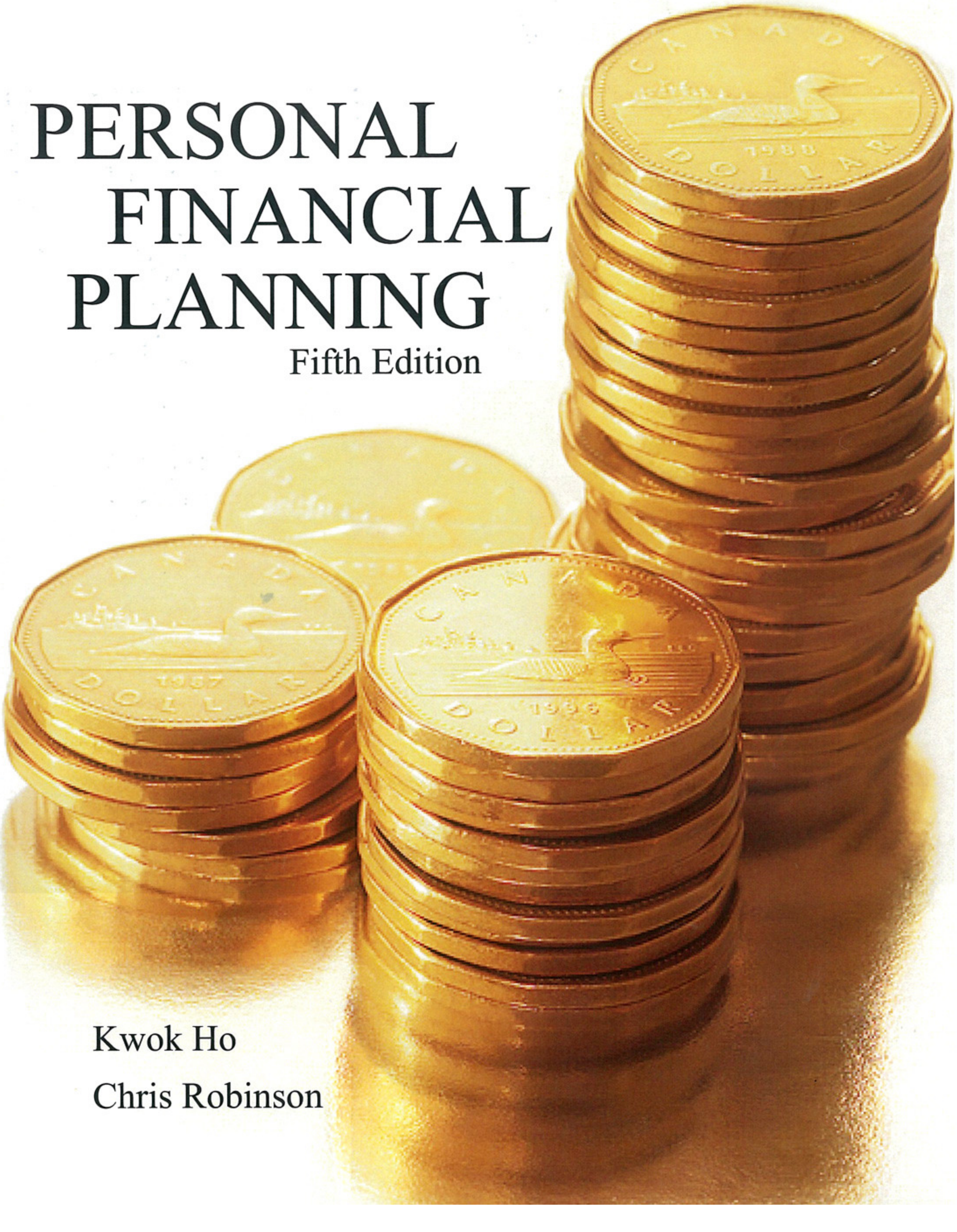
PERSONAL FINANCIAL PLANNING

Fifth Edition



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Chris Robinson

Preface

We wrote this book to provide a thorough coverage of personal finance grounded in finance theory. No such work is widely available for use in universities and colleges, but financial institutions need people who have proper training to work with their clientele. In addition, students need to learn how to manage their own finances in an orderly way.

We have taught part-time and full-time undergraduate and MBA students at York University using this textbook. Some of our graduates have successfully completed the Certified Financial Planner® exam and work as professional planners. They find it both personally relevant and useful in their careers. We hope you will enjoy it too.

In the fifth edition we have added substantial new material in tax and retirement planning. We deleted Chapters 19 and 20, but substantially revised versions will made available on the Captus Press website. We have made many smaller changes and additions throughout the book, including new problems.

Farshad Adlgostar helped us create problems and solutions. Professor Joanne Magee reviewed the tax chapters and provided extensive advice on tax questions throughout the book. Syed Ahmed, Bob Barney, John Benson, Shawn Brayman, Trevor Chamberlain, Helena Cheung, John Churchill, Coleen Clark, Dan Collison, Esther Deutsch, Alan Goldhar, Debbie Good, Yves Groleau, Ivon T. Hughes, Ken Hopper, Jury Kopach, Franck Lerman, Craig Lilley, Simeon Ling, Jane Londerville, Maureen MacDonald, Bernice Miedzinski, Moshe Arye Milevsky, Grady Perdue, Meredith Perren, Ruth Reimer, Fred and Fran Robinson, Chris Veld, David West, Victoria Zaremba, and Xiaoyu Zhang provided helpful comments on various sections. The late Nora Campbell typed and edited about half of the manuscript of the first edition. We would like to acknowledge also the support and patience of the students on whom we have practised the ideas contained in this book and our colleagues at York University.

Chris Robinson previously wrote a private textbook in personal finance for the Institute of Canadian Bankers, in 1986–87. For the knowledge and skills that he gained from that experience, he thanks: Gilles Bernier of Laval University, his co-

Nothing comes for free in personal finance, and annuities also have their disadvantages. We have already mentioned the loss of the bequest, which we do not regard as a reason to avoid annuities. We will discuss the others in the next few sections.

The OAS, CPP, and employer pensions are life annuities, which is part of their attraction. A family that has enough income from these sources doesn't need to annuitize. Most families should consider the annuity option seriously. As we have already stated, adding a guaranteed term reduces the payment, and this shows on Table 18.3. A guaranteed term reduces the effectiveness of the insurance aspect. If the lower income is sufficient for the family, then it should instead buy a life

TABLE 18.3
Life Annuity Rates

Monthly income from a single payment of $100,000 from registered funds (e.g., RRIF). The rates shown are quoted by a Canadian insurance company on March 13, 2012. The entire payment is taxable income because the annuitant buys it with registered funds. "Guarantee" means the payments will be made for that length of time, even if the annuitant dies before the end of guarantee period. The joint life values are for a male and female couple of the same age.

A. Fixed Life Annuity

	Single Male Guarantee?		Single Female Guarantee?		Joint Life Guarantee?	
Age at Start	No	20 year	No	20 year	No	20 year
55	$445.67	$412.12	$369.03	$360.16	$322.93	$321.47
60	505.92	450.36	439.82	414.85	383.29	378.75
65	582.34	478.03	502.72	452.76	449.30	435.33
70	690.80	502.50	582.94	482.93	507.46	471.21

B. Life Annuity Indexed at 2% per annum
(The table shows the initial payment, which rises by 2% each year thereafter.)

55	$312.04	$291.00	$256.73	$248.69	$228.17	$227.17
60	396.21	351.28	311.79	294.06	263.49	260.31
65	481.66	390.91	398.35	357.26	335.91	324.72
70	585.25	418.03	484.72	396.53	415.85	383.67

Source: Courtesy of Ivon Hughes, The Hughes Trustco Group Ltd. <www.lifeannuities.com>

taking on inflation risk (although governments also have some influence on the inflation rate) and hence they do not offer attractive yields because they are bearing the extra risk. This means that the insurance company has to take on some extra risk in offering real annuities and get lower yields on the investments it matches them against. As a result, the company has to charge a higher premium in the form of a lower payout than the expected rate of inflation appears to justify on a purely mathematical basis.

Second, a real annuity payment will start at a much lower level than the same lump sum will buy in the form of a fixed annuity. Retirees suffer from **money illusion**. Money illusion is the tendency of people to focus on nominal dollars rather than real dollars or purchasing power. We showed you how to deal with inflation and inter-period comparisons in Chapter 2, but most people have not read this textbook and don't allow for it. Real and indexed annuities start with lower payouts because the payouts will rise over time, but retirees focus on the first year and are not able to recognize the importance of providing for future increases in cost of living.

> ***I have always told clients to do their own inflation protection by having the bank automatically transfer 5% of each payment to a savings account. Nice and simple.***
>
> *— Ivon T. Hughes, Hughes Trustco*

Are the Annuities Secure?

The financial failure of the annuity provider is another reason why annuities are not the risk-free solution to avoid outliving your money. Unlike investment risk on the market, you cannot recover from a failed annuity provider or even take action to save yourself if you see the annuity provider running into difficulty because once you have started a life annuity, you cannot cash it in for the market value.

The risk has not been very large in the past. If a life insurance company sold you the annuity, it is regulated very heavily to ensure long-run solvency. Life insurance companies rarely fail, and when they do, the loss is never close to all the value of the liabilities. You can always expect at least part of the annuity payout to continue with another company that takes over the failed insurer. Furthermore, Assuris provides insurance for annuities as set out in Chapter 10. Many pension plans convert the retiree's entitlement at retirement date into an annuity paid by a life insurance company, rather than retaining the funds and paying the pension from the pooled funds of the retirement plan. Assuris covers only the first $2,000 per month of annuity, however, which is not a lot in today's values.

We are not so sure that the future will mirror the past. First, we have seen significant pension plan problems since 2008, and some of the worst problems

Leading personal finance academics, Kwok Ho and Chris Robinson, have designed *Personal Financial Planning* for serious students of the field and for those who wish to develop their own rigorous financial plans. The authors develop each topic from its basic finance foundation and add a wealth of descriptive and institutional information for implementation of personal financial plans in the real world. Students who wish to pursue careers in financial planning or in financial institutions will find the models and the practical applications they need through examples, problems, and case studies. It is also a valuable resource for practising professionals.

This fifth edition has been thoroughly revised to incorporate changes in laws applicable to financial planning, particularly changes in income tax rates and retirement payouts like the Canada Pension Plan and Old Age Security. The tax chapters include new material on instruments like the Tax Free Savings Account and a comprehensive description of tax assistance for post-secondary education and for persons with disabilities. Completely rewritten, the post-retirement planning section in Chapter 18 reflects tax changes like pension income splitting, and considerable new material is added on life annuities. The section on estate planning has also been extensively revised.

For readers who wish to gain hands-on experience in financial planning and the knowledge stemming from actually creating a financial planning document, the PlanPlus for Students software is now available free of charge. Internet-based and easy to use, this software assists in the analysis of problems in the text and in practice. Check the Captus Press website for information on the software and the system requirements.

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