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A good annuity strategy can help you beat inflation

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Inflation in Canada continues to remain subdued. Statistics Canada said this week that lower gas prices helped the annual inflation rate ease to 1.4% in May from 1.8% in April. The core inflation figure, which strips out energy, was 1.8% versus 1.9% the previous month.

Even so, long-term investors know inflation will eventually be a significant risk, especially for those on fixed incomes who expect to live long lives. Inflation and longevity risk are linked.

You hope to live a long life but also know the longer you live, the more inflation will cut into your purchasing power.

And even at these low recent rates of inflation, the cost of living can be expected to double in 20 years, says finance professor Moshe Milvesky in his new book, Pensionize Your Nest Egg (Wiley Canada).

Immediate annuities, also called SPIAs or single premium immediate annuities, help address longevity risk, which is why Milevsky describes their role as longevity insurance.

Luckily, there is also a relatively unknown product called the inflation-indexed life annuity, which pays out more if inflation rises.

Unfortunately, they probably have not been brought to your attention. The financial intermediaries you're dealing with typically "don't know, can't offer them or won't tell you," says Graham Cook, president of Nanaimo, B.C.-based Composite Finance Inc.

He has a primer on the topic at www.yourannuityadvisor.ca.Only one or two companies currently sell them in Canada, he says. The reason for this should be familiar by now: Advisors stand to earn only a small one-time commission on inflation-indexed annuities. Many would rather sell fancier vehicles that pay ongoing trailer fees, even if they don't handle inflation particularly well. One such example is the new variable annuity/segregated fund vehicles known as the Guaranteed Minimum Withdrawal Benefit (GMWB).

The net result is that inflation-indexed annuities suffer from the same underappreciation that inflation-indexed real return bonds experienced a decade ago.

Some financial advisors are familiar with such products. One is Clay Gillespie, a vice-president at Vancouverbased Rogers Group Financial.

He includes inflation-indexed life annuities in a list of "guaranteed income alternatives" he provides to clients.

His list also includes regular GICs and bonds, nonindexed life annuities, lifetime GICs or insured annuities and GMWBs.

"An inflation-adjusted, indexed annuity mitigates not only the risk of outliving your money, but also the risk of losing purchasing power as goods and services continue to rise in price each year," he says.

Almost always, you should annuitize registered assets first, Cook says. Buying annuities with non-registered money is something you do after you've "pensionized" your registered funds.

If you do use non-registered money, try "prescribed" annuities, which smooth out the ratio of interest and return of capital over the years. But there's a catch: You can't index prescribed annuities, says Asher Tward of Tridelta Financial. You can only index non-prescribed annuities.

Another problem is there is a cost to inflation-indexed annuities: For the same amount of principal, nonindexed annuities pay higher benefits than indexed ones. So, if inflation never takes off, the inflation-indexed variety may underperform the vanilla unindexed versions.

Ivon Hughes, president of Montreal-based The Hughes Trustco Group, says most Canadian insurance companies don't sell true inflation-indexed annuities, selling

instead "indexed annuities" that increase payment amounts by whatever annual amount you specify: 2%, 5% etc.

Here again, the higher the indexing, the less the monthly payout, so Hughes is doubtful pensioners with indexed annuities will ever catch up with unindexed ones.

Hughes produced a quote for a joint life annuity from Standard Life that is fully indexed to the Consumer Price Index. A couple aged 62 with $175,000 in an RRSP, with no guarantee period, would receive $525 a month for life.

But a comparable regular unindexed annuity generates a much heftier $826 a month.

"Any kind of indexing with a fixed amount of capital deposited means something has to give if the guarantee is for life," Hughes says.

"Either earlier or later, you have to receive less income. There's no way around it."

However, it's not all or nothing, Cook says. A mix of escalating and/or CPIindexed annuities can work well too.

"The idea is to cover all your guaranteed living expenses with an investment that will provide guaranteed income.

"Think of it as a CPP/OAS top-up strategy."

If you don't require income until age 65, it's best to buy into annuities in stages, laddering in with 20% chunks every two years after age 55.

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