STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

5th in a series

We've covered off the points that guaranteed withdrawal benefit plans provide guaranteed income while continuing to offer investors the opportunity to invest in the market. Investors understand that these guarantees come with fees. Investing and performance are not free of the effects of emotion. Investing also comes with a lot of moving parts and people may be uncomfortable or unable to handle this on their own. Two questions that come up are these; Am I locked in to getting a fixed amount of income no matter how my portfolio performs with one of these plans? And are these guarantees fixed on my initial deposits?

Investor behaviour

Studies and experience have shown that investor behaviour is frequently erratic, emotionally driven and inconsistent with illustrations of products performing under set assumptions. This combination leads to performance experience that is often lower than illustrations and examples.[1] When you couple this with a growing conservatism of an aging population, nearing or in retirement, stung by market performance, then you have an environment that welcomes products that offer guaranteed, lifetime income with upside potential. These product types become even more attractive when the administration of those product packages sits with the issuing companies. They provide an administrative system designed and put in place for people who aren't prepared on their own (or with a qualified advisor) to assemble customized investment packages and subsequent withdrawal streams, monitor performance and assume all the risk themselves.

One thing we have all learned since 2008 is that investors' risk tolerance to market volatility is much lower than they estimated. Much of that is due to the fact that people experienced negative volatility. Positive volatility describes scenarios where rates of return fluctuate, perhaps widely, but overall performance tends to remain positive, i.e. investors experience positive rates of return. Market and product performance since 2007 experienced volatility where rates of return not only fluctuated widely, but where overall performance measured by rates of return was negative. The fear of loss is a much stronger motivator than the chance of gain, particularly when the stakes get large.

[1] Source: Behavioral Economics and Investor Protection 2013; Emotion and Decision Making, 2015

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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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Setting and resetting the safety net

One of the concerns with retirement products is that once the income flow starts, they are not designed to keep up with the consumer price index (CPI) and especially the cost of living for retirees. The impact of inflation can be very different for a retiree compared to the general population. Another concern is that even with these plans, retirees still face longevity risk once the guarantees have been exhausted and all the promised money has been returned. Both of these concerns highlight the desire for real versus nominal income.

Let's go back to guaranteed minimum withdrawal benefit plans. The Income Base is the total of all deposits, minus any withdrawals, plus any increases from Income Base Resets and Income Base Bonuses. The Income Base value is used to determine the Lifetime Withdrawal Amount — the guaranteed retirement income going to the investor. The Income Base does not impact the market value of the investments and is not available for withdrawal. When an investor purchases a Guaranteed Minimum Withdrawal Benefit plan, the Income Base will be increased by 4-5% every year for the first 20 years, depending on the particular contract that was purchased. (including the year of the purchase), provided no withdrawals are made during that calendar year. Remember that the annual Income Base Bonus is not a guaranteed rate of return, has no cash value, and is not available for withdrawal.

Issuing companies, like Empire Life have introduced plans that step-up or reset the guaranteed base that is used to calculate the withdrawal benefits. These resets occur on contract anniversaries, typically every three years but ranging from quarterly to every five years. Some plans even guarantee this stepped-up income flow for a couple for life, providing the additional benefit of longevity insurance when investing non registered monies.

Each reset increases the Income Base and the resulting retirement income amount. If the market value of the underlying investments is higher than the current Income Base, the new amount is locked in and will not decrease, except for withdrawals made by the investor. Locked-in investment growth may increase guaranteed retirement income, which is important to help offset inflation. This step-up or reset feature addresses worries about market downturns and outliving money. It also helps to keep the guarantees relevant.

Once the income stream begins, a reset feature may boost the income base and the resulting income if the market value is greater than the initial deposit ($100,000 in this ongoing example or a subsequent higher market value at the time of the reset). The reset is calculated every three years for an Empire Life Class Plus 3.0 plan. If the market value of the policy is greater than the current income base, the income base will be reset to equal the market value of the policy.

The annual payment will be increased by the stipulated percentage of that income base as contained in the contract. If the market value is not greater than the income base, then the payment is guaranteed to remain at its current level ($4,000 in this ongoing example). Upon the death of the policyholder, the remaining account value, if any, belongs to the estate or a named beneficiary.

Income base bonus increases asset size used to calculate guaranteed lifetime income stream

Analysis of the reset feature by York University[2]. and others brings up some important considerations. Although the retiree can certainly expect to receive a step-up or reset and the median amount withdrawn does increase over time, there is at least a 25% chance that the policyholder will experience no resets during the first 10 -12 years of the policy. The probability of no reset is even higher if equities form a small percentage of the investments in the plan. A healthy allocation in equities within the underlying portfolio is critical for the reset feature to actually keep up with the inflation rate experienced by retirees. However, investors may be uncomfortable or ill-suited to holding a higher percentage of their holdings in equities which do experience higher volatility. Here again, low or negative returns that occur in the retirement risk zone may boost the chance that resets will help if investors had held a significant amount of equities in their portfolio over the years up to that time.

Another important by-product is the concept of an optimal asset allocation within a vehicle that offers a guaranteed minimum withdrawal benefit. Preliminary research by York University[3] seems to indicate that when investors are protected from prolonged negative returns during retirement in a guaranteed minimum withdrawal benefit structure, they can comfortably and rationally accept more financial market risk for a given risk tolerance level. The study found that optimal investor behaviour is to select the maximum allocation to equity that is allowed by the terms of the particular contract.

In a portfolio without guaranteed withdrawals, a significant allocation to fixed income bonds acts to protect future income withdrawals from downturns in the equity market. This allows little or no opportunity for growth. The guarantees in a guaranteed minimum withdrawal benefit plan provide that same protection. If the market declines, a rational and patient investor relies on the guarantee to support higher, future income needs. The investment portfolio should be structured to maximize exposure to equities in order to provide an opportunity for growth.

[2] (Asset Allocation and the Transition to Income: The Importance of Product Allocation in the Retirement Risk Zone; Moshe A. Milevsky and Thomas S. Salisbury, Huang, Milevsky and Salisbury (2006))

[3] Ibid

Peter Wouters

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