STEPUP

SALES TAX ESTATE PLANNING UNDERWRITING & PRODUCT NEWSLETTER

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Complexity, Confusion and Fit

Guaranteed Minimum Withdrawal Benefit plans

Some of the most frequent questions asked by investors looking at retirement include these:

- How much is enough?
- What number do I need to retire on?
- What figure do I need to reach in order to provide me with an income that will support my retirement lifestyle?
- What happens if there is a market downturn around the time I plan on retiring?
- How long does my retirement income have to last?
- Will I outlive my savings?
- What happens if I need extra money for emergencies?
- What happens if markets improve after I've set up my retirement programs?
- I'm looking for some certainty and peace of mind when it comes to my retirement income. Can I get it with the product choices available?

What is a GMWB?

Guaranteed Minimum Withdrawal Benefit plans provide long time wealth accumulation and capital preservation for investors. They are a combination of investment and income solutions built into one package. In general terms a guaranteed minimum withdrawal benefit plan works as follows. The investor allocates for example, $100,000, with the issuing company. This provides the income base. First year income will be 5% of that total, or $5,000.

The money is placed in an underlying portfolio chosen by the investor. At the end of the year, the remaining balance will depend on the return of the underlying investment less expenses. If the balance is greater than the initial balance ($100,000), the annual payment will increase to 5% of that new remaining balance. If not, the payment remains at its current level ($5,000). In each subsequent year the payment will be the greater of 5% of the remaining balance, or the prior year's payment. Upon the death of the policyholder, the remaining balance, if any, belongs to the estate.

For each year that the investor waits to receive income, (s)he receives an annual 5% income base bonus. This annual bonus is not a guaranteed rate of return or a cash deposit. It's not available for withdrawal.

Essentially, the investor is being guaranteed at least $5,000 (per $100,000 of investment) a year for life, with the potential for increases if the underlying funds perform well. The issuing company charges a fee for this guarantee, and those fees can be high. Furthermore, a major issue with a Guaranteed Minimum Withdrawal Benefit plan is the latitude it provides the issuing company with respect to guarantees in the product. It's very important then, to understand and compare policy terms and conditions.

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Empire Life

Peter A. Wouters is Director of Tax & Estate Planning and Risk Product Marketing for the Empire Life Insurance Company. He devotes much of his time working with independent advisors, their affluent clients and other professionals, uncovering needs and presenting information and options aimed at improving their tax and legacy plans and lifestyle priorities. He heads a team of accredited professionals providing case consultation, technical and advanced marketing support across Canada.

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Who is this for?

One of the many implications of the transition from defined benefit pension plans to defined contribution pension plans and the overall drop in numbers of people covered by any company pension plan at all is that current and future retirees may no longer be able to rely on a guaranteed retirement pension that provides lifetime income adjusted for inflation and is independent of market performance, interest rates and the general economic environment. Individuals are being handed the responsibility and task of protecting and optimizing their retirement nest egg themselves. In a world where volatility and unpredictability are the new norm, this is a scary task.

There are a lot of people in their 60s who have been hurt, financially and emotionally, and are now fearful of the extreme volatility and uncertainty of the markets. It's a real challenge today trying to find high yield, fixed-income investments for these customers. Bond yields and GICs aren't generating the rates of return necessary to build a retirement asset base and generate sufficient, sustainable income.

When it comes to generating investment income, ideally clients want a guaranteed floor, where they know what their income is going to be in the future and how it's going to be calculated. Furthermore they recognize the need to participate in the equity market as much as possible, knowing full well what the downside is going to be. If market performance spikes, these investors value the ability to lock in gains. These plans allow investors the opportunity to do both. They get a 5% rate of return on their notional account that is used to calculate a guaranteed, lifetime income, plus an exposure to the market if that's what they need and want. They have the flexibility to cash out if that's what they decide they want down the road. In summary, these plans are designed for individuals about to retire, in their early retirement years, or who are investing for retirement.

Investors remove certain risks and receive downside protection by repositioning part of their money in products like guaranteed minimum withdrawal benefit plans. A severe market downturn takes on added significance around retirement. Losing value in investments near retirement can be devastating and income could suffer throughout the retirement years. Guaranteed Minimum Withdrawal Benefit Plans are one way of safeguarding investors against market declines.

This type of plan is best suited for supplementing a long-term retirement income portfolio by providing guaranteed retirement income for life at the age of 65. Retirees can benefit from adding this product solution to their portfolios as the guaranteed retirement income for life will help minimize the risk of outliving their retirement income. On the other hand, pre-retirees who are years from retirement can use this plan to grow their savings and protect their capital from the effects of inflation and downward markets. To calculate the target age for pre-retirees, subtract the optimal income base bonus period from the planned retirement age. In summary, this type of product operates like a pension asset.

There are some additional advantages to using non-registered funds in a guaranteed minimum withdrawal benefit plan to generate income, namely the way income comes out—primarily capital first and then capital gain. This improves tax efficiency of income.

Guarantees –are they worth it?

This product solution offers value if the performance of the underlying funds is low or poor. For example, if the invested monies have a 0% return for 20 years, and the policyholder is still alive, then the 5% income guarantee on the initial amount has real value. At that point the account balance is zero but annual payments will continue for life. The cost for this can be as much as 75 or even 100 basis points per year. Under these circumstances, annuitization may be a better way to guarantee lifetime income.

Critics of guaranteed minimum withdrawal benefit plans point out that if market performance is similar to the past few decades leading up to the most recent recession in 2008, the buyer is paying for an insurance feature that arguably has little value. What happens though if people are in the retirement zone, ready to begin withdrawals and the markets and consumers behave like they did in 2008 and 2009?

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. 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 over the last three years (i.e. since 2007) 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.

Risk Tolerance and appropriateness

Many people today choose very conservative investments, including GICs. That may help protect against market volatility, but will it generate enough income to support their retirement lifestyles? Guaranteed Minimum Withdrawal Benefit plans provide freedom to choose investments with higher potential returns. The 5% annual Income Base Bonus credited during years when no withdrawals are made from the contract and guaranteed income during retirement act as a safety net. Investors can pursue the returns they want with the potential that all of the investment growth may increase the amount of guaranteed income. Herein lies a potential pitfall for investors and advisors alike. The safety net should not remove the responsibility of matching risk tolerance to investment choice and makeup of assets within such a plan. The same holds true for other features and benefits in such plans like the 100% survivors benefit guarantee on net deposits.

The Risk of Longevity

Canadians are living longer these days, so it's even more important to be financially prepared.

- A 65-year-old woman has a 50% chance of living to 86 and a 25% chance of reaching 92.
- A 65-year-old man has a 50% chance of living to 83 and a 25% chance of reaching 89.
- For a couple both aged 65, there's a 50% chance that at least one spouse will reach 90.

Source: Canadian Institute of Actuaries, 2007

Retirement risk zone

One of the less commonly discussed risks of retirement is the risk of having too much market risk in your portfolio at a time when you need income. Advisors have an opportunity to create and build awareness for something called the retirement risk zone.

The 5 to 10 years before and after the onset of retirement or the time when cash-flow begins represent a very fragile and critical period in the financial lifecycle. It is called the retirement risk zone. When planning for retirement, retirees need to really review their portfolios and see how much exposure they have to market risk during this period when the retirement nest egg is most vulnerable to market downturns. The retirement risk zone should be important to investors and advisors alike because short term portfolio losses due to markets during this time can have significant, long term, negative effects on the longevity of the investment portfolio.

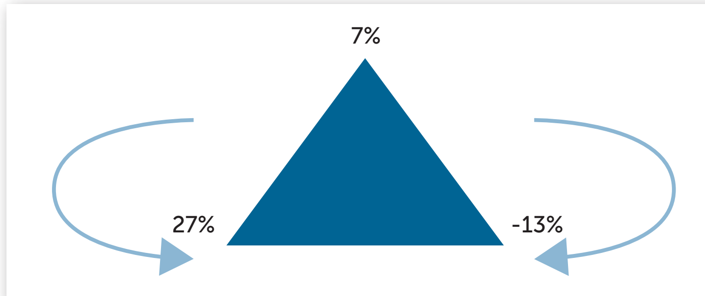
Accumulation period

Sequence of Returns

It is vital that investors are aware that the sequence of returns can have a dramatic effect on the longevity of an investor's portfolio when the emphasis switches from accumulation to spending. Most investors these days are exposed to markets, including those that are in the retirement risk zone. Most financial and retirement planning is done using average return assumptions. No investment based product package returns an assumed rate of return consistently. The sequence of returns may not matter during an accumulation period; the sequence of returns does not impact average returns. Average returns can be misleading particularly during income generation. Negative returns early in the withdrawal cycle magnify the challenge in returning to asset levels capable of generating sustainable income.

An investor in the Accumulation Phase has a longer time-period to recoup losses and earn income to invest additional monies. Someone in the Retirement Risk Zone does not. Furthermore, an investor in the Retirement Risk Zone may be withdrawing income and thus depleting assets faster. A negative sequence of returns has a greater affect during the Retirement Risk Zone than in the Accumulation Phase.

Sequence of returns



The challenge is how advisors and investors can avoid or minimize the problems or pitfalls within the retirement risk zone. If investors avoid exposure to the sequence of returns issue by putting all monies in short term fixed-income products that do not fluctuate, the portfolio will show comparatively little growth over time. It will not likely keep-up with inflation and the cost of living. If the retirement portfolio is comprised of equities, it's very likely that early negative returns will decimate the portfolio and force the retired investor to reduce planned spending levels or put off retirement. We cannot predict the sequence of returns in the future. How can we deal with this dilemma?

"In sum, although conventional wisdom dictates that asset allocation explains the greater part of investment performance in the accumulation phase, we believe that product allocation will determine success in the retirement income phase."

Asset Allocation and the Transition to Income:
The Importance of Product Allocation in the Retirement Risk Zone
By: Moshe A. Milevsky1 and Thomas S. Salisbury - September 27, 2006

Setting and resetting the safety net

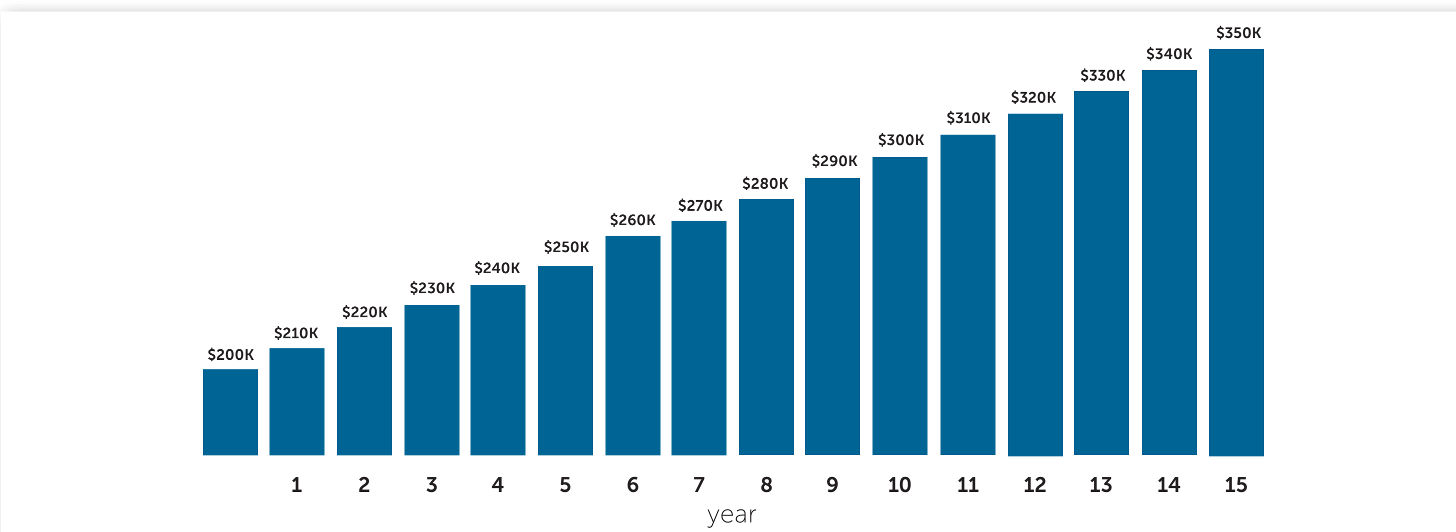
One of the concerns with retirement products is that once the income flow starts, they are not designed to keep up with the consumer price index (CPI) and especially the cost of living for retirees. Inflation can be very different (and higher) for a retiree compared to the general population. Another 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.

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 5% every year (including the year of the purchase), provided no withdrawals are made during that calendar year. The annual 5% Income Base Bonus is not a guaranteed rate of return, has no cash value, and is not available for withdrawal.

Issuing companies 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.

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.

Income Base Bonus increase a deposit by 75% in 15 years



Analysis of the reset feature by York University 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.

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 (Huang, Milevsky and Salisbury (2006)) 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. 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.

Calculating guaranteed retirement income

One question that arises is how the guaranteed retirement income for these plans calculated? The maximum amount available for withdrawals in a calendar year is sometimes referred to as the lifetime withdrawal amount. The lifetime withdrawal amount is equal to 5% of the Income Base, which includes all deposits and locked-in growth less withdrawals. It may increase if the Income Base increases, but it will not decrease (provided withdrawals don't exceed the allowable annual limit). The Lifetime Withdrawal Amount is available the year the investor turns 65.

Withdrawals from guaranteed minimum withdrawal benefit plans, except for fees, will reduce the Income Base and hence ongoing income. Excess Withdrawal Alert is an optional feature available on some plans that warns advisors and investors that a partial withdrawal request would result in a downward adjustment to the Income Base, temporarily stopping the excess withdrawal. The issuing company requests authorization to turn the excess withdrawal alert feature off and to proceed with the withdrawal.

There may be no fees or charges associated with Excess Withdrawal Alert. This can be an important benefit during the payout period when the impact of investor behaviour can be long forgotten.

If a retiree, receiving the lifetime withdrawal amount wants less money, the excess isn't normally carried over to the following year. The market value and Income Base will only decrease by the amount received.

Additionally if an investor withdraws the RRIF, LIF, LRIF or PRIF minimum from the plan, and it is greater than the lifetime withdrawal amount, there is no penalty up to the to the legislated minimum for RRIF, LIF, LRIF and PRIF. This is another demonstration of the flexibility of such plans.

A Guaranteed Minimum Withdrawal Benefit Plan is a viable product solution which can be used as an RRSP or non-registered investment vehicle for the years leading to retirement. An investor can benefit from potential market growth while being insulated every year from market declines. If there is a market downturn, the investor may still receive the annual 5% Income Base Bonus provided no withdrawals are made during that calendar year. If a downturn occurs after age 65, (s)he still receives a guaranteed retirement income. Normally, a sharp decline in the retirement risk zone would cause anxiety and potentially upset retirement plans. But with a Guaranteed Minimum Withdrawal Benefit plan, even though the market value drops considerably, the Income Base rises. And it's the Income Base that determines retirement income.

Estate and Survivor Benefits

The estate or survivors benefit guarantee amount is paid directly to the beneficiary when a beneficiary is named. The guarantee is generally 100% of net deposits or higher amounts if part of the reset process. This normally bypasses the probate and estate settlement process. Long delays are avoided as well as costly probate and estate fees. Also, beneficiaries receive proceeds in complete privacy.

Furthermore, the contract can be set up so that the surviving spouse may continue to receive a guaranteed retirement income. In fact, anyone can be named as the successor annuitant in a non-registered contract. For a RRIF, the successor annuitant can only be the spouse. If the successor annuitant named on the contract is not yet 65 when he/she takes ownership of the contract, a reset of the Income Base, the Bonus Base and the Survivors Benefit Guarantee will be performed. The lifetime Withdrawal Amount will be set to equal $0 and determined on December 31st of the calendar year that the Successor Annuitant turns age 64. Investments can be changed to other eligible Segregated Funds.

Potential Creditor Protection

Guaranteed minimum withdrawal benefit policies are individual variable insurance contract and, under provincial insurance legislation, may be protected from creditors if the beneficiary is the spouse or common-law partner, parent, child or grandchild of the Annuitant (except in Québec where the beneficiary is the spouse, parent, child or grandchild of the Contract Owner) or if the beneficiary is irrevocable. Note that there are certain circumstances where protection from creditors will not exist. If the possible protection from creditors is an important consideration advisors and investors should consult with a legal advisor before deciding to purchase the contract.

Minimizing Investor Confusion

These types of plans are rife with examples of why investors don't understand or remember what the various features of a product solution are and why these products come across as being even more complicated than they already are for advisors and customers alike. Acronyms, short forms and the use of initials all support the language of Alphabet and stand in stark contrast to the goal of plain language. After explaining how these plans work and where they fit, investors need to receive an Information folder and sign a form attesting to that receipt. While the information folder explains many of the important details of how these products work, they are not insurance contracts.

What a guaranteed minimum withdrawal benefit plan tries to achieve is to create an income stream that is protected from poor market performance early-on in retirement. A guaranteed minimum withdrawal benefit can be viewed as an umbrella that is placed on top of a portfolio of securities or funds. It guarantees that investors will get at least their money back and perhaps much more, as long as they do not withdraw more than a specified amount from this underlying portfolio in any given year.

In the last few years we have seen many different variations of this product. Some promise to increase payments over time, if the market performs well enough. Others add a bonus or extra return to the underlying investments if investors do not withdraw any funds from their portfolios for a period of time.

A guaranteed minimum withdrawal benefit plan has many protective features that work jointly to help secure a customer's retirement nest egg from the risks of inflation, volatile markets and outliving savings. The Income Base Bonus and automatic triennial resets may protect against a rising cost of living. The Lifetime Withdrawal Amount may reduce the risk of someone outliving their savings. Guaranteed Minimum Withdrawal Benefit plans are not mutually exclusive of other products such as systematic withdrawal plans or combination solutions like insured annuities or annuities coupled with growth investments. Once you recognize that retirement is a series of phases with fixed and variable income needs, you can better package an overall solution that uses a number of products, each with specific purposes.

In summary, the value proposition of this product is that it provides downside protection for any given investment portfolio within the retirement risk zone with a number of guarantees. It's well suited for those who don't want the responsibility of manufacturing the same packages themselves and so leave it to an insurance company.

"As Canadian baby boomers approach the retirement risk zone they must realize that asset allocation alone is not enough to generate a sustainable income stream for their retirement of unknown length. We believe that product allocation – namely buying instruments that can protect a portfolio against negative adverse returns early in retirement -- will become as important as asset allocation within the financial services industry over the next few years. Innovators will be rewarded."

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