

GMWBS BOOST RETIREMENT INCOME PLANNING

Michael Callahan / July 12, 2011



Even after reaching retirement, investors need to continue managing their finances prudently to ensure a healthy retirement stream.

Canadians are faced with new realities that pose significant challenges to traditional retirement planning approaches. Many Canadians are retiring earlier and living longer than ever. Currently, the average retirement age in Canada is age 62. With many living into their 90s, bridging that gap can be extremely challenging.

In addition, the tremendous liability associated with defined-benefit (DB) pension plans has taken a toll on many corporations. As a result, many employers have abandoned pension plans, leaving millions of Canadians to fend for themselves. In fact, of the total Canadian workforce of 17.6 million people, only 37% have a pension, leaving about 11 million with no pension plan whatsoever.

But those numbers may be misleading. Rock-bottom interest rates and recent market volatility caused by the global financial crisis have threatened the health of many pension plans. In 2008, the average Canadian pension solvency ratio — the measure of a pension's ability to meet its obligations — dropped to an astonishing 69%.

Clearly, we can no longer rely on governments, unions and employers to provide for us when our working days are done. The new reality is clear: Each Canadian must take charge of his or her own retirement.

Sources of retirement income

When planning for retirement, there are three main sources of income to consider.

Government pension plans: The Canada Pension Plan (CPP) and Old Age Security (OAS) are the two primary government pension plans in Canada. While OAS is non-contributory, based instead on years of residency in Canada, CPP is based on individual contributions. As of September 2010, the average monthly retirement benefits payable at age 65 are \$504 for CPP, and \$490 for OAS. Stated another way, the total average pension income from

government sources is a paltry \$11,928. These plans are not intended to be the cornerstone of retirement income, but rather as a supplement.

Employer-sponsored pension plans: For those fortunate enough to have an employer-sponsored pension, this is often the foundation of their retirement income. However, as more and more employers move away from traditional DB plans and toward defined-contribution (DC) pension plans, the responsibility of constructing a retirement income stream is passed from employer to employee. As of 2009, the average Canadian employer pension is roughly \$25,000 per year — a shadow of their former income.

Personal savings and investments: For many Canadians, the majority of retirement income must come from personal savings and investments. RRSPs and RRIFs are by far the most common retirement savings plans in Canada. However, as of 2009, only about four million Canadians have RRSPs. Evidently, many Canadians are unprepared and therefore have insufficient resources for retirement.

Retirement income risks

Converting one's life savings into a retirement income stream is a very delicate process. There is a unique set of risks that can potentially derail an otherwise healthy retirement income stream.

Longevity risk: Advances in medicine and healthcare mean we're living longer than ever before. That's the good news. The bad news is that, for many, living much longer than expected means outliving retirement savings.

Sequence-of-returns risk: We often use average rates of return in our investment calculations and portfolio projections. For example, we may assume an investor achieves an average 6% annual return over a given number of years, even though we know the actual investment performance experienced each year may be significantly different. This logic is fatally flawed for portfolios in the withdrawal phase, as poor returns in early years can be disastrous.

Inflation risk: While it doesn't appear too threatening in the short term, inflation poses a serious threat over longer periods of time. As the cost of living gradually increases over time, an investor's purchasing power is eroded by inflation. Retirement income portfolios must therefore be structured to provide an income stream that keeps pace with the rising cost of living.

Guaranteed minimum withdrawal benefit plans

Designed to address this set of risks, guaranteed minimum withdrawal benefit (GMWB) plans have become extremely popular in recent years. GMWBs are a kind of hybrid, offering features and benefits of both insurance and investment products. Essentially, a GMWB offers a payout feature similar to that of a traditional annuity, coupled with the potential for growth from an underlying basket of investments. It also offers death and maturity guarantees similar to segregated funds.

A relatively new product in Canada, GMWBs are currently offered by several Canadian insurers including Sun Life, Manulife, Desjardins and Industrial Alliance. It's important to note advisors must be insurance-licensed to implement GMWBs.

Although the primary function of GMWBs is to provide a reliable income stream, they are also valuable tools for wealth accumulation. Let's take a closer look at how GMWB plans can be used for both retirement income and retirement savings.

GMWBs for income

GMWB products offer a guaranteed income stream, either for a given number of years or for life, depending on the age of the investor and the product chosen. When the income is guaranteed for life, the product is sometimes referred to as a GLWB — Guaranteed Lifetime Withdrawal Benefit. The guaranteed payout is calculated as a function of the guaranteed withdrawal base (GWB), which is based on the original invested capital and subsequent market performance of the underlying basket of funds.

If favourable market performance causes an increase in the underlying investment value, most GMWB plans allow for a reset feature, and the subsequent payout stream is also increased accordingly. However, if market performance is less than desirable, the guarantee provides the investor with a minimum payout regardless of the investment value.

Let's look at an example where a client invests \$400,000 in a GMWB plan with a 5% payout, guaranteed for life. In this example, the client experiences poor investment performance, but the guarantee provides for a reliable income stream nonetheless.

We can see the investor's actual fund value has declined to just \$103,217 by age 73. Due to poor market performance, there is no opportunity to use the reset feature to lock in investment gains and generate additional income. However, the GWB remains constant at \$400,000, and therefore the investor's income stream remains a guaranteed \$20,000 per year. Without the GMWB guarantee, the investor would be approaching financial ruin in this situation.

Note, however, that should the investor wish to collapse this plan and take the proceeds, the amount available is the actual fund value, on which there is no guarantee. Otherwise, the investor can continue to enjoy a minimum payment of at least \$20,000 per year, guaranteed for life.

GMWB for accumulation

Although the primary function of a GMWB plan is to provide a reliable income stream, most GMWBs also have an "accumulation bonus" feature. If the investor does not withdraw the guaranteed income in any given year, the bonus amount (typically 5%, but it may vary according to provider) is applied to the guaranteed withdrawal base (GWB), thereby increasing the GWB and future guaranteed income stream.

The accumulation bonus feature makes GMWB plans attractive for those still in the accumulation phase. By electing not to receive the guaranteed income in each year of accumulation, the investor essentially guarantees a higher payout in future years. But keep in mind that the bonus is applied only to GWB, and not to the actual fund value.

Consider a situation where a client invests \$400,000 in a GMWB plan with a 5% payout and a corresponding 5% accumulation bonus. This time, however, the client is younger and does not actually take any withdrawals from the plan. The client will again be assumed to experience poor investment returns during the early years of the plan.

By not taking the guaranteed income each year, the investor increases the guaranteed payout stream for future years. For example, when the investor reaches age 58 the actual fund value has declined to \$221,171. But the guaranteed annual payment has increased from \$20,000 to \$28,000 due to the accumulation bonuses.

Again, should the investor choose to collapse the plan, the amount available is the fund value, and not the GWB. That is, the guarantee applies to the stream of payments, and not to the original invested capital.

Bottom line

GMWB plans can prove useful for clients who are saving for retirement as well as the already retired. In particular, for those who do not have an employer pension and must rely on their own savings as the primary source of retirement income, GMWBs can be a useful tool to provide a secure and predictable stream of income.

Unlike many traditional products used to generate income, such as GICs and term deposits, GMWBs offer the potential growth of equities, coupled with the guaranteed income of an annuity. This is particularly attractive to many investors, as evidenced by the tremendous popularity of many GMWB products to date. However, as with most other aspects of investing, GMWBs are not a blanket solution for everyone. It's important that advisors work with clients throughout the retirement planning process to ensure products and portfolios are suited to each investor's personal goals and time horizon.

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