Variable Annuities – Part 5 of 5

Variable annuities with Guaranteed Minimum Withdrawal Benefits (GMWB) are making inroads to Canadian retirement planning. Here is a synopsis of facts about them based on market history.

By Jim Otar, CFP, CMT, M. Eng.

In previous articles, we looked at how a Variable Annuity with Guaranteed Minimum Withdrawal Benefits (VAG for short) can help retirees when market conditions are adverse. This time I will discuss the benefits of the bonus in VAG that is available until withdrawals start.

One of the features of VAG is when you open an account and don't need the withdrawals immediately then a bonus is added to the guaranteed withdrawal balance each year. The bonus is usually 5%. If there is a step-up reset that is larger than 5% then no bonus is added. So, the insurance company guarantees, a minimum increase of 5% as long as you are not withdrawing funds. Many gets confused about the bonus, they think they can cash it out at will. You can't do that. The bonus is added to the guaranteed withdrawal balance and **not** to the contract balance. In other words, the bonus cannot be cashed out, but it increases the guaranteed annual income for the remainder of the guarantee term. For example, if a 55-year old client buys a $100,000 VAG and he is planning to start withdrawing at age 65, annual bonuses will increase his guaranteed withdrawal balance to $150,000 by age 65, even if the investments stay flat or go down. If the market does well, then the step-up resets may push the guaranteed withdrawal balance higher than $150,000. The bonus feature usually comes with a 10-year time limit; i.e. will not collect more than 10 installments.

Most contracts base the bonus on 5% of the most recent guaranteed withdrawal balance. So, if there is a step-up reset, the bonus will be 5% of the new, higher guaranteed withdrawal balance.

The bonus feature allows one to be more aggressive. An aggressive portfolio will provide two benefits: If markets do well, you'll end up with more step-up resets. If markets don't do well, you still have the 5% bonus on the guaranteed withdrawal balance and at the same time pay lower MER's and other fees, which are based on the market value of the portfolio and not the guaranteed withdrawal balance.

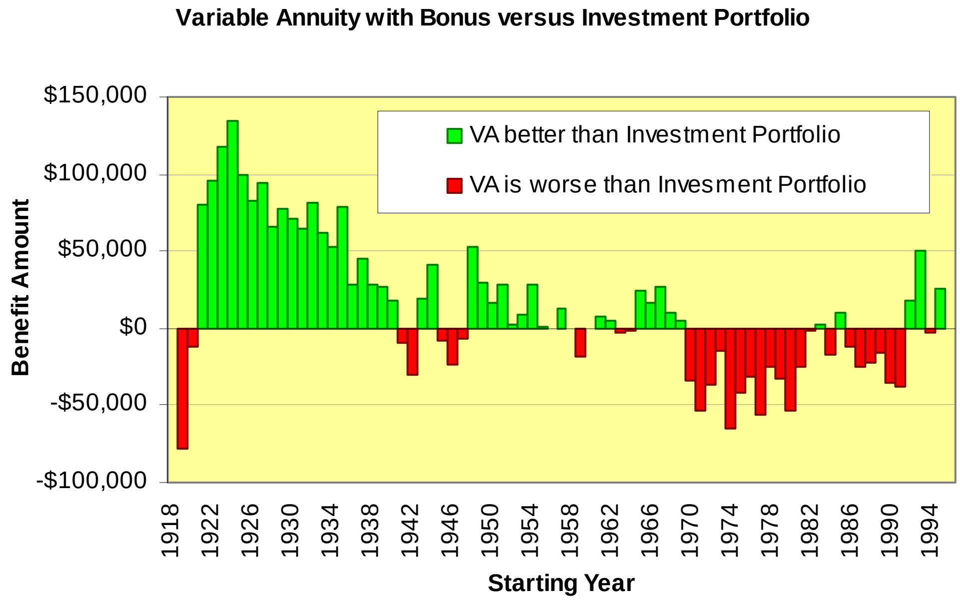
Here is the important question: You have 10 years before retirement and have two choices: (A) Invest in a portfolio of mutual funds, or (B) Buy a VAG contract and benefit from the bonus. Which would give you more money at the end of 10 years? Let's try to answer using an example:

(A) Steve is 55. His investment portfolio is worth $100,000 and it consists of mutual funds. His asset mix is 60% Canadian equities and 40% fixed income. He wants to keep this portfolio until age 65 for his retirement. He does not add to or withdraw any money from this portfolio.

(B) Jane is 55. She has $100,000. Unlike Steve, she buys a VAG contract invested in segregated funds. Her asset mix is 80% Canadian equities and 20% fixed income. She also wants to keep this portfolio until age 65 for her retirement. She also does not add to or withdraw any money from this portfolio.

For each retirement year since 1919, I calculated the value of the investment portfolio and the value of the guaranteed withdrawal base of the VAG after 10 years. The table indicates results:

Starting Year	Steve's Portfolio	Jane's Portfolio	Benefit of VA-GMWB
1919	$253,357	$174,978	-$78,379
1920	$196,499	$184,386	-$12,113
1921	$164,993	$245,362	$80,369
1922	$129,941	$225,296	$95,355
1923	$103,344	$220,699	$117,355
1924	$128,754	$263,007	$134,253
1925	$122,145	$221,544	$99,399
1926	$120,539	$203,093	$82,554
1927	$124,554	$218,768	$94,214
1928	$83,928	$150,000	$66,072
1929	$73,043	$150,000	$76,957
1930	$79,223	$150,000	$70,777
1931	$85,555	$150,000	$64,445
1932	$103,746	$184,778	$81,032
1933	$121,608	$184,168	$62,560
1987	$179,101	$153,951	-$25,150
1988	$188,201	$166,260	-$21,941
1989	$174,923	$159,114	-$15,809
1990	$184,635	$150,000	-$34,635
1991	$212,186	$173,993	-$38,193
1992	$184,370	$202,825	$18,455
1993	$172,034	$222,365	$50,331
1994	$166,695	$163,704	-$2,991
1995	$181,285	$207,554	$26,269
1996	$190,081	$198,921	$8,840



Jane would have done significantly better than Steve for the retirement years until the mid-1960's. After that, Steve would have done better.

What if the annual step-up resets were available in Canada? Annual step-up resets would have taken advantage of cyclical highs and would add a great deal of value to Jane's portfolio. Since 1919, the guaranteed withdrawal balance would be improved in 56% of the time. The maximum improvement was 42% and the average was 11%. With annual step-up resets, Jane would have done better.

In the final analysis, going forward, I believe the bonus is a valuable feature of VAG if annual step-up resets are available. Otherwise I would stick with a regular investment portfolio until retirement.

One word on asset allocation: The purpose of buying a VAG is to secure the highest guaranteed income possible throughout the guaranteed term. The highest income happens when you have multiple step-up resets of the guaranteed withdrawal balance. That means, at the start, you need to hold the highest allowable percentage of equities in the portfolio, 80% or more. However, once the hope of step-up resets diminishes, then your purpose should be to preserve the remaining assets. Therefore, as soon as the contract (market) value goes below 80% of the guaranteed withdrawal balance on the quarterly statement, move to a more conservative asset mix, perhaps 40% equities and 60% fixed income.

This is my last piece on this series of articles. I enjoyed researching and sharing with you these uncharted waters on variable annuities in Canada. I found great satisfaction that I was able to answer some of my questions. I hope I was able to help your practice and your clients in the process.

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