Should clients purchase an income annuity now or wait in a GIC, bond or balanced funds?

As a financial security advisor, how many times have you heard the statement, “Let’s wait for interest rates to go up”? In this period of low interest rates, clients often wait to make major financial decisions as they speculate when interest rates will go up, and by how much. Clients may wait it out in a GIC, bond, or balanced fund hoping that you, the advisor, will use a crystal ball to help them decide when it will be the best time to choose an income annuity. In this article we are going to look at whether it’s better to buy the income annuity now or later.

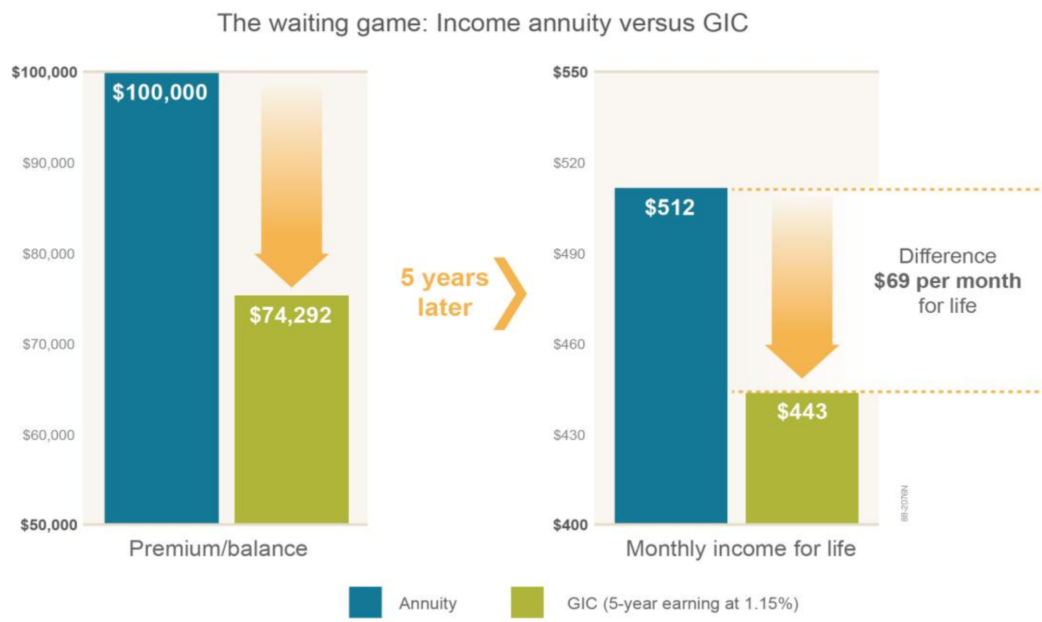
It is difficult to predict when interest rates will go back up. How long is your client willing to wait? This article will look at purchasing an income annuity now versus waiting in a GIC, Government Bond, or balanced fund for five years and then buying an annuity. In the following examples, we’re assuming all the clients are willing to wait for five years to purchase an income annuity.

Income annuity vs. GIC

Let’s explore two scenarios: one in which the client invests in a five-year GIC while waiting for the interest rate on income annuities to rise, and one in which they invest in an income annuity right away.

In this example, our client is a 65-year-old male who has $100,000 to invest.

Retirement planning



Rates as of Aug. 11, 2015. Annuity rates are for London Life, Great-West Life and Canada Life.
Guarantee period reduced by five years and age increased by five years in second scenario.
This example is for illustrative purposes only. Situations will vary according to specific circumstances.

Scenario A: The client invests $100,000 in a non-registered life income annuity guaranteed for 10 years (see left chart). The client will receive an income of $512 a month for the rest of his life (see right chart).

Scenario B: The client invests everything in a GIC for five years earning 1.15 per cent. From this, he draws the same income as he would have with an income annuity: $512 per month. After five years, the GIC would have a market value of $74,292 (see left chart). The client now purchases an income annuity with a five-year guarantee using the remaining $74,292. He would now receive a monthly income of $443 (see right chart). Note: We assumed that interest rates stayed the same over this time frame.

The income annuity advantage

By choosing to invest in an income annuity right now, this client will see payments of an additional **$69 per month for life** versus playing the waiting game for five years, if rates don't go up.

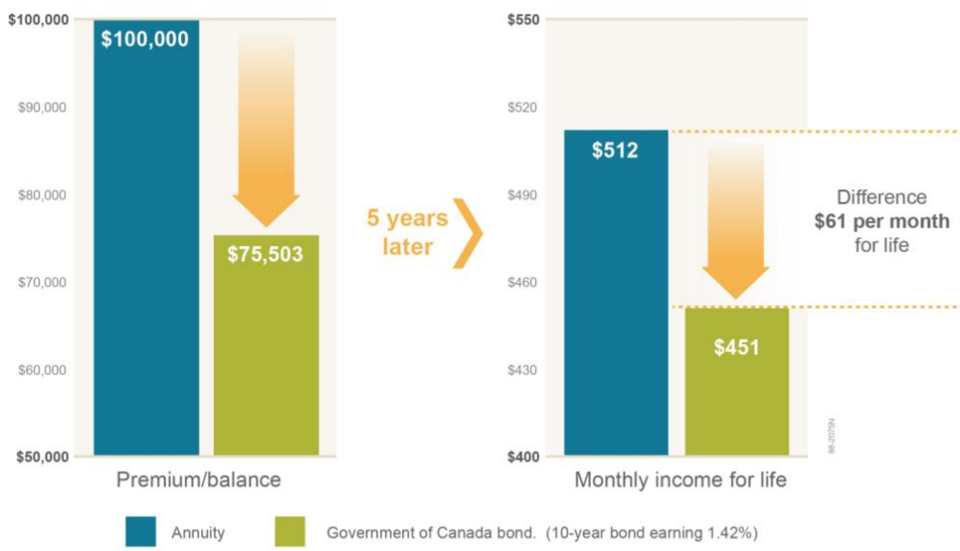
This is just one example. In our scenarios, we also wanted to calculate if males, females and joint-life income policies will experience the same results. Looking at 65 and 70-year olds, the results were the same. Clients would be better off buying the income annuity now versus waiting the five years if interest rates didn't go up. 65 and 70-year-old clients who bought the annuity now could expect to see additional monthly income of anywhere from $46 to $119 per month for life as long as interest rates didn't change.

Retirement planning

Income annuity vs. bond

Now let's take a look at another alternative: What would happen if the client invested in a long-term Government of Canada 10-year bond earning 1.42 per cent instead of the GIC? And how would this compare to investing immediately in an income annuity?

The waiting game: Income annuity versus Government of Canada bond



Rates as of Aug. 11, 2015. Annuity rates are for London Life, Great-West Life and Canada Life.
Guarantee period reduced by five years and age increased by five years in second scenario.
This example is for illustrative purposes only. Situations will vary according to specific circumstances.

In this example, our client is once again a 65-year-old male who has $100,000 to invest.

Scenario A: The client invests the full amount in a non-registered income annuity guaranteed for 10 years (see left chart). The client would draw an income of $512 a month for the rest of his life (see right chart).

Scenario B: The client purchases a 10-year Government of Canada bond from which he draws a monthly income of $512. At the end of five years, the bond would have a market value of $75,503 (see left chart). The client, who is now 70, purchases an income annuity with a five-year guarantee using the remaining $75,503 and would receive a monthly income of $451 (see right chart).

The income annuity advantage

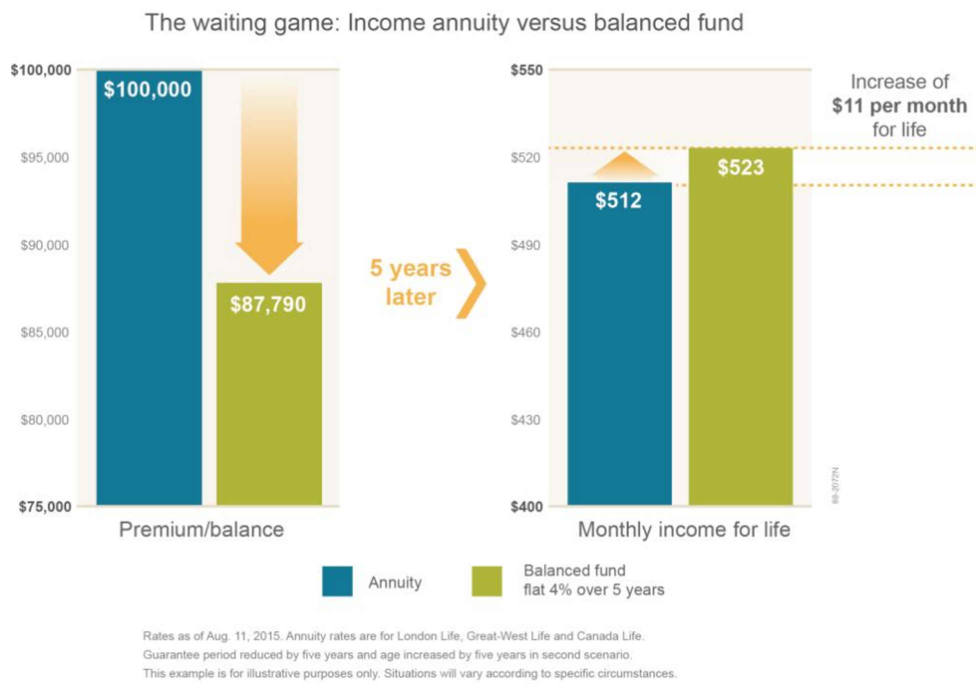
Again, by choosing to invest in an income annuity right now, this client will see payments of an **additional $61 per month for life** versus waiting five years, if rates don't go up.

Again, this is just one example. In our scenarios, we also wanted to calculate if males, females and joint-life income policies will experience the same results. Looking at 65 and 70-year olds, the results were the same. Clients would be better off buying the income annuity now versus waiting the five years if interest rates didn't go up. 65 and 70-year-old clients who bought the annuity now could expect to see additional monthly income of anywhere from $40 to $111 per month for life as long as interest rates didn't change.

Income annuity vs. balanced fund with flat four per cent returns

Let's look at a scenario where a client invests in a balanced fund instead of an income annuity. In this scenario we are going to assume that, over the five-year period, the client earns a consistent four per cent – which may be very challenging to achieve. Four per cent is also a typical drawdown rate many advisors use when illustrating an income plan.

In this example, our client is once again a 65-year-old male who has $100,000 to invest.



Scenario A: The client invests in a non-registered income annuity guaranteed for 10 years (see left chart). The client will then draw an income of $512 a month for the rest of his life (see right chart).

Balanced fund: The client earns four per cent over the five years and at the end of the five years the market value is $87,790 (see left chart). Taking the market value and then purchasing an income annuity that is guaranteed for five years, the client (who is now 70) would receive a monthly income of $523 (see right chart).

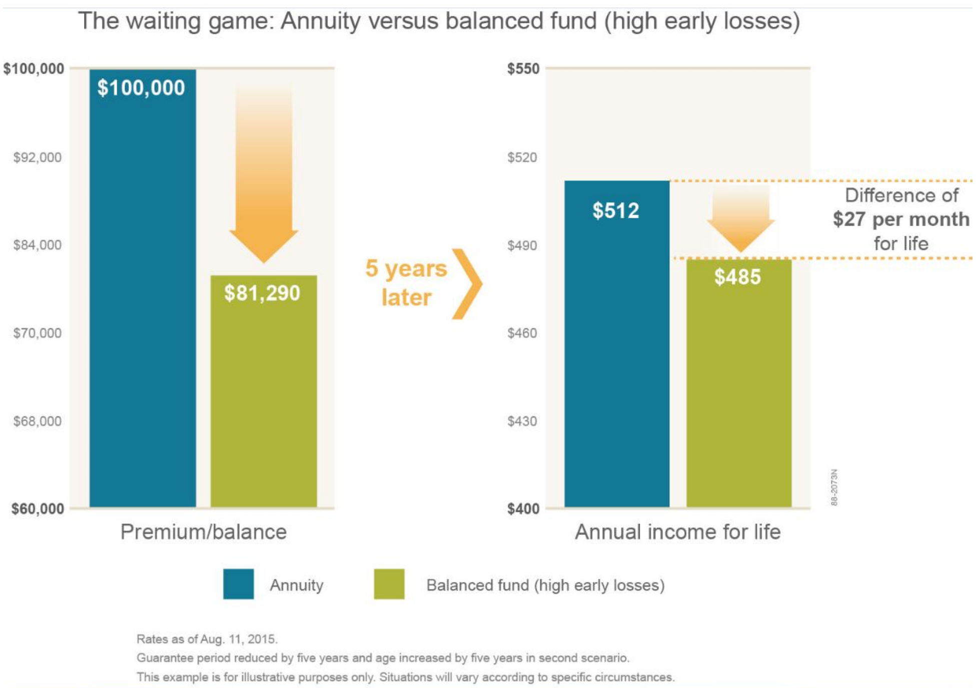
Does the immediate income annuity purchase still have the advantage?

In this example the client would have done better by investing in the balanced fund and then, at age 70, purchasing the life income annuity for a monthly income of $523. They would have gained $11 more per month than if they had bought the income annuity immediately. This raises several issues: First, what is the likelihood of receiving a constant rate of return of four per cent over the five years of waiting? And second, is it worth exposing the client to market volatility over those five years for a difference of $11 per month for life?

The first three examples may not have surprised you. The next scenario may be more challenging to answer for clients and may happen.

Income annuity vs. balanced fund with early losses

Let’s look at a scenario where a client invests in a balanced fund that experiences early losses in the first few years.



In this example, our client is once again a 65-year-old male who has $100,000 to invest.

Scenario A: The client invests in a non-registered income annuity guaranteed for 10 years (see left chart). The client will then receive an income of $512 per month for the rest of his life (see right chart).

Balanced fund: During the first five years of the balanced fund, returns were minus 10 per cent in year one, minus 5 per cent in year two and then three years of positive returns at 11.7 per cent, to average out at 4 per cent over five years. The market value after five years is $81,290 (see left chart). At age 70, the client purchases an income annuity (guaranteed for five years), and receives a monthly income of $485 (see right Chart).

The income annuity advantage

By investing in an income annuity now instead of waiting, this client would see payments of an **extra $27 per month for life,** if rates don't go up.

Again, we wanted to look at the same example for males, females and joint life income annuities at age 65 and at age 70. The results were the same: The client would be better off buying the income annuity now versus waiting the five years, with clients earning anywhere from an additional $7 per month to $78 per month for life if rates don't go up.

What's the conversation?

Many clients have a hard time committing to an income annuity because it's viewed as giving up flexibility and they want to hedge their bets as to what potential appreciation they could have in the short term. In our examples, we demonstrated that the indecision over a five-year period can cause a detrimental impact on clients' retirement income. In only one of the previous examples was it advantageous to wait the five years.

During any five-year period clients may be exposed to market volatility or fluctuations in interest rates that could affect the market value of a balanced fund or bond. You will also have many conversations about when will be the "right" time to buy. Will the "right" time to buy be when interest rates go up one per cent, two per cent or more?

In addition, the new option of short-term rate protection can be added at the time of purchase to help alleviate some of the anxiety clients may feel about interest rates going up in the short term. During the first year of the income annuity contract, at the six-month or 12-month anniversary, income payments may go up if the increase in the Government of Canada 10-year bond rate is higher than one per cent.

By providing clients with information about the "cost of waiting," you can help them understand that they don't have to wait to put a portion of their assets into an income annuity and secure a lifetime of predictable income.

The next article in our series will demonstrate how an income annuity can help protect an estate.

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