PERSONAL FINANCE OPINION

Why Canadian retirees need to give stuffy old annuities a second look. The returns might surprise you

While annuities aren't suited to everyone, writes David Aston, there is no more effective way to use retirement savings to generate steady cash flow that is guaranteed for life.

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Annuities make the most sense for retirees without a defined benefit employer pension who want reliable retirement cash flow, writes David Aston.
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Annuities have long been beloved by retirement experts while being spurned by most retirees.

But with recent dramatic increases in annuity payout rates, many retirees would do well to take a fresh look.

While annuities have their pros and cons and aren't suited to everyone, there is no more effective way to use your retirement savings to generate lots of steady cash flow that is guaranteed for life.

In recent months, due to sharp increases in interest rates, there's a lot more of that guaranteed cash flow than there has been for years.

Annuity payout rates in September were 25 to 35 per cent higher compared to three years ago, said Gary Baker, chief operating officer of CANNEX Financial Exchanges Limited, in a recent email. Those recent payouts are generally the highest since 2010, adds Baker, whose firm is a well-known source of annuity quotes obtained from different insurers.

As a result, you can buy an annuity in your early 70s that pays out well over six per cent a year, or you can wait until your mid-70s or later and get well above seven per cent. See the accompanying table for examples of current annuity payouts.

Monthly Income from a $100,000 Annuity

(Also expressed as annualized percentage payout rate)[1,2]

Age when purchased	Joint annuity - couple (increased by 2% a year)[3]	Single annuity - female (increased by 2% a year)	Single annuity - male (increased by 2% a year)
65	$462 (5.5%)	$482 (5.8%)	$516 (6.2%)
70	$522 (6.3%)	$547 (6.6%)	$588 (7.1%)
75	$618 (7.4%)	$660 (7.9%)	$730 (8.8%)

Notes
1. Monthly income quoted is the highest amount from the insurance companies surveyed. The initial income amount is increased by two per cent a year. (Initial payouts would be higher for annuities with payouts that don't increase.)
2. The minimum payout period is assumed to be guaranteed for 10 years in the case of annuities purchased at 65 and 70, and five years in the case of annuities purchased at 75.
3. The joint annuity payout for couples is reduced by 20 per cent after the death of the first spouse.
Source for annuity quotes is CANNEX Financial Exchanges Ltd. based on its survey of major insurers on Oct. 5.

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Three forms of return

Baker notes that annuities have the uncommon feature of providing "three forms of return." Payouts are made up of a blended combination of interest, return of your principal, and "mortality credits" (which means that retirees who live an exceptionally long life can receive more money for longer because those who die relatively young receive payouts for a much shorter period).

Annuities tend to make the most sense for middle class retirees without a defined benefit employer pension who place particular importance on generating more retirement cash flow of the most reliable kind.

Think of it as your chance to use some of your retirement savings to buy the equivalent of a traditional employer defined-benefit pension, a concept popularized by Moshe Milevsky and Alexandra Macqueen in their book, "Pensionize Your Nest Egg."

But buying annuities makes less sense if: you're in poor health (a larger annuity payoff comes from long life), or if you might have need to tap those savings for a big lump sum withdrawal (once an annuity is purchased, the money is committed).

They also tend to make less sense if you place high priority on leaving money to your children. (Annuity payouts end at death in order to maximize cash flow while you're alive, although they often come with five or 10 years of guaranteed minimum payouts.).

Annuity payouts vary with gender as well as age. Men receive bigger payouts than women of equal age because they have lower average life expectancy.

Topping up CPP and OAS

Annuities can top up other sources of guaranteed income such as payouts from the Canada Pension Plan and Old Age Security.

"Start with 'how much guaranteed income do you need to supplement other sources of income that you have'," says Milevsky, professor of finance at the Schulich School of Business at York University.

It's useful to get a comprehensive financial plan to identify how much retirement cash flow you can expect and to show how best to generate it from different sources. Most people who buy annuities only use part of their nest egg for that purpose.

The strengths and weaknesses of a conventional stock and bond portfolio tend to complement those of annuities. Annuities generate lots of guaranteed cash flow for life, but a conventional stock and bond portfolio provides liquidity for lump-sum withdrawals, upside if stock markets do well, and the potential for a sizable bequest to your heirs.

Annuities are also vulnerable to inflation, since "real" inflation-adjusted annuities aren't available in Canada at reasonable prices. Milevsky advises getting inflation protection from other investments. These might include inflation-protected bonds, short-term bonds, real assets like real estate, and some types of stocks. (Annuity payouts quoted in the table are assumed to increase by two per cent a year, but that's a set increase rather than true inflation-indexing.)

Practical appeal

In practice, annuities tend to have particular appeal in specific situations, says Rona Birenbaum, a certified financial planner and president of Caring for Clients, a financial planning and wealth management firm.

Birenbaum says one example is retirees with a very conservative mindset "who are afraid of outliving their money and want to create guardrails against the risk of that."

Another scenario is to protect "vulnerable" investors, says Birenbaum. That might occur where a retiree has trouble saying no to financial requests from their children at the expense of the retiree's own financial security, she says.

Annuities can also simplify retirement finances. Birenbaum had one client who purchased annuities in case he was outlived by his spouse, who didn't have experience at handling the couple's investments.

Do it slowly

Milevsky advises to invest in annuities gradually and tactically. Since purchasing an annuity is irreversible, "the potential for regret is too high" if you do a very large amount all at once. While you should be mindful of how high annuity payout rates are in relation to historical norms, you'll never identify the precise best time to buy except by luck.

"You're going to have to (annuitize) slowly," says Milevsky. "As interest rates pick up, get more of it. As the cycle of interest rates reach its peak, make sure you get the bulk of your buying done." (The example of the $100,000 annuity in the table could, in practice, be built up in smaller purchases over a number of years.)

Buying annuities at a later age gets you higher payout rates, although the payouts last for a shorter remaining lifespan. In my view, the "sweet spot" for most people is probably to buy annuities gradually over a few years starting in your early 70s, although there are exceptions where starting in your late 60s can make sense. Seniors are required to convert their RRSPs to a RRIF or an annuity by the end of the year they turn 71, so that's an opportune occasion to get some annuity purchasing done.

If you're keen on guaranteed income before the age of 70, I would generally suggest considering CPP and OAS deferral to age 70 first, then consider purchasing an annuity only if you want more sources of guaranteed income after you have done that. Although

CPP and OAS deferral generates no immediate cash flow, attractive deferral rates allow you to build up a superior form of inflation-protected guaranteed income for the rest of your life once you do start the payouts.

Depending on specific circumstances, it can make sense to purchase annuities with either RRSP/RRIF funds or nonregistered funds (in which case a "prescribed annuity" provides some tax advantages).

Advisers need to be licensed for insurance products in order to sell you an annuity. But even if your adviser isn't licensed to do so themselves, many investment firms can bring in insurance-licensed specialists for that purpose.

Annuity quotes from different insurance companies vary significantly, so it helps if you find an insurance-licensed adviser with access to multiple insurers to get you the best payout.

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