

Clientel



*The central message of Clientel is that I value my clients.
I'm as close as your telephone, and available
and delighted to serve you.*

David Chalmers BA, FLMI, CLU, CFP, RFP, ChFC

Welcome to another edition of *Clientel*.

In this issue, I shall discuss:

- Should you convert a portion of your RRIF to an annuity?
- Congratulations to respondents to the trivia questions in my last newsletter.
- A look to the future: “fee-based financial planning.”

Should You Convert a Portion of your RRIF to an Annuity?

In my July 2003 edition of *Clientel*, I outlined how RRIFs (registered retirement income funds) are structured and the rules for “minimum income withdrawals.”

As about 75% of my clients have (or are about to have) RRIFs, the “RRIF rules” should be of considerable interest. If you'd like another copy of my July 2003 newsletter, please call Jeanette Mackie at (604) 732-6551, or visit our website at www.rogersgroup.com, click on “Financial Advisors,” then click on “David Chalmers,” and then choose “Click here to view David Chalmers' *Clientel* Newsletters.”

As a very quick (and abbreviated) review of the points made in my July 2003 newsletter, please consider the following:

Assume that my clients are a couple (we'll call them Lucy and Ricky) both born in 1932. Thus, they both turned 71 in 2003. In the year 2004, they will each be required to draw 7.38% of their (January 1, 2004) RRIF balances as taxable income.

While many of my clients have more than \$100,000 in RRIFs, I'm going to use \$100,000 for the basis for my explanations (as the number \$100,000 “makes the math easy”). I'm going to focus on “Lucy” rather than “Ricky” for the following examples.

We have invested Lucy's RRIF very conservatively, as she doesn't want to lose any capital. We have arranged a series of “laddered GICs” that will deliver a long-term return equal to the “average 5-year interest rate.” Of course, we don't know what interest rates are going to be over the long term, but we are “anticipating” an average rate of 4.5%.

Thus, Lucy will start the year 2004 at age 71 with \$100,000 in her RRIF. She must draw income of 7.38% or \$7,380, and will end the year with \$97,120 in her RRIF. (This calcula-

tion assumes that she always draws RRIF income annually at the end of the year. If she drew her income monthly, she'd still have to take \$7,380 (\$615/month) of income and she'd have a slightly lower balance at year-end, because she had drawn her average dollar of income sooner.

As you can see, her RRIF balance has dropped from \$100,000 to \$97,120 in the year 2004. In the year 2005, she must draw an increased percentage from her RRIF, as the income factor rises from 7.38% to 7.48%. But she will be drawing a higher percentage of a smaller balance (7.48% of \$97,120 vs. 7.38% of \$100,000). This results in a year 2005 income of \$7,265 compared to \$7,380 in 2004.

In fact, both her income and her capital balance will decline every year. By her age 90, her RRIF balance will have shrunk to \$40,026 and her income in that year would be \$5,452. Thus, Lucy will have an ever-diminishing income from this RRIF and her capital balance will continue to erode (all of which can create uncertainty as one gets older).

At Lucy's death, the residual balance of her RRIF can pass on a tax-free basis to Ricky, if he survives her. If she does not have a surviving spouse, then the RRIF balance is subject to income tax before passing to her estate or to a "non-spouse" beneficiary.

If Lucy dies at age 90 (and Ricky has predeceased her), the net benefit to her estate (assuming an income tax rate of 45% in that year) will be \$22,014 (the RRIF balance of \$40,026 less 45% tax).

Thus, while the RRIF allows her flexibility and provides for an estate benefit, the actual estate benefit may only be about 20% of the original age 71 (\$100,000) RRIF balance.

Converting a RRIF to an Annuity

Now let's examine what would happen if Lucy converted her RRIF to a life annuity at age 71.

A life annuity pays an income for as long as she lives.

Lucy can exchange her RRIF capital for a life annuity (no tax is paid on this exchange transaction). She could choose an annuity of approximately \$9,200/yr paid for her lifetime.

This means that a life insurance company pays her a guaranteed income for life. (The income will continue even if she survives to age 90, or 95, or beyond age 100. The income will also stop and there will be no residual payment to her estate if she dies after only one or two income payments have been made.)

The advantage of the annuity is that she receives a guaranteed income higher than the age 71 RRIF income of \$7,380. The annuity income stays level for her lifetime (no matter how long) whereas the RRIF income diminishes every year.

The disadvantages of the life annuity are:

1. A lack of flexibility. A life annuity is a locked-in arrangement.
2. Nothing goes to her estate (or Ricky if he survives her).
3. The income paid by the annuity is based somewhat on interest rates in the economy at the time the annuity is issued, so she has "locked in" today's interest rate (literally for the rest of her life). This may be either good (if interest rates stay level or go down in the future) or bad (if interest rates rise in the future).

However, an annuity can also be arranged on a "joint and last survivor" basis (referred to as "JLS"). This means that there is an income paid by the insurance company as long as either Lucy or Ricky is alive. Since there is a chance that the insurance company will end up paying for a longer period of time under the JLS option, they will only pay an income of approx-

imately \$8,100 rather than the \$9,200 that would be paid under the “life only” option.

What if both Lucy and Ricky die a year or two after the annuity is issued? Again, there would be no residual payment to their estates. A basic principle of an annuity (or a pension plan or the Canada Pension Plan or Old Age Security) is that those people who die early subsidize those who live a long time.

However, Lucy can opt for a joint and survivor annuity with a “minimum guaranteed period.” Assume that she elects a minimum guaranteed period of 15 years (the minimum guaranteed period can be as long as she wants but cannot run beyond her age 90). The resultant “JLS 15” annuity would operate as follows. An income of approximately \$7,850/yr would be paid for as long as either Lucy or Ricky lives, no matter how long that would be. If, however, both of them have died before 15 years of payments have been made, the residue of the 15 years of payments continues to the estate or beneficiary of the last survivor. Thus, if they died after one annual payment (or 12 monthly payments) had been made, the residual 14 years of payments would be made to their heirs.

The insurance company usually offers to make a lump sum settlement to the estate rather than to continue paying for (in this case) 14 years. The lump sum settlement is the “mathematical value” of the remaining payments (also referred to as the “present value” or “commuted value”). This lump sum payment would be less than the sum of the remaining payments as it would be paid all at once.

So what would Lucy’s estate receive if she opted for the JLS 15 annuity and died after only one year of payments had been made? The “commuted value” to be paid out by the life insurance company would be approximately \$83,860. This is less than \$109,900 (14 x \$7,850), as the commuted value is paid in a lump sum rather than over a number of years.

By comparison, if Lucy had stayed in the RRIF, and had died after one year, the payment to her estate would have been \$97,120. This is \$13,260 more than the commuted value of the annuity.

I note that if she chose the annuity option she would have received an extra \$470 of income in that first year (an annuity income of \$7,850 vs. RRIF income of \$7,380). Thus, the difference between the estate position of the annuity and the RRIF is really only about \$12,800, or 12.8% of the original (\$100,000) RRIF balance. We can express this as a 12.8% “estate shrinkage.”

Remember that the residual payment to Lucy’s estate under either the RRIF or the annuity is subject to income tax. Thus, the differential in the amount that Lucy’s children or grandchildren will actually inherit under the RRIF vs. the annuity is about \$7,040 (the after-tax value of \$12,800).

Now let’s consider another scenario:

Lucy opts for the JLS 15 annuity. Ricky predeceases her. She dies at age 90. There is no residual payment under the annuity, as the 15-year minimum guaranteed period has expired. Thus, the estate benefit under the annuity is \$0.

Had she continued with the RRIF, the capital balance would be \$40,026 at her age 90. After tax (at 45%), this would give her heirs \$22,014 (vs. \$0 from the annuity).

However, the annuity has given her an income of \$7,850/yr for the past 19 years. The RRIF income started at \$7,380 and diminished every year (and was only \$5,452 at her age 90).

If we calculate the additional income that she has received, account for the tax on the additional income, and note that she could have put this money in the bank or in GICs (and paid tax on the interest earned), she would have accumulated more than \$22,014 and thus would

have been able to leave more to her heirs with the annuity option than with the RRIF option.

Thus, with a RRIF, her estate position starts off about \$12,800 (\$7,040 after tax) higher than if she had chosen an annuity, but it eventually ends up lower. The RRIF gives her an ever-diminishing income and the risk of running out of money. The annuity gives her a higher and guaranteed income with no risk of the income stopping during her lifetime, and (contrary to conventional wisdom) it ultimately gives her a better estate benefit.

At her age 90, the estate benefit from the extra income from the annuity payments adds up to \$23,244. This is \$1,230 more than the RRIF. However, the annuity payments continue at \$7,850 per year beyond age 90 while the RRIF payments drop dramatically every year. By her age 95, the annuity produces an estate benefit of over \$30,000 more than the RRIF.

Aside from the estate position being dramatically better off at this point for having chosen the annuity, Lucy's income from the annuity remains fixed at \$7,850/year. Had she chosen the RRIF option, her income would now be only \$4,223/year and would be rapidly declining every year.

What About the Risk of Locking in a Long-Term Interest Rate When Rates are So Low?

Having gone through this theoretical explanation of Lucy and Ricky trying to decide what to do with Lucy's \$100,000 RRIF, let me look at a more likely scenario.

Let's consider a client with \$1,000,000 in a RRIF. The client is likely to be either a couple (where the husband is older than the wife), or a widow or single woman. (Regrettably, the wife who has a husband older than she is has a very high expectancy of becoming a widow).

Of the \$1,000,000 in RRIFs that the client has, probably 60% or more (depending on the

client's individual circumstances) is invested in "laddered" guaranteed investment certificates or bonds. The remainder is in conservative investment funds. Let's assume that there is \$600,000 in the "GIC ladder."

We have structured this (GIC) portion of the RRIF capital to earn the average five-year interest rate. This \$600,000 will behave just like the \$100,000 in Lucy's example. The numbers will simply be six times as big. (The \$400,000 in investment funds will behave differently. We are expecting a better return on the investment funds than the GICs but are limiting the amount of money we put there in case we get a worse return.)

The client, therefore, has \$120,000 (one-fifth of \$600,000) in GICs maturing every year. What if the client were to put half of that amount maturing each year (\$60,000 out of the \$120,000) in an annuity and reinvest the residue in a five-year GIC (to keep the "ladder" going)?

The "estate shrinkage" for Lucy in the first year was 12.8% (in return for an ultimate higher estate benefit and a more secure income) when she converted all of her RRIF to an annuity. However, the client we are now considering is only converting 6% (\$60,000 out of \$1,000,000) of the RRIF to an annuity this year. Thus, the immediate "estate shrinkage" is 6% of 12.8% which is less than 1% (about 3/4 of 1%).

If the client converts the entire \$600,000 from GICs to 10 life annuities in increments over a 10-year period of time, he/she will achieve the average annuity purchase rate over that period of time (just as we achieve the average GIC interest rate through a "laddering" technique). Each "annuity conversion" creates a very small immediate "estate shrinkage," but this is eventually offset by the cumulative higher income from the annuities relative to a RRIF.

While the plan may be to convert the entire GIC portion of the RRIF to annuities over a

10-year period of time, the strategy can be amended at any time. Thus, the three disadvantages of the annuity (estate shrinkage, lack of flexibility, fixing an interest rate at a single point in time) have disappeared.

Is This a Good Strategy?

Who Should (or Should Not) Consider it?

You probably have surmised that I would not have gone into this much detail if I did not think that this was a good strategy for my clients to consider.

The younger one is at the time of purchasing an annuity, the less the increase of income that an annuity provides is relative to the corresponding RRIF income.

Thus, this strategy generally works for a couple once the younger spouse has attained age 70, or for a single (or widowed) person once he or she has attained age 70.

The older one is at the time of purchasing an annuity, the greater the increase of income from an annuity is relative to a RRIF. There is, however, a point of diminishing returns. One cannot have a “minimum guaranteed period” that runs beyond age 90. Thus, at age 85, an annuity provides for an extremely high income relative to a RRIF, but if one dies after one year of payments have been made, the residual (commuted) value paid to the estate is based on only the four payments remaining. (Thus, the short-term “estate shrinkage” is somewhat higher.)

Remember that one of the principles underlying an annuity is that the people who die early subsidize those who live for a long time. If you are in poor health, you may want to avoid a life annuity. If you are in average health for your age, the annuity option is quite viable.

Thus, if you:

- Have a RRIF
- Are between ages 70 and 85
- And consider yourself to be in average health or better,

you may want to consider this strategy of converting the fixed-income component of your RRIF to a series of life annuities over a period of time. (I note that one can start on this strategy and then stop purchasing the stream of annuities if one's health deteriorates part way through the strategy.)

Additional Information on “Structured Annuitization” (a term just invented by David)

In the “Lucy” example, I used a female aged 71 and a male aged 71 to calculate the annuity incomes. The actual annuity income will be different for every combination of ages. If you'd like to consider pursuing this strategy, I shall prepare a sample annuity quotation specifically for you in respect of the portion of your RRIF balance that we are considering for conversion to an annuity.

I have prepared a computer model that I can use for clients to illustrate the long-term income, capital and estate differences between an annuity and a RRIF for the portion of their RRIF balance in question. If you meet the criteria of ages 70 to 85 and are in average health, the results will tend to be just like Lucy's ... a higher and more secure income, an initial reduction in estate, and a higher eventual estate (unless you spend all of the money from the extra annuity income, which also has its advantages).

Clients who have a locked-in RRSP or a life income fund may be compelled to convert to a life annuity in any event (at age 80 under current rules). Thus, if one must “annuitize,” the strategy of “structured annuitization” makes lots of sense.

If you have a RRIF with money invested in a bond or GIC “ladder,” please note that government bonds are guaranteed by the government who issues them (e.g., the Government of Canada) and GICs are guaranteed under deposit insurance plans (up to \$60,000 for banks, trust companies and life insurance companies and up to \$100,000 for BC credit unions).

If we establish an annuity, the annuity income is guaranteed under the life insurance industry deposit insurance plan for up to \$2,000/month or \$24,000/year per person per life insurance company. Thus, we pay attention to deposit insurance limits for annuities just as we do for GICs.

I usually place an annuity for a client with the insurance company that quotes the highest income (unless placing an annuity with that company would put you in a position of having a total annuity income with that company of more than (the insured limit of) \$24,000/year.

If you want me to prepare a sample annuity quote for a portion of the money in your RRIF, and to do a “RRIF/Annuity Comparison,” there is, of course, no obligation. Please give me (or Nathan Narusis) a call if we can provide any further information on this subject.

Congratulations to the Trivia Question Winners from my Last Newsletter

I tried to “lighten the tone” of my last newsletter by the throwing in two “trivia questions.” I entitled the newsletter “RRIF RRAF” (as it dealt exclusively with RRIFs) and asked which movie (which has played in Vancouver more times than any other movie) featured a character named “RIFRAF.”

The answer is “The Rocky Horror Picture Show” (which played every Friday at midnight at the Ridge Theatre for many years). RIFRAF was the (archetypical horror movie) butler.

The second question (after referring to the Canada Customs and Revenue Agency as an organization that structured the rules so as to get their “pound of flesh”) was, which Shakespearean character sought a “pound of flesh”?

The answer is “Shylock” from the play “The Merchant of Venice.”

Congratulations to the various people who got the correct answer to one or the other of the two questions. Special congratulations to Mike Dawson, Gordon Caulder, Ali Pollard and Jim Satterthwaite, who got both answers. Mike Dawson even knew the name of the actor (Richard O’Brien) who played RIFRAF in the movie (wow!). (P.S. all client names are published with their permission).

Looking to the Future ... Fee-based Financial Planning

In my January 2003 edition of Clientel, I spoke to some of the concerns I have with respect to the current system of clients compensating their financial advisor (e.g. you compensating me) through the commissions that are embedded in financial products.

My biggest concern is the potential for a conflict of interest on the financial advisor’s (my) part.

In July 2002, I sent a letter to all clients that dealt with the stock market conditions of the time. (The stock market had been dropping precipitously in early and mid-2002. I sent a letter saying, “Stay the course.” The market

started recovering shortly thereafter.) If we have a similar market drop, I'll send a similar letter. I ended the letter by saying that I was considering a new model for the way I structure my practice.

I now plan to introduce a new "fee-based" model. I note that the new approach that I plan to introduce in the year 2004 will be optional. Thus, you won't need to consider a change if you "like things the way they are."

I hope to introduce the new model early in the New Year (I'll devote the next issue of Clientel to this introduction). I anticipate that some clients will want "no change" and that others will want to opt for the "new model" (the outcome for many clients who opt for the new model is that the overall expense charges of their portfolio will be slightly lower under the new model ... but expenses will be more transparent).

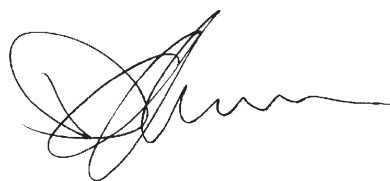
Look for (considerable) details in my next newsletter.

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Thank you for reading this issue of Clientel. Please don't hesitate to call me or a member of my support team if we can be of service or provide you with any further information.

As always, the central message of this newsletter is that I value my relationships with my clients and I am as close as the phone.

Sincerely,



ROGERS GROUP FINANCIAL

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David N. Chalmers is a Financial Advisor with Rogers Group Financial. The views expressed are those of the author and not necessarily those of Rogers Group Financial, which makes no representations as to their completeness or accuracy.

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