FINANCIAL PLANNING 101

Life after work

TURNING SAVINGS INTO RETIREMENT INCOME

It's there in black and white — and it's a little bit scary. When recent retirees look at their last paycheque, they may experience a moment of anxiety. Will they be able to sustain their lifestyle without income from work?

The good news is that some expenses disappear completely after retirement — such as the costs of commuting, work clothing and many breakfasts and lunches on the run. Also, retirees who have developed a financial plan for their savings and investments with the guidance of an advisor should be in a better position in retirement.

In the following story, we learn how expert financial advice helps a retired couple enjoy the lifestyle that is their reward for years of saving and following a financial plan. Meet Graham and Ashley, both age 65 and excited about starting a new phase of their lives.

CLIENT OVERVIEW

Clients: Graham, age 65, and Ashley, age 65, married

Financial goals: Organize their sources of retirement income, find a way to generate regular income for life and build in flexibility to access lump sums when needed, all with a focus on tax efficiency

Annual expected expenses: Property taxes $3,300; vehicle $5,000; utilities $5,000; home insurance $1,200; health insurance $5,000; food $8,000; clothing and personal $3,000; travel $5,000; entertainment $5,000; other $4,000

Total annual expected expenses: $44,500

Annual guaranteed income (combined): CPP $15,790; OAS $12,960; defined benefit pension plan $8,000

Savings: Graham's RRSP $225,000; Graham's and Ashley's TFSAs $30,000; non-registered savings account $250,000 (from downsizing)

The plan: Use Graham's RRSP to purchase an annuity that generates an additional $10,000 in annual guaranteed income for a total annual guaranteed income of $44,500 after taxes; invest $250,000 in non-registered savings and $20,000 in TFSAs in balanced mutual funds for growth potential, and $10,000 in TFSAs in a high-interest savings account for emergencies

For illustrative purposes only. This is a fictional scenario.

Graham worked full-time from age 22, but because he was self-employed as a management consultant he doesn't have an employer-sponsored pension plan. Ashley worked part-time in administration for the local school board for many years while she was raising their two children: Beatrice, age 35 with two children of her own, and Jonah, age 31 and engaged to be married. The couple can count on some income from Ashley's defined benefit pension plan.

Over breakfast one morning, Ashley asks the question that's been at the back of both their minds: "Do we have enough money for our current and future expenses, including the unexpected?" Graham sets his coffee down and says, "I wish I had the answer — but I know who can help us figure it out. Let's set up a meeting with Nancy next week."

When Graham and Ashley meet with Nancy, their advisor, they tell her they want to:

1. Organize their sources of retirement income
2. Find a way to generate regular income for life
3. Build in flexibility to access lump sums of cash when needed

They also emphasize that they want a tax-efficient plan for their retirement. After all, no one wants to pay more than their fair share of taxes.

Nancy nods and reassures them that she can help them accomplish all of their objectives. "One of the most important principles we'll follow is to make sure your retirement savings are diversified in a variety of products that offer different guarantees and features. This is one of the best ways to plan for sustainable retirement income, whatever your risks and preferences," she says.

She goes on to tell them that any retirement plan should consider a multi-product strategy that provides:

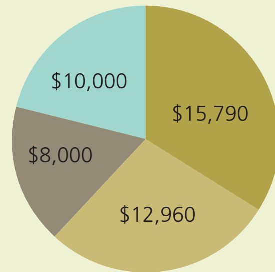
- Guaranteed income for life
- Protection from interest rate fluctuations
- Growth potential of the markets to help keep up with inflation
- Protection from market downturns
- Diversification
- Flexibility and access to cash
- Cost-effective and easy transfer of assets upon death

Do they have enough guaranteed income to meet their expenses?

"Let's start by looking at where your retirement income will come from," Nancy says. "First up — the guaranteed income. As a couple, you're entitled to $15,790 from the Canada Pension Plan (CPP) and $12,960 from Old Age Security (OAS) each year. In addition, Ashley's defined benefit pension plan will provide $8,000 annually. You'll have to pay taxes on this income, but it's money you can count on

Income sources for annual guaranteed income

To generate $46,750 pre-tax ($44,500 after tax)



- CPP
- OAS
- Defined benefit pension plan
- Annuity

For illustration purposes only.

receiving no matter what other decisions you make."

Nancy flips to another page in their file. "Graham, you've saved $225,000 in your Registered Retirement Savings Plan (RRSP) and $15,000 in your Tax-Free Savings Account (TFSA). Nancy, you've got $15,000 in your TFSA too. Also, you've sold your house and moved into a smaller home, freeing up a further $250,000. That money is currently in a non-registered account. All of those savings will help to fill any gaps between your income and your expenses."

She continues, "We ran the numbers on your expected retirement expenses last year. Including necessities, as well as some extras such as travel and entertainment, you anticipated spending $44,500 a year. Has anything changed that would bring that figure up or down?"

Ashley glances through the budget Nancy hands to her. "No, that still sounds right."

"Then your CPP, OAS and defined benefit pension plan will cover all but about $10,000 of your expected expenses. I have a very effective solution for that shortfall," Nancy says.

How can they get an extra $10,000 in guaranteed income?

Nancy explains that Graham's $225,000 in RRSP savings is sufficient to purchase an annuity that will provide $10,000 a year in guaranteed income. In other words, an insurer can turn his lump sum into guaranteed regular income payments. Annuity payments can continue for a chosen period of time or for the lifetime(s) of one or two people.

"The reason I think an annuity is the right choice for you is that it provides higher guaranteed income than many other guaranteed income products, and we can set it up as a Life Annuity so it pays money to you as long as either of you is alive," Nancy explains. "It doesn't matter what happens to interest rates or in the markets — that $10,000 a year will be there for you, giving you financial security and peace of mind."

Ashley tilts her head. "That sounds great, but what happens if we pass away within the next few years? That lump sum will be gone forever, won't it? And our children won't get any benefit from all those years of saving in the RRSP?" she asks.

"Actually, that's a common misunderstanding about annuities," Nancy replies. "Some annuities offer payment guarantees, which are options that can be added to the contract that ensure a minimum amount of income is paid from the investment to you or your beneficiaries should you die prematurely. One type of payment guarantee is the cash refund guarantee — also known as principal protection. Adding a principal protection option would pay your beneficiaries a lump-sum payment equal to the difference between your original investment and all of the payments you received before your death."

Graham nods. "We'd definitely like to add the principal protection option to the annuity. We want to make sure

Some annuities offer payment guarantees, which are options that can be added to the contract that ensure a minimum amount of income is paid from the investment to you or your beneficiaries should you die prematurely.

both Beatrice and Jonah are well taken care of if we were to die prematurely."

Nancy points out a few other things they need to know about annuities. Annuities don't offer a lot of flexibility," she says. "You can't access the principal if you need cash. However, in exchange for giving up that liquidity they provide the highest level of income per dollar invested. They're a terrific choice as a component of your retirement strategy — combined with other investment vehicles that provide liquidity."

Where should they invest for growth potential and access to cash?

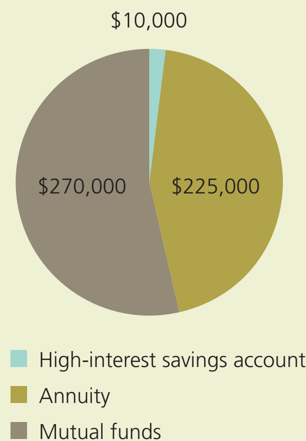
Graham and Ashley have the opportunity to invest $250,000 in non-registered savings — the surplus from their move to a more modest house.

"I'd recommend balanced mutual funds for that money," says Nancy. "A lot of retired investors worry about investing in equities, but balanced mutual funds provide a good mix of stability from fixed-income investments and growth potential from equities."

She explains that the combination of a fixed-income component and an equity component means a balanced mutual fund is diversified between two asset classes that are not highly correlated — so if one decreases, the other doesn't necessarily follow. Meanwhile, balanced mutual funds may provide important growth potential to help keep their savings one or two steps ahead of inflation.

"A wide variety of balanced mutual funds are available," Nancy advises them. "Some are more conservative, with a higher fixed-income component.

Multi-product strategy



High-interest savings account
Annuity
Mutual funds

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Some are neutral, with a 50/50 fixed-income/equity split. And some are more aggressive, with a higher equity weighting. Also, there are balanced mutual funds that focus on Canadian or North American markets, and balanced mutual funds that provide exposure to economies and companies throughout the world. The key is to select the fund that best meets your investment objectives and risk profile."

Nancy emphasizes that part of her job is to assess the individual portfolio managers' track records and investment styles to help recommend the most appropriate mutual fund to her clients. She favours mutual funds available in corporate class versions for Graham and Ashley, since this structure will allow them to easily move money from one mutual fund to another within the corporate class without realizing taxable capital gains in their non-registered account, thereby making this a tax-efficient investment.

"Aren't balanced mutual funds for longer-term savings? Would we be able to withdraw money if we needed it in a hurry?" asks Ashley.

"You would be able to withdraw your money at any time at the current market value.[1] But there's a final piece of the puzzle that will provide a dedicated emergency fund for you," says Nancy. "You can invest $10,000 of your TFSA savings in a high-interest savings account to cover unexpected costs. The remaining $20,000 of TFSA savings can be invested in balanced mutual funds to help give it greater growth potential."

Graham and Ashley leave their meeting with Nancy satisfied that they have met their objectives. They have a clear sense of where their retirement income will come from. Their annuity will generate regular payments for life, topping up other guaranteed income sources to meet their expected expenses. Their balanced mutual funds and high-interest savings account will provide flexibility and access to lump sums when they need them. And Nancy has assured them that she'll work with them to minimize their annual tax bill. Overall, they are confident their allocation to several distinct products with different benefits will help them achieve their retirement dreams.

Speak with your advisor

Are you wondering if you will have enough money for current and future expenses in retirement? Please speak with your advisor. He or she can make sure your retirement strategy includes a mix of products with various guarantees and features that will help you generate sustainable retirement income. ●

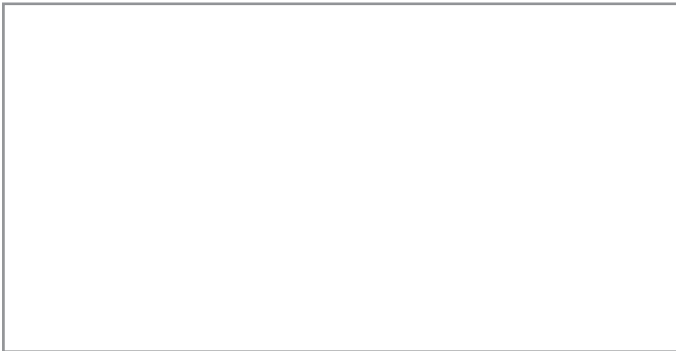
Scan this QR code with your smartphone to learn more. Don't have a QR code scanner app? Go to 2Dscan.com for a free download or see page 11 for details.

WHAT IS LIQUIDITY?

A "liquid" asset is one that you can quickly and easily convert to cash — for example, cash invested in a high-interest savings account or mutual fund investments. An "illiquid" asset is one that is more difficult, or perhaps even impossible, to convert to cash — for example, GICs can only be cashed out without penalty at the end of the guaranteed period and annuities can never be cashed out by the purchaser. It is very important to hold some liquid assets in your portfolio at all times so you have access to cash when you need it.

[1] Fees may apply.

Solutions



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