Insurance Feature

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Insured Annuities: Achieve a Higher Guaranteed Return Without Compromising Risk

Depending on your circumstances, today's low interest rates can provide you with either opportunities or challenges, or possibly both. On the positive side, the cost of borrowing has never been lower and it encourages spending on large purchases such as that new car you've had your eye on. There has also never been a better time to purchase real estate for either personal use or as a rental property; after all, purchasing real estate is another way to diversify an investment portfolio.

On the negative side, the return that is currently available on traditional investments such as bonds or GICs is much lower than desired. If you are at or nearing retirement, it is quite likely that fixed-income instruments of this kind play a big part in your overall investment strategy. During periods of high interest rates, the net rate of return on these investments may be high enough to provide you with the income you require, however, with current rates as low as they are, you may experience a significant income gap.

In an effort to enhance your after-tax rate of return and income, you, like many investors may succumb to the pressure of purchasing investments that don't necessarily meet your risk tolerance or address important goals like safety and preservation of capital. You can overcome the risk of loss of capital and increase your after-tax rate of return by combining the purchase of two products: a permanent life insurance policy and a prescribed life annuity. The strategy is called the Insured Annuity and it results in increased after-tax rates of return when compared to other fixed income investment vehicles. The strategy provides not only higher returns but also an income stream that is guaranteed for life, in addition to ensuring that your originally invested capital is protected for those individuals to whom you intend to leave it.

How It Works

A prescribed life annuity is a product where you give a lump sum of non-registered capital to a life insurance company, and in return they pay you a fixed income for life at specified intervals (usually monthly). Purchased on its own, a straight life annuity would most likely provide the highest amount of income achievable from an investment; however, the downside is that it does not provide an estate benefit. That is why a life insurance policy is added to the equation.

Once the amount of capital to be invested into the insured annuity strategy has been decided upon and earmarked, a permanent life insurance policy equal to that same amount is applied for. The purpose of this coverage is to "insure the annuity", thereby recreating or replacing the capital that buys the annuity, and in turn, maintaining that estate value for your heirs. Once the insurance is approved, you proceed to purchase the annuity. A portion of the income pays for the insurance policy while the remainder can be used at your discretion.

Example

A 60 year-old male currently invests a large portion of his portfolio in GICs. He is looking to increase his income without taking on additional risk. It is also important to him to leave his capital intact for his children and grandchildren, upon his death.

Using rates effective as at time of print, the chart below compares keeping an amount of capital (we'll use $200,000 as an example) invested in a 5 year GIC versus buying an insured annuity.

Insured Annuity vs. GIC with 4.2% return

5-Year GIC		Insured Annuity
$200,000	Amount Invested	$200,000
$700	Monthly Cash Flow	$1,328 1
$700	Taxable Amount	$499
$325	Tax Payable (at 46.4%)	$231 2
$n.a.	Insurance Cost	$355 3
$375	Net Cash Flow	$742 = 1 – 2 – 3

This chart has been produced using Maritime Life annuity rates and Manulife T-100 insurance rates as of January 09, 2002 based on a 60 year-old male non-smoker with a 46.4% marginal tax rate. Returns will differ depending on age, sex, tax bracket, health, smoking status and prevailing interest rates.
Source: ScotiaMcLeod

Looking at the above example, a 5-year GIC with a 4.2% rate would provide $700 per month in interest. Assuming a 46.4% tax bracket, on an after-tax basis, this return might only be 2.25% or $375.

However, if this investor instead applied for and was approved for $200,000 of T-100 insurance, the monthly cost would be $355 per month which would be subtracted from the $1,328 that the annuity would pay him monthly. Even once $231 in taxes is accounted for, the net cash flow is still 97.94% higher than what this investor would earn with the GIC example. In fact, he would need to buy a GIC earning 8.31% for the rest of his life to match what he would earn with the insured annuity.

If you could buy a GIC guaranteeing a 8.31% rate forever, wouldn't you consider it?

Who This Strategy is Suited for

Are you, or someone you may have this strategy in mind for, between the ages of 60 and 85? Are you interested in a long-term, guaranteed investment without being subject to reinvestment risk? Are you in good health (in order to qualify for life insurance)? If you answered yes to all of these questions, then you should consider putting part of your non-registered capital towards this strategy.

Caveats

You may be thinking that this strategy sounds too good to be true. While it's not, there are some issues that you should consider before proceeding with an insured annuity.

First, once a life annuity is purchased, it is locked in for life. Unlike a GIC, where you have access to the capital once it matures, with an annuity this feature is not available. Also, if you ever did choose to cancel the insurance portion once the strategy is put into place, the "return of capital" element of the strategy would be eliminated.

Since maintaining liquidity should be of some importance, only a portion of your assets should be invested in this strategy. This is to ensure that if something unexpected occurs and capital is required, all of it would not be locked up.

As well, you may be hesitant to lock in rates in this low interest rate environment. While this is understandable, it is worth noting that the accumulated cash flow over the lifetime of an insured annuity often exceeds that of a GIC, even with increasing interest rates.

Conclusion

If you, like many, are looking to achieve the highest return without compromising risk, speak to your life insurance licensed ScotiaMcLeod advisor to review your personal situation and see if the insured annuity suits your needs.