They may not be exciting, but annuities can play an important role in retirement – especially for clients who are worried about outliving their money

By Megan Harman |

As Canadians live longer and face the prospect of potentially running out of money in retirement, the annuity is garnering renewed interest as a valuable tool that can provide retired clients with steady income and peace of mind.

"Annuities are pretty boring, but it's a good foundation [on which] to build your retirement income portfolio – your portfolio after work," says Earl Siegle, insurance advisor with Siegle Financial Group Ltd. in Westlock, Alta. "For a client who has a very low risk profile, and wants steady guaranteed monthly income, it's one option to add to a portfolio."

With a growing proportion of Canadians poised to retire without a workplace pension, retirement income is a priority for many clients. Furthermore, given the market volatility and economic uncertainty that investors have faced in recent years, the prospect of any sort of guarantee holds appeal for a growing number of investors, according to Peter Wouters, director of tax and estate planning with Toronto-based Empire Life Investments Inc.

"People are looking for peace of mind, they're looking for quality, they're looking for predictability," says Wouters.

An annuity is a contract with an insurance company that provides a series of future payments to a client in exchange for an initial lump-sum investment. The payments can be guaranteed to last for the duration of the client's life, in the case of a life annuity, or for a specified period of time, in the case of a term certain annuity.

Term certain annuities are typically used in cases where clients need income for a specific period of time, or for younger clients who have come into sudden wealth, and are looking to conserve that money by turning it into a stream of income. If the client dies before the end of the designated term, the annuity will continue to be paid to the client's beneficiary or estate for the remainder of the term.

For clients who are looking for retirement income, life annuities are generally the best option, as they ensure clients will continue to receive income for the duration of their retirement. Life annuities are often sold with an optional minimum payout guarantee period, so that if the client passes away during the first few years of the contract, payments will continue to be made to the client's beneficiaries for the remainder of the guaranteed term.

Couples can opt to purchase joint life annuities, in which payments continue until the death of last surviving spouse.

Life annuities are typically best suited to clients who have a low tolerance for risk, and are concerned about the possibility of outliving their money.

Everyone has a different level of tolerance for longevity risk, according to Moshe Milevsky, associate professor of finance at York University's Schulich School of Business and executive director of the Individual Finance and Insurance Decisions Centre. He says advisors should assess the extent to which clients are worried about this possibility in order to determine whether they're good candidates for annuities.

"Some people are very longevity risk averse – they worry that they're going to [live to 100], and that they'll have no money," says Milevksy. "Somebody that is longevity risk tolerant – they're willing to take a chance – they should have less of an allocation [to annuities] than somebody that is very risk averse, that really worries about that."

Adds Milevsky: "You've got to elicit their attitude towards longevity risk, just like you elicit their attitude to financial risk."

Clients who hope to leave an inheritance behind will likely be reluctant to consider annuities, since the products essentially destroy their capital in exchange for lifetime income. However, advisors should warn such clients that without an annuity, they run the risk of spending all their money anyway – potentially running out of funds for their own needs late in life, let alone for any sort of legacy, notes Bruce Cumming, executive director, private client group, and senior investment advisor with HollisWealth Inc. in Oakville, Ont.

He urges such clients to buy an annuity to ensure their income will last the duration of their retirement, along with a life insurance policy for inheritance purposes.

"The most effective way to leave money behind is to buy life insurance," says Cumming. "It will take away some of their savings dollars, but it will guarantee the replacement of that [money] that they want for their children."

Given the lack of flexibility and liquidity associated with annuities, experts recommend investing only a portion of a client's portfolio in an annuity. To determine an appropriate allocation, Cumming suggests calculating all of the non-discretionary expenses that the client will face in retirement, and working backwards from there.

"I want the annuity to guarantee that all of their fixed expenses are covered," he says. "Then, their variable expenses will be covered by the remainder of the investment assets."