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Jim and Shirley fear the market downturn will eat into their retirement savings. Should they buy an annuity to see them through?

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"My wife and I are retired and nervous with this downturn that we will not have enough funds to see us through," Jim writes in an e-mail. "We are looking to buy an annuity to improve our stability."

Jim is age 60, Shirley 61. They have three adult children.

They are drawing on their work pensions and registered savings to cover their lifestyle expenses to the tune of $6,155 a month. In addition to their savings, they have a mortgage-free house in Eastern Canada.

They've based their retirement plan on achieving a 6-per-cent average annual rate of return – dividends, interest and capital gain.

Their investments are the uppermost element of their retirement income plan, Jim writes. They are managed mainly by an investment adviser. "The hit in 2020 and now again in 2022 has created doubt that our strategy will see us through." They are considering using up to 20 per cent of their portfolio to buy an annuity. "Would this be advisable and (if so) should we use non-registered funds to purchase it?" Jim asks.

We asked Ian Calvert, a certified financial planner and portfolio manager at HighView Financial Group in Toronto, to look at Jim and Shirley's situation.

WHAT THE EXPERT SAYS

Jim and Shirley require a cash flow plan that satisfies their monthly income needs and ensures the longevity of their investable assets, Mr. Calvert says. Their private pension income is a valuable component of their retirement plan, he says. However, at $1,894 a month, "their financial security will be mostly dependent on the management and withdrawal strategy of their retirement savings."

They plan to begin collecting Canada Pension Plan and Old Age Security benefits at age 65. In the meantime, they have an after-tax cash flow deficiency of about $51,000 a year, which they are taking from their investment portfolio to meet their spending target of $74,000 a year.

Taking some funds from their RRSPs/registered retirement income funds to meet their current lifestyle needs is a good start, but they should also consider how much and where to take their withdrawals from.

A tax-efficient strategy would be to withdraw $20,000 from each RRIF account, and the maximum allowable withdrawal from each LIF, or life income fund. The combined maximum withdrawal from their LIF accounts would be about $9,700. They would then need about

$1,000 a month from their non-registered assets.

Their total withdrawal plan would be: $22,728 of pension income, $40,000 from their RRSP/RRIF accounts, $9,700 from their LIFs, and $12,000 from their non-registered portfolio. This would result in total income of $84,428, less $10,200 in combined income taxes, to provide after-tax spending of $74,228, the planner says.

"This withdrawal plan would keep their taxable income at a favourable $43,000 each, with no concern that would rise so high that their Old Age Security would be partly clawed back when they start to receive CPP and OAS benefits at age 65."

Their retirement income strategy is to earn an average annual rate of return (including dividends, interest and capital gains) of 6 per cent from their investable assets, Mr. Calvert notes. "If on average they could earn 6 per cent, they would still have considerable financial assets at their respective ages of 90 and 91," he says – about $2-million. "Their retirement plan would run very efficiently, assuming their spending remains consistent and grows at the targeted rate of inflation."

Also, they should be cycling $6,000 each, per year, from their non-registered assets into their tax-free savings accounts to ensure not only the longevity but the tax-efficient location of their assets, the planner says.

Although 6 per cent may be an achievable return target, it's no guarantee, he notes. "It will take the proper portfolio design and monitoring to accomplish that goal."

One way to increase the probability of consistently hitting their target return would be to build a portfolio with a strong income yield. "If their portfolio was consistently returning 4 per cent in the form of dividends, interest, and other income distributions, it would bring greater predictability," Mr. Calvert says. "It would also remove their dependence on capital appreciation, which is more of a challenge to predict and obtain each year."

They also ask about buying an annuity to help stabilize their retirement income. An annuity is a financial product that offers a guaranteed income payment for as long as you live.

"Annuities have been a tough sell and not a popular product throughout the extremely low interest rate environment," he says. Interest rates – along with age – are a key determinant of annuity payouts. Given the recent spike in inflation and the interest rate response from central banks, annuities are gaining more attention.

"One of the major criticisms of annuities is the loss of liquidity and access to your capital," Mr. Calvert says.

"A sensible retirement income plan will have a blend of guaranteed and variable income," the planner says. For Jim and Shirley, their work pensions, CPP, OAS and a potential annuity would all, in theory, provide secure, recurring income for their retirement. They should have their portfolio invested in dividend-paying stocks or stock funds and interest-paying investments.

"This balance will help keep their assets diversified to mitigate risk and keep the majority of their assets liquid and accessible," Mr. Calvert says.

As to putting 20 per cent of their portfolio into an annuity, that's likely on the high side, he says. They already have steady income from their pensions and government benefits. If they do decide to buy an annuity, they should consider using their registered funds, he says. This would keep their non-registered funds available in case of an emergency or lump-sum withdrawal. Lump-sum RRSP/RRIF withdrawals are taxable in the year of withdrawal.

Jim and Shirley have about 80 per cent of their assets managed by an investment adviser. "The hits to their portfolio in both 2020 and 2022 have created doubts about their current investment strategy," Mr. Calvert says. "It's during these more volatile times an investor can experience – and uncover – the underlying weakness in a poorly constructed portfolio." They need to ask themselves: Is this portfolio tailored to my specific goals?

If Jim and Shirley continue to work with an investment professional, they should ensure they are working with an individual or firm who is registered as a portfolio manager, Mr. Calvert says. Portfolio managers have a fiduciary duty to act in their client's best interest. They should also ensure the fees they are paying are transparent, clearly reported, and not buried in financial products.

CLIENT SITUATION

The person: Jim, 60, and Shirley, 61

The problem: The 2020 and 2022 stock market drops have them wondering whether they will have enough savings to see them through retirement. Should they use some to buy an annuity?

The plan: Despite the recent rise in interest rates, an annuity may not be the best choice for Jim and Shirley because they already have a steady income stream from their work and government pensions. If they do buy one, they should keep it small. Revisit their risk tolerance and adjust their investments if necessary.

The payoff: Financial security

Monthly net income: $6,185

Assets: GICs $30,000; joint non-registered stocks $263,000; his stocks $133,000; her stocks $12,000; his life income fund $135,000; her LIF $9,000; his TFSA $95,000; her TFSA $93,000; his RRSP $194,000; her RRSP $182,000; his registered pension plan (defined contribution) $150,000; her RPP $450,000; residence $600,000. Total: $2.3-million

Monthly outlays: Property tax $455; water, sewer, garbage $45; home insurance $100; electricity $300; maintenance $335; transportation $850; groceries $800; clothing $200; gifts, charity $400; vacation, travel $1,000; dining, drinks, entertainment $700; personal care $250; club memberships $100; sports, hobbies $50; subscriptions $100; drugstore $25; health, dental insurance $180; phones, TV, Internet $265. Total: $6,155

Liabilities: None

Ian Calvert is a Vice President & Principal at HighView Financial Group.