Is a life annuity better for men than managing your own retirement withdrawals from savings?

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A life annuity involves paying a lump sum to a life insurance company in exchange for a guaranteed income stream for the rest of your life.

Life annuities have never been popular in Canada, even when payouts were higher than they are now. It seems most retirees prefer to follow a DIY approach, in which they continue to control their investments and decide themselves how much to draw each year as income.

The question I'm exploring today is whether the DIY approach is better than a life annuity.

Consider a 70-year-old male with $100,000 in his RRSP. He could buy a life annuity, with payments guaranteed for 10 years. Or he could follow a DIY approach in which he invests the $100,000 in a long-term bond portfolio and removes a certain fixed amount each year until age 90, at which point the funds would be exhausted. He uses an Excel spreadsheet to figure out the amount to withdraw that would totally use up his savings by age 90.

The chart compares these two approaches for each year going back to 2017. Note that the life annuity always provides more income than the DIY approach. For instance, the life annuity in the case of a November, 2025, purchase would be $7,171 versus $6,699 using the DIY approach. The fact the amounts vary from year to year reflects fluctuations in the prevailing long-term bond yield.

It might surprise some readers that the life annuity always comes out on top; after all, the life insurance company is using part of your lump sum payment to cover its expenses, and earn a profit. The reason the life annuity still does better is the "mortality credit," which is the windfall insurance companies get when some annuitants die earlier than they predicted.

So why aren’t life annuities more popular? The biggest reason is the possibility of early death. Payments from a life annuity stop on death (but not until 10 years of payments have been made in this case). With the DIY approach, the remaining savings can be passed along to one’s heirs. For instance, if the 2025 DIY retiree dies in 10 years’ time, at age 80, his heirs would receive about $51,000 before taxes.

Of course, there is the flip side: If the annuitant lives beyond age 90, he continues to receive income while the DIY retiree will have exhausted his savings.

Another reason most retirees opt for the DIY approach is that they prefer to control their own investments, though this does not come without risk. At an advanced age, retirees may not be as adept in making sound decisions or may simply become the victims of bad timing, as capital markets sometimes stay in the doldrums for years.

One compromise is to deploy only 20 per cent or so of your RRSP money to buy a life annuity and use the DIY approach with the rest of the money.

I want to thank Rino Racanelli for providing the historic annuity quotes. The next chart, in two weeks, will look at female annuitants.

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