

Sylvia Bitelli



Segregated Funds: The Best of Both Worlds

Balance between risk and opportunity is the cornerstone of a healthy financial plan. As we regularly review our investments and their performance, we come to realize how our past financial decisions have affected our lives and how changes in our lives have affected our financial decisions. In addition, market fluctuations, media frenzies, and political agendas of the day further modify our perception of the right balance for our financial plan.

The recent volatility of the markets and instability of the international political arenas seem to have rekindled a keen interest in investments that offer benefits and guarantees. In a low interest rate scenario, for instance, some conservative investors find themselves wondering if there could be any other alternative to the options of either lowering their future income expectations or reconsidering their estate planning goals.

The question often asked is: *Is there an investment solution that would satisfy our desire for potential higher returns with our need for security and protection . . . an investment that would minimize our risks, while enhancing our opportunities?* In other words: *How can we get the best of both worlds?*

Segregated funds may be one of the answers that satisfy this need. What are they? How do they work?

Segregated funds are investment vehicles offered by insurance companies. While they may look similar to mutual funds, they have substantial differences that make them an interesting alternative.

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We will first quickly explore the similarities to see how they could satisfy our desire for potential market returns. We will then briefly explore the differences to see how they could satisfy our need for protection and security.

Segregated funds and mutual funds are both pool investments, where investors deposit their money into accounts managed by professional managers or management teams employed or hired by the insurance or mutual funds companies. In return, the investors own units of the fund, not

actual assets. The units represent investors' proportionate interest in the total investment pool.

Like mutual funds, segregated funds offer a vast range of choices and a considerable degree of flexibility, which will enable the advisor to suit most investor's profiles. For instance, there are Segregated Income Funds, Dividend Funds, Balanced Funds, Canadian or US Equity Funds, Global Equity Funds, and more. Many of these funds are eligible for RRSP and RIF plans. The mix and proportion that best suit the client's needs should be discussed with the advisor when the account is opened and should be reviewed regularly, at least once a year.

Segregated funds and mutual funds have several significant differences that fundamentally stem from the way they are regulated and taxed. We will briefly explore only those differences that affect the decision-making process for those investors looking for protection and guarantees; segregated funds do offer a considerable degree of both.

First, there is a maturity guarantee. This ensures that, on the maturity date of the contract—which should be at least 10 years from the effective date of the

contract—the value of the benefit payable to the annuitant will be whichever is the greater of the following two amounts:

- the account value of the funds, based on the current market value of the units held, or
- 75 percent of the gross premiums deposited by the annuitant, proportionally reduced by any subsequent withdrawals and transfers.

Some companies extend this guarantee to 100 percent of the initial investment, add bonuses after a certain number of years, and add a Market Value guarantee for those funds invested in any year preceding the minimum 10-year maturity.

Second, being a deferred annuity contract, it has a component of life insurance protection in the event of death: a death guarantee. This provides that at death, the benefit may pass directly to a named beneficiary and potentially bypass probate, lawyers, and executor's fees.

Moreover, the benefit paid to the beneficiary is guaranteed to be the greater of the following two amounts:

- the accumulated value of the units held, or
- a percentage of all the gross premiums deposited by the annuitant, proportionally reduced by any subsequent withdrawals and transfers. The percentage varies from company to company; it can be 100 percent for the entire life of the contract or decline from 100 to 75 percent in relation to the annuitant's attained age at death.

Finally, there could be a degree of protection from creditors during the life of the policyholder, as provided by the *Insurance Act* of the various provinces. It seems that as long as the chosen beneficiaries are of the preferred kind—spouses, children, and grandchildren, and they have been designated by the policyholder well before the occurrence of any bankruptcy or legal suits—

segregated funds are protected against personal liability claims in business litigation proceedings.

This is not an infallible certainty and is not a guarantee. It is more of a general conclusion based on a number of past court cases, where various types of annuity contracts, including segregated funds, have been qualified as “life insurance” contracts for creditor protection purposes.

At this point it should be noted that all the above guarantees come at a cost—reflected in the segregated funds' MERs (Management Expense Ratios)—which may be higher than the underlying Mutual Funds' MERs. This difference varies from fund to fund and is somewhat proportionate to the type of guarantees and bonuses offered by the different insurance companies.

In addition, income tax treatment and creditor protection are complex and ever-changing issues that should be addressed at the moment the various alternatives are considered, as they may affect the investor's overall goals and plans.

In conclusion, segregated funds may offer the right balance between risk and opportunity to those investors looking for the best of both worlds: potential market returns and strong guarantees. Segregated funds should be approached only with the help of professional advice. Investors should understand how the various issues might affect their overall goals and plans. ▲

The contents of this article should not be construed as professional advice and readers should consult their own professional advisors before acting.

Sylvia M. Bitelli, AICB, is an associate broker of Equinox Financial Group/Customplan, offering retirement and succession planning. She is a member of Advocis, the Financial Advisors Association of Canada, and an Associate of the Institute of Canadian Bankers.

Voice: 604 687-7773
sbitelli@shaw.ca