Segregated Funds

There comes a time in every investor's life when they may face a dilemma. Do they continue to emphasize growth in their portfolios and risk investment losses? Or is it better to forsake growth and preserve and protect their retirement nest egg by opting for safety and security – even if it means a more conservative investment strategy and lower returns?

It doesn't have to be an all or nothing situation. For investors who have been attracted to principal-protected notes and market-linked GICs as protected investment opportunities there's another option – segregated funds.

A segregated fund, also known as an Individual Variable Insurance Contract, is a pool of professionally managed investment holdings within a life insurance contract providing the best of both worlds – the growth potential of equity markets and the security of capital protection. As a result of the structure of segregated funds, you have the potential to maximize investment growth while minimizing investment risk.

How do they work?

Like mutual funds, segregated funds offer an economical way to achieve diversification by allowing you to spread risk across many different investments and asset classes. Investments are fully liquid and funds can be added at any time over the 10-year period – the standard term for segregated funds.

The investment attraction is brought about through the insured guarantees. Upon the eventual maturity of the contract, you are guaranteed at least 75% and up to 100% of the original investment or the current market value of the underlying securities, whichever is higher. In the event of death, 100% of the original investment will be guaranteed and payable to a designated beneficiary.

An additional level of security called a "reset" allows you to lock in the market gains periodically. In so doing, the contract is extended for a further 10 years and the investment starts all over at the higher value, which becomes the new death benefit and maturity guarantee.

Estate planning advantages

Segregated funds offer more than just a guaranteed protection of capital. They can become a highly effective estate planning tool as well. Since there is no health or medical requirement, investors regardless of any health issues can buy a segregated fund.

As an insurance contract, the holder can name a beneficiary so in the event of death, the beneficiary named in the policy is paid directly and not through your estate. This keeps the segregated fund out of your Will and by-passes probate fees.

For investors who intend to make a charitable donation, the organization can be named as beneficiary, avoiding probate and other legal expenses. Business professionals can direct proceeds to a designated beneficiary as a protection against creditors.

Guaranteed income for life

A Guaranteed Lifetime Withdrawal Benefit (GLWB) is an option available in some segregated fund policies. When you add a GLWB to a segregated fund policy, the provider tracks a separate "income account" alongside your investment account.

The income account is eligible to earn a five per cent deferral bonus every year until you make a withdrawal. If you don't need to take an income right away, the deferral bonus can help grow your guaranteed lifetime income amount, regardless of how markets perform. Keep in mind, deferral bonuses are not a guaranteed rate of return and they have no cash value.

When you are ready to start making withdrawals your eligible lifetime income amount is the market value of your policy multiplied by the income percentage that corresponds with your age. The percentage used to calculate the lifetime income amount increases with age. When a deferral bonus or income reset applies, the lifetime income amount is recalculated, using the income percentage corresponding to the current age, at that time.

The lifetime income benefit is just one component of a well-diversified retirement income portfolio. It's appropriate for people getting ready to retire and retirees looking for secure, predictable, guaranteed income as well as those who do not already have guaranteed retirement income from government benefits, company pension plans or life annuities.

The cost of safety

The downside to segregated funds is that safety has a price. For segregated funds that comes in a higher management expense ratio (MER). Expect a management fee about 0.5% higher than a comparable mutual fund investment to cover the insurance premium on the capital protection mentioned above.

Another feature to consider is the 10-year time frame for the maturity guarantee benefit. Cashing in early eliminates the guarantee.

Segregated funds are an attractive investment option for investors seeking safety in their investment without abandoning the possibility for capital appreciation. The downside is limited to retaining your original investment. This, coupled with the estate planning potential, makes segregated funds a potentially valuable investment option for investors who want or need to diversify their investment exposure.

Raymond James Financial Planning advisors can work with your Financial Advisor to determine if segregated funds should be part of your investment asset mix. They might just add a little bit of insurance to your investment portfolio.