Seeking shelter in stormy seas

Segregated fund contracts are designed to help offer a safe harbour for Canadians worried about volatile markets.

MANY CANADIANS ARE APPREHENSIVE about investing. And who can blame them? Between plunging oil and commodity prices, and the Canadian dollar's free-fall, the economy has taken a big hit. So has investor confidence. Market volatility, together with economic uncertainty, is the new normal – at least for now.

But even in a tough investment environment, diversification, with at least some exposure to stock markets, may be one way to stay ahead of inflation. This is precisely why today's turbulent conditions are leading some investors to take a second look at segregated fund solutions.

What is a segregated fund contract?

A segregated fund contract combines the growth potential offered by a broad range of investment funds with the unique wealth protection features of an insurance contract. Segregated fund contracts can help minimize exposure to risk through various guarantees, such as income, death and maturity guarantees, potential creditor protection features, and estate planning benefits – all from a single product or insurance contract.

The value of a guarantee

For risk-averse investors, a segregated fund contract's most appealing attributes are its guarantees. After all, life doesn't come with too many guarantees.

With a segregated fund contract, you're sure to receive at least 75 per cent of your deposits (or 100 per cent, depending on the contract), less any withdrawals, when the contract matures. This is known as a maturity guarantee, and it applies at the maturity date (which occurs after a minimum number of years has elapsed or at a contract set date,

for example, age 100 of the annuitant), even if markets decline during the period. And if markets rise, you have the opportunity to grow your savings. Some contracts even let you "reset" your maturity guarantee to lock in growth. So you get the opportunity to protect your capital, while also enjoying growth potential.

Segregated fund products demystified

An important thing to know about segregated fund contracts is that they're actually insurance products. Only insurance companies can offer them, and only licensed insurance representatives can sell them.

Segregated fund contracts also vary widely. They offer different guarantees, features and fees. Your advisor can explain the differences and recommend various options available to you.

Who might choose a segregated fund contract?

Segregated fund solutions typically appeal to conservative investors, especially during turbulent markets. For investors who don't want to lose sleep over the market roller-coaster ride, the guarantees that come with segregated fund contracts can provide some peace of mind. They also appeal to people for whom estate planning advantages or potential creditor protection is top of mind (see the sidebar).

Death benefit guarantee

Segregated fund contracts also include a death benefit guarantee. The guarantee can be up to 100 per cent, depending on the type of contract selected and the age of the annuitant when the product is purchased. Your named beneficiary gets the death benefit in the event of death. Your beneficiary can be anyone – a family member, a friend or a charity.

The costs

Keep in mind that the guarantees are a type of insurance, which you're paying for. Segregated fund costs include management fees, insurance fees, operating costs and applicable sales tax. A contract might also include a charge for early withdrawal. Ask for all the fees and costs to be clearly itemized, so you can make an informed decision.

The reset

So what happens if your segregated fund contract maturity guarantee is 100 per cent of your initial deposit (let's say $10,000), but the underlying investment grows five per cent within the first year? Some segregated fund contracts allow you to lock in this growth, so your new guaranteed amount is higher – 100 per cent of $10,500 (unless, of course, you withdraw money). Insurance companies that offer segregated fund contracts call this a "reset." Resets are a great feature in volatile markets, since you can take advantage of the peaks to reset without descending to the valleys.

Depending on the product, resets may be automatic, or you may initiate them yourself. They may affect the maturity guarantee and/or the death benefit guarantee, and they can happen annually or more frequently. Certain conditions apply to elect a reset, and these are specific to the contract you are purchasing.

DID YOU KNOW?

Segregated fund contracts offer other benefits, including:

Ability to bypass the estate
In the event of death, the proceeds of the contract have the ability to pass quickly and privately[1] to designated beneficiaries (other than an estate), without legal, estate administration and probate fees.

Potential creditor protection
Investments held with an insurance company are generally protected from creditors in bankruptcy and non-bankruptcy situations provided an appropriate beneficiary is named.[2] Another requirement is that there cannot be a fraudulent conveyance. In other words, the investments cannot have been deposited into an insurance investment merely to avoid existing creditors. This feature can be of interest to professionals and business owners looking to protect their personal assets from professional liability.

Decisions, decisions...

That's a lot to mull over. Segregated fund contracts could be just the answer for investors looking to help minimize risk, and given the ups and downs of today's markets, they deserve a close look. The best advice? Discuss with your advisor whether segregated fund contracts are right for you. ■

[1] In Saskatchewan, jointly held property and insurance policies with a named beneficiary are included on the application for probate despite the fact that these assets do not flow through the estate and are not subject to probate. [2] In jurisdictions other than Quebec, the beneficiary designation must be irrevocable or the beneficiary must be a spouse or common-law partner, child, parent or grandchild of the annuitant. In Quebec, the contract must qualify as an annuity contract and have a named beneficiary in one of these categories: a married or civil union spouse (not common-law spouse), ascendants or descendants of the owner, or anyone named as an irrevocable beneficiary.