

# INVESTMENT *facts*

SPECIAL EDITION

Segregated Funds

## About *INVESTMENT facts*

Investment Facts is published by the Investor Learning Centre of Canada, an independent not-for-profit organization. Our aim is to help people like you become better informed about your investment choices.

The ILC works closely with the Canadian Securities Institute – the official educator of the securities industry – and other highly regarded organizations. This helps ensure our publications and programs are accurate and non-promotional.

This issue of Investment Facts is part of an ongoing series. It complements our many other national investment learning programs, including books, seminars and a walk-in-phone-in resource centre.

For more information, call one of our offices listed on the back page. We'll be happy to help!

### What are segregated, guaranteed and protected funds?

Many Canadians want the growth and flexibility available from investment funds, but they worry about losing their capital.

Now, a growing range of funds will “guarantee” your capital. But in most cases these funds – called segregated, guaranteed or protected funds – will only give you back your original investment after the agreement ends, typically after 10 years, or at your death. If you make withdrawals in less than 10 years, you could get back less than you invested. So the guarantee is not absolute.

**Segregated funds** – or “seg” funds – are the life insurance industry’s version of mutual funds. By law, the insurer must return at least 75% of your capital after typically 10 years or at death, whichever comes first. Many guarantee 100% of the money you invest. There are now two types of seg funds: Traditional seg funds and new-generation seg funds. Traditional seg funds have been offered for years by insurance companies. The new-generation funds are basically regular mutual funds offered by mutual fund companies – but with an insurance “wrapper” which includes the capital guarantee.

**Guaranteed investment funds** is simply another name for new-generation seg funds.

**Protected mutual funds** are the newest variation on funds that promise return of capital. Certain mutual funds now promise to return the money you put in, after either five or 10 years.

### Can I lose money investing in these funds?

Yes. To get the guarantee, you have to keep your money in the fund for a minimum holding period. This is normally 10 years, though some protected mutual funds require

five years. If you withdraw some or all of your investment before the holding period is up, the guarantee doesn’t apply. So you can lose money if markets fall and you withdraw money early. Also, some funds guarantee just 75% of your capital, so even after 10 years you might not get all your money back.

### Do I need a capital guarantee?

That’s really an emotional question, not a financial one. Most of these funds are invested in stock markets, and some in bonds. Generally, stock markets drop in one out of every four years but gain far more during the other three.

Consultants William M. Mercer Ltd. found there’s a 2% likelihood of losing money in the stock market over 10 years. Of course, this is no guarantee that history will repeat itself. Also, remember that you want a good investment, not only a guarantee on your capital. If you put your money in a guaranteed but poorly performing fund, you miss out on the opportunity to have made higher returns on a better investment. The death benefit on seg funds means that these funds are likely of more value to an older person than they are for a young person.

### What is a reset provision?

Many funds “lock-in” gains by letting you periodically reset the guaranteed amount. So if and when the fund’s value rises, you may have the option of having the guarantee based on that new, larger amount. But the resetting often also

*If you withdraw your money during the holding period, then you could get back less than you invested.*

restarts the guarantee's 10-year holding period. In that case, you would have to wait another 10 years in order to collect on the guarantee – unless you die. Some companies won't let older people use the reset option. And some funds base death payouts only on the initial capital, not the reset amounts.

If you switch from one fund to another, this will usually restart the holding period. If you have more than one seg fund, you may want to hold each in a separate account since some companies require you to reset your entire account – which may force you to lock in losses on some funds in order to preserve gains on others.

Be aware too that some funds start a new holding period each time you buy more units of the fund, while others group all purchases in the same year. As well, withdrawals reduce the guaranteed amount. These features vary widely and can be complex. Check the fine print.

*Many insured funds charge higher fees than their mutual fund equivalents.*

## How secure is the guarantee?

These are not government guarantees. So check the insurer's "solvency" rating. These ratings are issued by independent companies and can be obtained from the insurer or your financial advisor. If the insurer fails, the guarantee is backed to \$60,000 by the life insurance industry's own consumer protection plan, but your money could be tied up for some time.

A protected mutual fund might be guaranteed by insurance or by the mutual fund company itself, especially if that company is owned by a large financial institution.

## What does the guarantee cost?

First understand that, besides any sales commissions, every investment fund has built-in fees that cover its management and expenses. These fees are deducted from the fund and automatically included in calculating its performance. If the fund makes 10% and the fees equal 2%, your reported return will be less than 8%.

These fees are expressed as a "management expense ratio" (MER) and average 2% to 2.5% a year. Some funds charge less while many charge more. The MER is charged whether your fund makes money or not.

Many older seg funds have MERs similar to those for regular mutual funds, but new-generation seg funds and protected funds typically cost more. A capital guarantee might boost the MER by anywhere from 0.4% to 1% or more. That may not look like much, but it adds up over time. If you invest \$10,000 in a fund that earns an average 8% return yearly, then 0.5% more in MER charges, over 10 years, reduces your return by \$979 – nearly 10% of your capital.

## Can the guarantee's cost rise?

Seg funds are allowed to raise fees without investor approval. That includes those which really just package a mutual fund as an insurance contract. Due to tighter regulation, regular mutual funds – and their protected versions – must hold a unitholder vote if they wish to raise their fees.

There is, however, a special rule under which no-load mutual funds can raise their fees without unitholder approval.

## Is my money safe from creditors?

This depends on the fund type. As a life insurance contract, a seg fund can be protected if you go bankrupt. But you can lose that protection if you commit fraud by

moving assets into a seg fund to avoid your debts. You also lose the creditor-proofing if your seg fund is in a regular self-directed RRSP or self-directed RRIF. Protected funds don't offer creditor protection. Consult your advisor.

## What about probate fees?

Probate is a legal process that, at death, allows the transfer of assets to your beneficiaries. Provincial governments get revenue from this because they charge probate fees which are a percentage of the estate's value, ranging as high as 1.5% in Ontario. But these fees aren't charged on seg funds if there's a named beneficiary. This benefit has been used to market seg funds. However, if the fund has a high MER, this may offset that advantage. Protected funds don't offer this benefit. Check with your advisor.

## What should I look for in a seg or other guaranteed fund?

You want a good investment. A guarantee on your capital may be less valuable than it appears. Make sure you understand how the guarantee works, so you can judge if it may meet your needs. Look at how secure the guarantee is by checking how it is backed up. Get professional investment advice before you invest your money.

The Investor Learning Centre of Canada is Canada's only independent not-for-profit organization solely dedicated to providing non-promotional investment information to the general public. It is funded through revenues from its low-cost programs and by grants from the Canadian Securities Institute, the national educator for the securities industry.

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