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Financial Facelift

A retooled strategy needed for retirement

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Desmond and Molly are sitting pretty.

He is 61, she is 56. Both are retired with government pensions large enough to assure they will live comfortably for the rest of their lives.

They have substantial savings, in addition to a fair amount of debt – money they have borrowed to invest. The way Desmond sees things, their pensions constitute the fixed-income portion of their capital so their savings are fully invested in stocks and equity-type mutual funds, earning superior returns.

They plan to use money from their RRSPs before they turn 65 to pay for their two daughters' weddings, renovate their house and travel abroad. The idea is to spend the RRSP money first and leave their non-registered holdings to grow.

"The issue is, are the assumptions good?" Desmond asks in an e-mail. He manages their investments and wonders if his estimated rate of return – an annual 2.5-per-cent capital gain, plus 5.5-per-cent interest and dividend income – is too hopeful.

We asked Marc Lamontagne, a financial planner with Ryan Lamontagne Inc. in Ottawa, to look at Desmond and Molly's situation.

What the Expert Says

Mr. Lamontagne sees problems on all fronts: the high amount of leverage or money the couple has borrowed to invest, Desmond's optimistic rate of return assumptions on their non-registered investment accounts and the plan to spend their registered savings first.

Borrowing to invest magnifies the potential rate of return – and the potential loss, Mr. Lamontagne notes, so he only recommends that strategy to clients who have many working years left.

"The reason is that if the market goes down, you always should have time to wait until it recovers before having to sell your investments," he says.

With Desmond's strategy, if the market value of their investments falls even short term while they are drawing income, "you will never recover the loss from the portion withdrawn."

Besides, the difference between Desmond's assumed rate of return and the cost of the borrowed money is narrower than it might appear if it is calculated on an after-tax basis, the planner says.

"When you look at the amount of the spread, is it really worth the additional risk? I don't believe so," he adds. "I think it would be prudent to be more conservative in their assumptions at this stage of their financial life, the danger being that they could run out of money if they use overly optimistic assumptions."

Mr. Lamontagne acknowledges that deciding which savings to draw from first – registered or non-registered – is a concern for retirees because several elements go into making the decision. Usually, people are better off drawing from their non-registered savings first, leaving their registered investments to continue to compound tax free.

One concern pensioners have is that they will end up paying more taxes on money they withdraw from registered accounts than they saved by contributing in the first place, or that the income will push them over the threshold where Old Age Security is clawed back. The planner suggests Desmond and Molly lower their tax bill by taking advantage of the federal government's pension splitting rule. His calculations show both will qualify for full OAS when they reach age 65.

Even with a more conservative rate of return, and assuming they repay all their debts, Molly and Desmond will have enough money to sustain a financial shock such as the cost of a nursing home or home care and still leave an estate to their three children, Mr. Lamontagne concludes.

"So why bother taking on the extra risk of borrowing if it doesn't improve your lifestyle?"

He recommends they sell enough of their investments to pay off all their debts, spreading the sale over a couple of years to reduce capital gains tax. For income needs, they should withdraw funds from the remaining non-registered holdings before dipping into the registered ones, continuing to make TFSA contributions from the non-registered savings as well. Once the non-registered holdings are depleted, they can begin withdrawing money from their TFSAs and the finally, their RRSPs.

On the investment front, the planner suggests Desmond take a more balanced approach, with cash, short -term bonds, preferred shares and real estate investment trusts making up the fixed-income side of their portfolios (50 per cent) and Canadian, U.S. and international equities (overweight Canada) comprising the other half.

The People

Desmond, 61, and Molly, 56

The Problem

Determining whether their investment strategy will yield the desired results, enriching them well beyond their basic income requirements now and in the future. Also, deciding which pool of savings to draw on first – their RRSPs or non-registered holdings.

The Plan

Shift to a more conservative investment stance, balancing their portfolios at 50 per cent fixed income and 50 per cent stocks. Set investment forecasts using a more modest estimated rate of return to avoid running out of money if investments fall short.

The Payoff

Secure retirement with plenty of income and no unnecessary risk, and enough money to cover contingencies and leave an estate for their children.

Monthly Net Income

$11,655

Assets

Ottawa house $300,000; cash $35,000; Portfolios $497,700; RRSPs $249,050; TFSAs $25,400. Total: $1,107,150

Monthly Disbursements

TFSA contributions $850; food, drinks, dining $1,200; clothing $75; medical, drugs, dental $100; miscellaneous $750; property taxes $300; house and life insurance $190; utilities, telecom and cable $660; repairs, maintenance $500; furniture $425; vacations $2,100; entertainment $250; education, hobbies $425; auto loan $750; auto expenses $700; bus $20; loan repayment $880; donations $100; gifts $300. Total: $10,575

Liabilities

Credit lines $166,100; investment margin loans $163,400; auto loans $26,650. Total: $356,150

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