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Debt or the RRSP?
February 25, 2008 | Mark Noble

One question advisors are hearing from clients with more frequency this year is whether their RRSP contribution would be better used to pay down debt than invested in a volatile market. In certain cases, the former may make sense.

According to Preet Banerjee, an investment executive with ScotiaMcLeod and author of the recently published book *RRSPs: The Definitive Book on Registered Retirement Savings Plans*, there are times when a client should choose to pay down debt, particularly mortgage debt, over contributing to an RRSP.

For investors with a conservative risk profile, opting to pay down their mortgage rather than contributing to their RRSPs can be useful, Banerjee says in the book. This is because clients more or less have a guaranteed rate of return in the form of the interest they are eliminating off the loan.

"When you are paying down your mortgage debt, there is little to no volatility in your rate of return on your mortgage," he says. "For the next five years or so, you know what the so-called rate of return is by paying down that debt. Whereas in your investment portfolio, the next few years may be good years or bad years, and that can grossly affect the long-term results. It's not a cut-and-dried debate."

Using Monte Carlo projections, Banerjee estimates there is an 84% probability that a 30-year-old investor earning $60,000 would be able to replenish 80% of his or her pre-retirement income by using an aggressive mortgage-reduction strategy followed by diligent RRSP investing, coupled with redeployment of the tax refund after the mortgage is paid off.

This calculation also assumes that the client's salary would increases by 4% every year, inflation tracks at 3%, the investor will retire at 65, and he or she will live to be 90. The simulation also assumes that the investments would earn an average of 8% and that the rate of interest on the mortgage is 6.5%, amortized over 25 years.

Obviously, there are a lot of specific factors there, which is why Banerjee stresses that opting for debt reduction versus paying into an RRSP has to be assessed on a client-by-client basis.

"The lower the rate of return that you expect on your portfolio, the more likely it is that paying down the mortgage is worth looking at," he says. "[If you are] expecting a high rate of return, then it makes sense to put the money into something that is going to grow faster."

Banerjee also warns that ignoring the RRSP until the debt is paid off leaves the client vulnerable to other risks outside the market.

By aggressively paying down the mortgage first, the client is sacrificing flexibility. For example, if a client has an emergency, such as a job loss, that requires access to cash, chances are the reason for the emergency would hinder applications for an extension of credit, unless the client has already established a home line of credit. Since you're dealing with a risk-adverse client, insurance would also be crucial to this type of investment strategy.

The majority of clients carry debt *and* need to accumulate assets, which is why the standard approach is to make the RRSP contribution first, then redeploy the income tax refund toward paying down debt, according to Ted Rechtshaffen, president of TriDelta Financial Partners.

"Mortgage debt is a funny thing," he says. "It is a major psychological debt. Some people hate debt and want to pay it down as soon as possible. Some are more comfortable with it. Our view is that debt is part of the financial equation. If you are someone who is earning $40,000 plus, you should definitely be putting money into your RRSP first."

He says it will be pretty tough to get an immediate rate of return that will be larger than the refund, so he suggests putting money in the RRSP, then using the refund to pay down the mortgage. Younger investors in particular need to make use of the tax deferred growth in the RRSP because their longer time horizons allow them to ride out volatility.

"For someone who is younger, taking your refund and buying a Nintendo Wii is not a good financial strategy. If you get a refund and you have a mortgage that's 6%, pay off the mortgage. There is no tax deductibility on that mortgage. If you use the refund to pay it off, for every dollar of principal you pay off, you are getting a 6% return after tax," he says.

Scott Plaskett, a CFP and president of IRONSHIELD Financial Planning, commonly uses the same strategy, but he says he gauges RRSP contributions based on his client's tax rate. The lower the income tax bracket, the more he considers using debt reduction over an RRSP, because in proportional terms, the tax advantage of the RRSP is not as advantageous as paying off the debt.

"Generally, we will look at a strategy where we put money into the RRSP and then simply use the refund that is coming from taxes and put that into debt," he says. "There is no cardinal rule because tax rates are different, so it really depends on your tax situation. For low-income earners, depending on the interest rate level, I look at paying down the debt first."

Plaskett says he understands why clients have a tendency to want to pay down debt in a low-return environment — they know for sure what the benefit will be. He stresses it should always be a long-term view of the client's financial plan that dictates the decision to choose debt reduction over the RRSP.

"I see where they are going with that argument, but a lot of that is short-term thinking. Short-term thinking is just not the way to invest," he says. "It's got to be a long-term financial plan that directs your decision making."

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(02/25/08)