HOW TO INVEST FOR RETIREMENT WITHOUT CRACKING YOUR NEST EGG

By Randy Perram

Investing for retirement – it's a novel concept. We've all seen the advertising of the happy couple sipping hot coffee while watching a sunset. Or how about the retired couple, dancing all night on their Caribbean cruise. A little on the corny side but it does beg the question – will that be me some day or will I miss out?

Whatever your retirement dream is, it can only happen with some forethought and a little planning. Without a game plan you're much more likely to *crack* your nest egg; you could fall short of your potential or even destroy your life savings.

Rising costs and shrinking government benefits are making it increasingly challenging for Canadians to build a nest egg that will let them retire in style. If you plan to retire earlier than the "standard" age of 65, the challenge becomes even greater. It doesn't mean you have to give up your dream of early retirement.

With careful planning and some special strategies, you can overcome the hurdle of fewer income-producing years to enjoy a prosperous early retirement. The planning begins right now.

CHANGING EXPECTATIONS

Retiring early means you'll need to re-assess some of the assumptions of your current retirement savings plan. For example, if you belong to a company pension plan, how will it be affected? Depending on the specific plan, the pension payment to which you're entitled could be significantly lower than what you have counted on. With less time to earn employment income and accumulate savings, you will need to make your investments work harder for you to make up the difference.

THE "GOLDEN RULE"

The golden rule of saving for retirement is to shelter income from tax as much as you can, for as long as you can. Many people believe that nothing beats a Registered Retirement Savings Plan (RSP) for maximizing long-term savings. Regardless of when you retire, you can leave your RSP intact until the end of the year in which you turn 69 (the 2007 Federal Budget has proposed an increase to age 71). Then, if you convert to a Registered Retirement Income Fund (RIF), you only have to take out a government-imposed minimum amount each year.

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In the meantime, a good strategy may be to use your non-registered savings to provide the income you currently need. The advantage you'll gain from doing so is that your tax-sheltered savings can continue to accumulate, tax-deferred, for a longer time period. For example, you may want to rely primarily on non-registered savings early in your retirement and then use the bulk of your registered plan savings in your later years. If the income from your non-registered portfolio comes in the form of capital gains or Canadian source dividends, there's another advantage – preferential tax treatment.

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INVESTING TAX-EFFICIENTLY

It's important to ensure your non-registered savings are invested as tax-efficiently as possible. All investment earnings and realized capital gains must be included in your taxable income each year. What is your best choice for non-registered investing? Consider equity investments that generate capital gains and Canadian source dividend income.

Here's why:

- Retirement is a long-term savings goal. Historically, equity investments have produced higher returns over the long term than fixed-income and cash-type investments.
- You aren't taxed on capital gains until you realize the gain by selling (or otherwise disposing of) the investment. This means you can defer tax on any gains by holding on to your investments for the long term.
- Only half of capital gains are included in your taxable income under current tax laws. By contrast, interest income is 100% taxable.
- Dividend income from Canadian companies qualifies for the Dividend Tax Credit. As a result, dividends from Canadian companies are also a tax-favorable way to receive investment income.

While equity investments are a good choice for long-term investing, always keep in mind that diversification is vital to your portfolio in order to reduce risk. Make sure your total portfolio (both registered and non-registered) has a combination of stock, bond and cash investments that are appropriate to your retirement goals and the level of risk you are comfortable with.

OTHER SOURCES OF INCOME

You should consider other ways to maximize your retirement income in addition to your RSP and non-registered investments.

Have a careful look at the following possibilities:

Life insurance: Certain insurance products, such as whole life and universal life insurance, offer an investment component in addition to the life insurance protection they provide. While your premiums are paid with after-tax dollars, policies can be structured to allow your savings to grow tax-free.

Spousal RSP: If you're married or have a common-law partner, a spousal RSP can help equalize incomes in retirement. This can lower the total tax payable by the couple (pending legislation regarding income splitting could eliminate the need for spousal plans).

Reverse mortgage: If you have substantial equity in your home, a reverse mortgage can provide a tax-free source of income. Of course, this advantage must be carefully weighed against the loss of equity in your home.

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Now that we understand some of the basics of structuring a retirement plan the next step is to build a portfolio to match your needs. Your goals and objectives are going to change as you get older and closer to your retirement date.

So the question now becomes: "How much money will I need to sustain my lifestyle in retirement?" This is a very difficult question to answer if you are in your 20s and just starting to accumulate wealth; retirement is still a far-off concept with little relevance to your daily life. On the other end of the spectrum, people in their late 40s and 50s tend to have a better sense of this number. Either way, there are some common questions and criteria we can use to determine the money you'll need. The next question is: "When would I like to retire?" This is a key variable in determining your retirement projection. If we examine these two questions together, we can calculate the amount of wealth needed for retirement, as well as your savings rate and the average portfolio return required to reach your goals.

No matter what stage of life these variables need to be established:

1. Annual income in retirement
2. Current portfolio value
3. Number of years to retirement
4. Annual contributions up until retirement
5. Portfolio value at retirement
6. Average annual rate of return required to reach retirement goals.

PUTTING TOGETHER A PLAN

I'm going to profile two fictitious people from different stages of life and give examples of what to expect when planning for retirement.

The first is John: he is 27 years old. He graduated with a degree in business and is just starting his career as a marketing manager. He has paid off his student loans and has opened his first investment account with $20,000 in accumulated savings. He plans on contributing at least $10,000 per year to his retirement portfolio. He would also like to retire by age 60.

Beginning portfolio value	$20,000
Number of years to retirement	33
Number of years in retirement (age 90)	30
Rate of return before retirement	8.0%
Rate of return after retirement	6.0%
Annual income from portfolio in retirement	$50,000
Portfolio value at retirement (age 60)	$2,957,366

As you can see John has time on his side and the power of compounding. John simply needs to maximize his RRSP contribution every year and his retirement goals will be largely met. Notice that I have used a conservative rate of return before retirement and deliberately lowered the risk in the portfolio after retirement. John doesn't need to take on an inordinate amount of risk to succeed. This is a great starting point for John. His life will no doubt change as he gets married and has children. He may even start a business one day. His retirement plan needs to be revisited whenever his circumstances change.

Bob and Cindy are both 48 years old. They have three children: Anthony, Laura and Megan. Bob is a successful engineer and Cindy is also successful as an HR manager at a large manufacturer. Bob has saved $250,000 in his RRSP and Cindy has saved $150,000 in hers. They have already set aside money for their children's' education. They plan to maximize their RRSP contributions and can afford to save an additional $10,000 each in their joint non-registered account. They currently plan on retiring at age 60, and they anticipate drawing

$75,000 per year from their portfolio. The income from their pensions together with income from their retirement portfolio will more than provide the lifestyle they have become accustomed to. They are prepared take on some additional risk to help achieve their goals and are targeting a rate of return of 9% in the years before retirement. They plan to reduce their risk exposure during retirement.

Beginning portfolio value	$40,000
Number of years to retirement	12
Number of years in retirement (age 90)	30
Rate of return before retirement	9.0%
Rate of return after retirement	6.0%
Annual income from portfolio in retirement	$70,000
Portfolio value at retirement (age 60)	$2,115,075

Clearly, Bob and Cindy will achieve their dream of a retiring early and living a very comfortable lifestyle. Those were a couple of examples of how a simple retirement plan can be the difference in retiring on your own terms.

Think in terms of your own situation and ask yourself this: "Do I have an adequate retirement plan in place today?" If you are unsure, contact a trusted financial advisor and have them put together a plan that works for you.

"The idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely. Yet the market is full of people who think they can do it and full of other people who believe them.

This is one of the greatest mysteries of finance: Why do people believe they can do the impossible? And why do other people believe them?"
Daniel H Kahneman
Nobel Laureate 2002

Source: Dow Jones Asset Management; Nov\Dec 1998

Before you design your retirement plan you have to decide if you are an *investor* or a *speculator*. An *investor* participates in the positive growth of capital markets and never takes on uncompensated risk. Not all risk is risk worth taking. We know that a balanced portfolio diversified throughout the different asset classes will deliver 8% to 10% over the long term. In our examples both John and Bob and Cindy required a return that a diversified portfolio delivers.

On the other hand, a *speculator* will try to outsmart the market. He'll look for the "hot tip" or try to time the highs and lows. The futility of speculation is good news for investors. Speculators keep the market efficient and prices fair. It certainly is possible to outperform the market but not without accepting greater risk. When you reject speculation, investing becomes a case of identifying risk that is worth taking.

The prudent investor realizes that trying to outsmart the market is futile and concentrates on what he can control such as high fees, high turnover and uncompensated risk. Recognizing this fact, and coupling it with a solid plan to achieve your financial goals, will make it much easier for you to live the retirement you've always wanted. ■