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An affluent but not rich couple have adult children and no mortgage. The couple need a strategy that will allow them to top up their RRSPs and provide for medical expenses while preserving their comfortable lifestyle

By Catherine Harris | August 2014

"Financial Checkup" is an ongoing series that discusses financial planning options. In this issue, Investment Executive *consulted with Margaret Cameron, a registered financial planner and president of Cameron Leadership Development Inc. in Ottawa; and Mick Jackson, branch manager and senior financial planner with Assante Capital Management Ltd. in Sarnia, Ont.*

The scenario: Sandra and Tom are 50-year-olds in Sarnia. They are turning their attention to retirement savings now that their two children have just finished university and the mortgage has been paid off.

Tom is an engineer who earns $100,000 annually; Sandra earns $40,000 as a receptionist for a medical doctor.

Neither spouse has RRSPs because of their focus on getting their children through university and paying off the mortgage. The house is worth about $400,000. However, the couple do have $25,000 in a savings account for unexpected expenses.

Tom has $330,000 in unused RRSP room; Sandra, who took 15 years off to raise the children, has $50,000 in unused room.

The couple also have a term-65 insurance policy of $200,000 for Tom. In addition, Tom has disability insurance through his employer. Neither spouse has critical illness (CI), long-term care (LTC) or enhanced medical insurance. Both Tom and Sandra are non-smokers in good health.

The couple have been spending about $70,000 annually after taxes, excluding mortgage payments and their children's education expenses. The couple would like to continue to do so. That should leave them with $38,000 in excess income that can be saved.

Tom and Sandra want to know if they can reasonably expect to retire at age 65 and spend $60,000 after taxes in today's dollars to age 80. After that, the couple would like to spend $50,000 from age 80 to 95. They also want to ensure that they won't become a burden to their children if one or both spouses require expensive medical care at home or in an institution.

The couple are not concerned about leaving an estate for their children, although they would be happy to do so. They have wills and powers of attorney for property and medical needs in place.

The recommendations: Both advisors say that if Sandra and Tom save as they plan to, they should be fine. But there isn't a lot of wiggle room, adds Jackson, so it's going to take a lot of discipline.

Cameron agrees, noting that it's hard for people to go for years without at least some "treats." A few indulgences will be possible - but not a lot. Allowing $3,000 annually for extras could provide a lift when needed.

Assuming an average annual rate of return on investment (ROI) of 5% after fees and annual inflation of 3%, Cameron's projections indicate that Tom and Sandra should put at least $30,000 in today's dollars into RRSPs and put the tax rebate into a tax-free savings account (TFSA). In theory, that would leave the couple with $8,000 to spend annually. But, in Cameron's opinion, that's much too close for comfort. She strongly suggests that the couple put the full $38,000 in excess income into the RRSPs most years and make sure that, on average, they are putting in $35,000 annually.

Cameron points out that Sandra and Tom will have the option of selling their house at some point in retirement. If the couple downsize, that would give them additional investible assets that can produce extra income. If the couple decide to rent, there would be even more investible assets.

Jackson's projections also assume an average ROI of 5% a year, but he assumes annual inflation of only 2%. That, however, is offset by the inclusion of around $9,400 in annual insurance premiums (details below) that would be paid out of capital. This results in the need for minimum annual RRSP contributions of $34,000, but also allows for some treats. Jackson agrees with Cameron's suggestion to put the RRSP tax rebates into TFSAs: "It's clean and simple."

This discipline will have to continue when Tom and Sandra are retired. Once they have maxed out their RRSPs and TFSAs, Jackson recommends that the couple put the excess income into a joint non-registered account and invest the assets in corporate-class mutual funds, which allow unitholders to switch among a number of funds without triggering capital gains taxes. Cameron agrees with that suggestion.

Jackson does not recommend a spousal RRSP because Sandra and Tom will be able to split the income from their RRSPs or registered retirement investment funds and other pension income once they start receiving it.

However, Cameron thinks there are other reasons, apart from income splitting, to consider using spousal RRSPs. That strategy would give Sandra the psychological comfort of having access to those assets - and there's always the possibility that a future federal government could change or even eliminate the current pension income-splitting rules.

The advisors also differ on how the TFSAs should be used. Cameron suggests these accounts be used as both emergency funds and tax-sheltering vehicles. That is, the couple should keep an appropriate amount of emergency savings in the TFSAs invested in an easily accessible, high interest rate savings account, with the balance of the assets invested for long-term growth.

However, Jackson feels the TFSAs should be used entirely for tax-sheltering. He prefers that any emergency savings, including the current $25,000, be placed in a non-registered account.

The advisors don't agree on when Sandra and Tom should start taking Canada Pension Plan (CPP) benefits. Jackson advises starting at age 60 - the theory being that a "bird in the hand" is better than a potentially larger bird down the road.

Cameron suggests the couple wait to claim CPP until they retire, both because their benefits will be higher and also to avoid dipping into the income from the CPP. However, if the couple turn out to be very disciplined and commit to saving that income, Cameron says, taking the CPP beginning at 60 would be acceptable.

Sandra and Tom won't be able to draw old-age security (OAS) until they are 67, due to recent changes affecting OAS entitlement. Both advisors suggest that's when the couple should start collecting it.

Both advisors also think the couple need more term life insurance for Tom to ensure that if he dies prematurely, Sandra has enough assets to have a comfortable retirement. Cameron suggests another $150,000; Jackson recommends an additional $330,000. The cost of the latter would be about $75 a month.

Cameron doesn't see any need for term insurance for Sandra. However, Jackson suggests a $107,000 term-15 policy for Sandra, which would cost about $25 a month.

Both advisors think CI and LTC insurance are worth looking into. This is particularly true of LTC, given the couple's desire not to be a burden on their children. Jackson obtained a quote for a $100,000 term-15 CI policy, which would cost about $140 a month for Tom and $110 a month for Sandra. LTC policies that pay $2,400 a month would cost $90 a month for Tom but $120 for Sandra, due to longer life expectancies for women.

Jackson thinks enhanced medical insurance is even more important than CI or LTC. That's because the cost of prescription drugs can be enormous. The cost of such insurance for a policy covering both spouses would be around $220 a month. (Note that Jackson has included the costs of all these policies in his projections of the couple's expenses.)

Cameron didn't include premiums for additional insurance in her projections. She suggests the couple could either pay such premiums out of any excess income or rely on selling their house if they are faced with high medical costs.

Outside of making sure the couple's wills and powers of attorney are up to date and that the spouses are each the other's RRSP beneficiary, there isn't much Tom and Sandra need to do at this point from an estate planning perspective. However, Jackson suggests, the couple should consider prepaying for their funerals. Not only does this ease the burden on the children, but such prepayments are invested in fixed-income investments and, over a long time horizon, sometimes return money to the estate.

Jackson suggests an aggressive asset mix for the couple's investments of 70% equities/30% fixed-income. Cameron favours starting with balanced mutual funds, then moving to a 60% equities/40% fixed-income asset mix.

Jackson notes that a 70/30 asset mix might well return more than 5%, but he goes with conservative return assumptions so that long periods with weak returns are covered.

Both advisors suggest well-diversified investments, in terms of geographical areas, sectors and management styles. Jackson recommends investment pools that would achieve this; Cameron suggests mutual funds.

Cameron also suggests that Tom and Sandra consider an annuity when they are 65 years old to cover their basic shelter and food costs - assuming interest rates rise. With interest rates currently very low, the cost of an annuity would be very expensive.

Jackson isn't a fan of annuities because "they die when you die." However, if Sandra and Tom really want an annuity, Jackson suggests a guaranteed annuity, which returns the principal if the annuitant dies before a specific age.

Jackson's compensation comes from trailer fees on investments he manages for clients.

Cameron, who doesn't invest for clients, charges $250 an hour, resulting in a total fee of about $1,500 for a plan such as this.

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