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TAX-EFFICIENT INVESTMENT STRATEGIES FOR EVERY LIFE STAGE: THREE CASE STUDIES

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Jordan Dancey has just started his first full-time job. Bill and DeeDee Williams are in their 50s, juggling saving for their retirement while putting their kids through university. Joe Connors is retiring at the end of the year. Different life stages, different priorities—what are the most tax-efficient investment strategies for each stage of life?

Starting out

Jordan Dancey just graduated and has landed his first full-time job. He's moved to Vancouver with a roommate. He has a large student loan but no other debts. Jordan knows it's important to save for the future, but he'd also like to buy a house or condo in the next five years. In Vancouver's housing market, he'll need a down payment of approximately $30,000 to buy a condo the size of his parents' basement.

Peter Drake, vice-president of retirement and economic research with Fidelity Investments Canada, states, "This is a good opportunity to learn that financial decisions usually involve several issues, both long and short term. The student loans should be paid off, but starting to save for retirement—even if only a small amount to start—ingrains the habit of saving and takes advantage of the power of compounding."

Rona Birenbaum, CFP with Queensbury Strategies Inc., advises Jordan to pay off his student loan but to not lose sight of his retirement planning. Since interest paid on student loans can be tax deductible, Jordan should focus on paying off any non-deductible loans first. She suggests Jordan max out any employer-sponsored programs, such as pension plans, RRSP matching programs or share ownership plans.

"Traditional investment wisdom states young people should invest heavily in equities," says John Cairns, Chartered Financial Analyst (CFA) with Scotia Private Client Group, "but I disagree. Young people often have short-term vision—they want the car or the house. Rather than investing heavily in equities, they should stick with low-risk investments to preserve whatever capital they can scrape together."

With the $5000 annual contribution limit, Jordan could save $30,000 in approximately six years if he invests in a Tax-Free Savings Account (TFSA)—if he can max out his contributions. Cairns thinks setting up pre-authorized withdrawals to contribute to a TFSA is the best investment choice, because the money is "out of sight, out of mind. People don't miss what they don't see in their bank account. RRSPs may not make sense for Jordan since he intends to withdraw the funds in a short time, although he could take advantage of the Canadian Home Buyers' Plan as a first-time homebuyer."

While life insurance premiums are very inexpensive if the insured is young, buying life insurance may not make financial sense, although the cash value in a life insurance policy can be used for collateral in the future, says Dan Burjoski, CFP, CLU with Dundee Wealth Management. If there is no house and there are no dependents, it might make more sense to invest in critical illness insurance. "Critical illness insurance provides six to 12 months of income while you receive treatment. Regular contributions to a TFSA could serve the same goal, while providing some investment opportunities, since the TFSA's flexibility allows the investor to use it for any purpose."

If Jordan does have money to invest, Cairns and Birenbaum recommend investing in corporate class funds for non-registered investments, after he has maxed out his employer-sponsored programs and registered plans. Corporate class funds can be tailored to the client's investment risk tolerance. The funds provide the most tax-efficient basis for investing, because an investor can rebalance a portfolio by switching between class funds with different investment objectives without triggering capital gains. Investors receive taxable income from traditional asset classes (including traditional mutual funds) in the year the income is earned. Corporate class funds can provide tax-deferred growth through the potential for reduced taxable distributions and the resulting compounding effects on asset growth.

The middle years

Bill and DeeDee Williams are in their early 50s, and both work full-time in well-paying jobs. They have three children in university, and DeeDee's elderly mother lives with them. DeeDee is an only child and has been sole caregiver to her mother for several years. Bill and DeeDee are struggling to save for retirement and meet all their financial obligations.

Cairns says that the middle years are when people earn the highest income and have the highest expenses. From age 50 to 65, people typically should focus on financing their eventual retirement, and Cairns advocates a top-heavy equities investment strategy if the client's risk tolerance will support it. "If people haven't saved enough for retirement, they still have time to adjust their retirement plan and work longer. Investing in equities as much as the client's risk tolerance will bear will help grow the contributions."

Drake adds, "It's time for big-picture thinking about retirement. What do the couple want to do when they retire? Could their retirement vision include working in retirement? What risks could their retirement income face? They need an asset allocation strategy that will give them the returns they need but will let them sleep at night."

To maximize tax efficiency, Cairns advocates insurance-based products, such as a universal life policy with an investment component or, if the client is more risk averse, a segregated funds contract with a guarantee. Bill and DeeDee had purchased term insurance to cover the mortgage, but are considering switching to a whole life policy with a wealth accumulation component. DeeDee has been looking into long-term care for her mother, and she was shocked at the cost. The couple are now considering purchasing long-term care insurance.

Drake adds DeeDee needs to ensure that she is applying for and receiving the Family Caregiver Amount tax credit. She also needs to look into the availability of in-home support programs, which can help defray some of the caregiving costs and help manage DeeDee's commitment to supporting her mother.

Financial planner Tony Mensch, CFP, adds Bill and DeeDee need to ensure any interest-bearing investments are held in registered products. Michelle Munro, director of tax planning with Fidelity

Investments Canada, adds that if their desired fixed-income exposure exceeds their contribution room, capital yield funds are a good alternative. Capital yield funds provide investors with the returns of a fixed-income fund less transaction and hedging costs, realizing tax-efficient capital gains rather than interest.

Mensch would also recommend corporate class funds over regular mutual funds because of their tax-deferral benefits. In addition, it makes sense for the couple to pay down their mortgage. “It’s a guaranteed rate of return. RRSPs can bring down current taxable income, but you have to remember that when you start withdrawing from them, they are taxed as income at the marginal tax rate. It’s important to talk to your financial advisor about tax-efficient income withdrawal strategies.”

Birenbaum adds, “This is the time for Bill and DeeDee to prioritize their financial decisions. If they have to pay [for a child’s] tuition, they may have to cut back on RRSP contributions. Adding an insurance product to their portfolio to cover the eventual estate costs, especially one with a wealth accumulation component, would be a good choice.”

Retirement

Joe Connors plans to retire at the end of the year at age 65. He’s worked in the oil industry all his life, his house is paid for and he has a company pension he contributed to for 40 years. He also has some non-registered investments. His group health coverage ends when he retires. He’s a widower, and he has two married daughters and three grandchildren that are the light of his life. He wants to ensure he has enough money to live on in retirement, but would like to leave some money for his family when he dies.

Burjoski quips, “As people reach the end of their life they have two concerns: Will I be remembered? And will I have to eat cat food to survive? People underestimate how long they may live.” He advocates having a portion of net worth in life insurance products, either term, whole life or universal life. If the client can afford it, long-term care insurance is a good investment. “People are far more likely to move to a long-term care facility at this stage in life than to need critical illness insurance. It’s expensive, but it’s not as difficult as watching your hard-earned savings disappear as you pay for a nursing home.”

Drake recommends closely examining how much an investor can safely withdraw from their savings. The risk of large out-of-pocket health care costs is only one potential risk an investor could face in retirement. “The first thing to think about is withdrawal rate risk—keeping the annual inflation-adjusted withdrawal rate low enough to ensure sustainability of the portfolio and to ensure those investments are withdrawn in the most tax-efficient way possible. Investors need to also consider inflation risk. Even a low, 2% annual rate—about what we’ve had over the past 20 years—will erode approximately 40% of the [portfolio’s] purchasing power over a 25-year period.”

Cairns advocates leaving approximately 25% to 30% of investments in equities even at retirement, because there’s still a need for growth to offset the withdrawals that now take place. “If you’re too conservative, withdrawals will deplete your capital faster than your investments can recover, especially when there are no further contributions being made.”

Mensch sees the loss of group health benefits as a major concern for Joe. Medical costs increase as people age and Joe may not have budgeted for the additional cost. “A TFSA is a tax-effective alternative to private health insurance to cover medical and dental costs when the group plan ends.”

Burjoski has seen a resurgence in annuities as the stock market remains volatile. Annuities provide a lifetime income with minimum clawbacks to income-tested government benefits such as CPP and OAS. Joe needs to understand that annuities provide income during his lifetime, and do not provide residual value after death. Munro adds another option is the tax-efficient systematic withdrawal program (T-SWP) that is offered on mutual funds. T-SWP is a cash management strategy that provides monthly payments by drawing on the cost of the investment first. Most of these payments are characterized as return of capital (ROC). Since ROC payments are not included in taxable income, they won't trigger any clawback on income-tested government benefits. The investment continues to grow if the return on the investment exceeds the withdrawal rate, which can provide residual value for the estate.

Because Joe has no spouse, any funds remaining in his portfolio will be taxed as income to his estate when he dies. Joe's children may not be aware they need to have enough funds to pay the final taxes on his estate. Birenbaum and Burjoski both suggest paying probate fees on at least a portion of the estate. The easiest way to achieve this is to make the estate beneficiary for some of the proceeds. Birenbaum says, "It's easier to pay a probate fee than to try to get money back from someone to pay the taxes."

Jordan, Bill and DeeDee, and Joe are at different stages in their lives, but with simple choices, they can achieve their short- and long-term financial goals.

At a glance: Investment strategies for every life stage

Life stage	Investment strategies and other considerations
Starting out	• Balance long- and short-term goals by maxing out any employer-sponsored programs, such as RRSP matching programs or share ownership plans. • TFSAs invested in low-risk investments for short-term goals, and investments with higher return potential for longer-term goals (depending on risk tolerance), are recommended. • Consider investing in corporate class funds for non-registered investments. • Insurance isn't essential unless there are dependents. • Balance paying off student loans with saving for a house and planning for retirement.
Middle years	• Depending on risk tolerance and investment horizon, investments should be heavily weighted in equities for long-term growth. • RRSPs and TFSAs are recommended to maximize tax savings and hold tax-inefficient investments such as interest-bearing securities. • Consider capital yield funds for additional fixed-income exposure outside of RRSPs. • Consider term insurance to cover mortgage and expenses. • Pay down mortgage to build home equity. • Build RRSP savings and start planning for future tax-efficient income withdrawals. • Start planning to counter the key risks to retirement income.
Retirement	• Maintain some equities to provide capital preservation. • Consider T-SWP plans as an alternative to annuities to provide tax-efficient cash flow with minimum clawback to government benefits.

	• Capital yield funds could be considered for fixed-income exposure to take advantage of capital gain tax treatment. • Consider long-term care insurance. • Estate will be responsible for final taxes. Consider naming the estate as beneficiary for a portion of the portfolio to ensure funds for taxes owing are in the estate.