New divorcée has to cut back on spending to meet goals

Client is having trouble keeping within her income because she is used to spending freely now that her children are independent

Wednesday, March 31, 2010

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"Financial Checkup" is an ongoing series that discusses financial planning options. In this issue, Investment Executive speaks with Chris Ball, a certified financial planner, Canadian investment manager, fellow of the Canadian Securities Institute and financial planner with ***Assante Capital Management Ltd.*** *in Halifax; and Treena Nault, CIM and consultant with* ***Investors Group Inc.*** *in Winnipeg.*

The Scenario: Jill, a 55-year-old executive assistant in Winnipeg who earns $50,000 a year, is in the process of being divorced. She had not bothered with RRSP contributions because she had figured the pension of her 60-year-old soon to be ex-husband — worth about $60,000 annually, in today's dollars — and his inherited financial assets of $500,000 would give the couple a sufficient income in retirement — particularly because the mortgage on their $500,000 house was fully paid off.

Jill has $90,000 in unused RRSP contribution room, partly because she took 15 years off work between ages 25 and 40 to bring up the couple's three children.

Jill's husband has retained the house, which she couldn't afford to keep, and has agreed to a settlement of $500,000, which Jill expects to receive around the middle of this year. She has been renting an apartment for $1,500 a month for the past nine months and is having trouble keeping within her income because she now is used to spending freely because their children are now financially independent. Jill has incurred $10,000 in credit card debt since moving into her apartment six months ago.

Jill expects she will need to replace her five-year-old car in the next two to three years. She has medical and dental benefits, as well as disability insurance, through her employer, but no pension.

Her parents, both in their 80s, are in nursing homes, so Jill doesn't expect an inheritance. She isn't concerned about leaving money to her children but doesn't want to bur-den them with the cost of caring for her in her old age.

She wants to know how much she can afford to spend, after taxes and in today's dollars, to age 95, and whether she can increase that amount through financial planning. She knows nothing about investing.

The Recommendations:
Both Ball and Nault recommend that Jill work to age 65. Even if she does that, she will still have to cut back on her current spending, which amounts to approximately $60,000 a year. Her current annual income, after taxes, is less than $40,000. (All figures are in today's dollars unless stated otherwise.)

Both advisors have assumed a 6.5% average annual return, after fees, in their projections. They both recommend that once Jill receives her divorce settlement, she should pay off her credit card debt, put aside money for her next car purchase and make a $90,000 lump-sum RRSP contribution to use up her unused room.

Jill can carry forward the RRSP tax deduction for the $90,000 lump-sum contribution, using it over a number of years, both advisors note. Ball suggests she claim $19,000 this year and in each of the next three years, then claim $14,000 in the fifth year.

Ball also suggests that Jill ask her employer to adjust the amount of income taxes deducted from her salary based on this RRSP claim schedule. This would give Jill almost $500 more to spend a year for the first four years and $333 more in Year 5. Nault agrees that this is a good idea.

Regarding annual expenditures, Nault's numbers suggest Jill can spend only $29,400 a year to age 95 if she retires now. (Ball's figure is $27,400.) If Jill retires at age 60, Nault believes, she could spend $35,520. (Ball says $35,400.) If Jill waits until 65 to retire, Nault thinks she could spend $41,390. (Ball says $46,750.)

The main reason Nault's projection for retirement at age 65 is lower is that she has factored in lump sums of $20,000 for new vehicle purchases every eight years.

Ball has allotted just $25,000 (which will come out of the divorce settlement) for Jill's next vehicle purchase, and he assumes Jill will pay for her subsequent cars from her income.

An annuity that provides Jill with an income that covers her basic expenses is critical, Ball suggests, because it will provide Jill with peace of mind. She will be reassured by knowing that this tax-efficient income stream is guaranteed and consistent on both a pre- and after-tax basis and is not subject to any market risk. When Jill stops working, she will need to reduce her market risk.

Ball recommends that when Jill retires at age 65, she buy an annuity that gives her $32,000 a year. He notes that annuities are tax-efficient, pointing out that only $10,000 of the $32,000 Jill would receive each year would be taxable. That should ensure that her taxable income is never high enough to be affected by clawbacks of her old-age security or her age tax credit.

Ball suggests that Jill put $10,000 into a tax-free savings account when her divorce settlement arrives; he also recommends that Jill continue to make maximum TFSA contributions each year out of her capital until she is 65. When she retires, much of her non-registered assets will be used up by the purchase of the annuity. However, if there is money left over, she should continue to make

maximum TFSA contributions. Jill should also make maximum RRSP contributions while she's still working, as they would reduce her taxable income, Ball recommends. He notes that Jill is in a higher tax bracket now than she will be in retirement and, thus, needs the tax credit now.

Jill should reduce these contributions only if it looks like she won't have sufficient funds to buy the annuity, which will cost $468,000 in 2020 dollars. Ball notes that Jill will need a return of just 1.6% a year to be able to buy the annuity he is recommending, so the odds are Jill would be able to make these contributions.

Nault doesn't think all of Jill's non-registered funds should be tied up in an annuity because that wouldn't leave her any flexibility with her money. For instance, Jill wouldn't be able to make any big purchases, such as a trip or gifts.

Using only some of Jill's investments to buy an annuity or a segregated fund with a guaranteed minimum withdrawal benefit ensures that she has a certain guaranteed income for life, but this strategy still allows her the flexibility to draw on her funds if and when she needs them.

Nault recommends that Jill make sure she uses all of her non-registered investments to make maximum contributions to a TFSA until she is 95 — and to use only a portion to buy an annuity or a seg fund with a GMWB.

Nault also disagrees with Ball about making more RRSP contributions instead of allocating the assets toward a TFSA.

"It's better to have as much money as possible in a TFSA," Nault says, "because withdrawals are completely tax-free, while RRSP withdrawals are taxable. Why pay taxes when you don't have to?"

Both advisors say Jill shouldn't need to make RRSP withdrawals until age 72, when she will be required to do so by law. This will ensure maximum compounding in her RRSP and delay the payment of taxes until money is withdrawn from the RRSP-turned-RRIF.

In Nault's projections, Jill would move $250,000 in 2020 dollars into an annuity or a seg fund with a GMWB when she retires at 65. With this, Jill could get an annuity that would give her $18,400 a year, or a seg fund with a GMWB that Nault suggests would pay Jill $12,500 for the first 10 years of retirement and $15,000 for the following 20 years.

Annuities and seg funds with GMWBs have both pluses and minuses, says Nault. Annuities pay more and shelter some income from taxes; but unlike seg funds, annuities don't have the ability to reset income based on the growth of the underlying assets. The annuity payments may also stop at a certain age, so a life insurance policy must be bought if there's desire for some residual value at death.

A seg fund with a GMWB has the potential to increase income through the deferral of bonuses that are paid out every five years, or by resetting the base income through purchasing additional riders every three years. There's also the potential for a death benefit payout, and capital can be accessed at any time — although that will lower the income received and make the policyholder ineligible for deferral bonuses.

Both advisors recommend that Jill apply for the child-rearing provision under the Canada Pension Plan, which will increase her pension because it will add back in 13 of the 15 years she was out of the workforce while raising her children.

Ball and Nault also suggest Jill split her pension credits with her soon to be ex-husband, as that will also increase her pension benefit. CPP rules allow married or common-law couples to pool their pension credits and split them. The longer the couple has been together and the greater the difference between the two incomes, the more valuable the pension credit splitting.

Nault suggests Jill purchase a long-term care insurance policy that would pay $500 a week for either home or institutional care for 250 weeks (4.8 years), costing $129.11 a month and paid for over 20 years. Nault also suggests extended health, dental care and travel insurance when Jill stops working, which would cost $125 a month. (Nault's overall projections take these premiums into account.)

Ball recommends similar LTC insurance and extended medical policies.

Neither advisor recommends critical illness insurance because, as a single person renting an apartment, Jill could get by without it. Besides, the cost of this type of insurance would be prohibitive for her.

Both advisors would have to sit down with Jill to get a feel for her risk tolerance regarding her investment portfolio. But based on a moderate risk tolerance, Nault suggests a 60% equities/40% fixed-income asset mix. She suggests the funds be invested in a managed mutual fund portfolio based on a strategic asset-allocation model rather than individual securities because Jill doesn't have any investment experience.

On the equities side, half of the portfolio's assets would be in Canadian stocks and the rest split between U.S. and international equities. Corporate-class funds would be used for the non-registered assets to defer taxes until the assets are moved to Jill's TFSA over time.

Ball agrees that Jill's lack of investment experience precludes her making investment decisions. He recommends a 50% equities/50% fixed-income weighting in Jill's RRSP and suggests putting those assets into a managed pool portfolio that uses a strategic asset-allocation approach and automatically rebalances on a periodic basis.

The equities portion would be diversified by geography, company size and investment style (growth, value and alpha) and would include hedged exposure to foreign currency.

Non-Canadian investments in the portfolio would include 31% foreign equities and 6% global fixed-income.

The $25,000 set aside from the divorce settlement for the purchase of the next car would be in a mortgage fund that doesn't have a negative one-year return and that yields at least 3%.

The rest of Jill's non-registered assets would be invested similarly to those in her RRSP, but with slightly more exposure to fixed-income (55% vs 50%) because the time horizon will be shorter — the portfolio will be required to support Jill's RRSP and TFSA contributions.

The non-registered portfolio would also incorporate funds for tax efficiency. These allow rebalancing to occur within the portfolio without triggering any capital gains and will also convert interest income to more tax-efficient dividend and capital gains income.

For Jill's TFSA, Ball recommends a high-yielding Canadian income fund, which would yield around 8% and consist of high-yield bonds, preferred shares and real estate trusts and other income trusts. Neither Ball nor Nault would charge a fee for developing, implementing, monitoring and updating Jill's financial plan — provided they were managing the money — because they would be compensated through trailer fees or product commissions (the latter in the case of the annuity).

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