# The big question: what to pay first

## Mortgage, RRSPs and RESPS all demand attention

**BY ANDREW ALLENTUCK, FINANCIAL POST** APRIL 4, 2012

Paying down the mortgage on your home first can free up money for contributions to RRSPs and RESPs.
**Photograph by:** ReMax, handout

It is every family's dilemma: What to pay first — the mortgage, the kids' education or putting something away for retirement? Plan it right and a life free of many financial worries follows. Get it wrong and the kids may not get the education you want and your retirement could be threadbare. You might even be forced to sell your home if interest rates soar before you've paid down the mortgage a lot.

"Pay for the home first," suggests Benoît Poliquin, lead portfolio manager at ExPonent Investment Management Inc. in Ottawa. The reason: Buying your home quickly has financial advantages so powerful and so immediate that it would be foolish to ignore it.

"Look what the homeowner gets," Mr. Poliquin says. "There is the return on equity. That is what the home gains in owner equity every month as the debt declines. The more you pay and the sooner you pay, the faster you gain equity through the mortgage."

There is the possibility of capital gains that, in Canada, are not taxed as long as the home is a primary residence. Moreover, in many cities, price gains more than pay for interest costs, says Graeme Egan, a

financial planner and portfolio manager at KCM Wealth Management Inc. in Vancouver.

On top of probable price gains, there is the tax advantage. Today, if you pay 3.5% on a five-year mortgage and you have a 40% tax rate, your actual cost of paying the mortgage with after-tax dollars is 5%, Mr. Poliquin says. "The rational thing is to pay the mortgage while your income is lower, though it may be harder. As your tax rate rises, the after-tax cost of the mortgage goes up."

Finally, the home offers a rental service, Mr. Poliquin says. That is, what it would cost to rent a similar property. Add it up and the case for paying the mortgage down quickly is compelling.

Next - the kids' post-secondary education. On the one hand, much of the value of education is intangible. But in terms of cost management, there are solutions.

The Canada Education Savings Grant of the lesser of 20% of sums contributed or $500 per year and the supplemental Quebec Education Savings Incentive of the lesser of 10% of sums contributed or $250 per year mean that any contribution up to the specified limits pays instant returns of 20% or 30%. You can lose the terrific boosts or the underlying contribution through bad luck in investments, so the incentive is to invest these funds conservatively.

How much to contribute over years is not hard to calculate. Assume that you have one child, just born, and you want to build up $50,000, which happens to be the lifetime RESP limit per beneficiary. If you can get a 3.5% average annual compounded return in GICs, then to build up that $50,000 takes an annual contribution of $2,130. That works out to $1,775 per year for all provinces except Quebec and $1,638 in Quebec. In 17 years, with those assumptions, the child has $50,000 in RESP savings.

Finally, there is the problem of retirement. You can estimate a cost of living in retirement. That could be today's annual cost of living with education savings or retirement savings taken out and perhaps elimination of mortgage payments after your home is fully paid.

Assume you will need $50,000 per year after tax. Take off what you may get from pensions and Old Age Security, say $30,000 per year for a couple in 2012 dollars. You have a $20,000 annual income gap to fill. Push it up to $25,000 to allow for error or higher tax rates - it's best to budget for a few unknowns. $25,000 is the annual income of $500,000 yielding 5% per year. Your income at the start of retirement will be $30,000 from public pensions and $25,000 from investments, for a total of $55,000. If you manage taxes well and take advantage of certain pension income tax credits, your average tax rate could be as low as 9%. That will leave $50,000 and a little change for spending.

If you have 30 years to go to retirement, you need to save $7,167 per year, or $597 per month, at a 5% rate of interest to get to $500,000. You can take a little more risk than you would with education savings when you have three decades to get your returns. Finding money for RRSP savings may be tough if you are working hard to pay down your mortgage, but income tax actually creates a strategy.

"Just as it makes sense to pay down the mortgage early in your career before your tax bracket goes up and raises the after-tax cost of the mortgage, it makes sense to defer your retirement savings until your salary or inflation push up your tax bracket and give you bigger tax savings," explains Derek Moran, head of Smarter Financial Planning Ltd. in Kelowna, B.C.

In the end, the sequencing of savings turns out to be a problem with rational solutions. Time and tax rates are on your side. Pay down the house and you have money to build up education savings. Hit the $50,000 RESP limit per dependent and then salary gains and relatively large RRSP tax savings are on your side.

"You can add to any category at any time, but this plan is rational allocation," Mr. Poliquin concludes.

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