Don't Invest in an RRSP Before Paying Down Your Mortgage

David Trahair

David Trahair, a chartered accountant, takes a revealing position on some of the common myths perpetuated by the financial services industry. Based on Trahair's experiences with investing clients, he exposes the facts behind such common money issues as:

- the need to have over $1 million to retire;
- the dangers of some types of life insurance;
- why trying to avoid taxes may result in lousy financial decisions;
- the reasons your personal rates of return are not given to you;
- the need to understand mortgage secrets; and
- the dangers of debt.

This book also includes a CD-ROM containing MS Excel spreadsheets that you can use to calculate your own personal rate of return on your RRSP and track your finances.

Trahair contends that you shouldn't contribute to your RRSP until your debts and mortgage are paid off. The following brief excerpt from his book exemplifies the importance of his thinking:

"This question of whether or not it's wise to invest in an RRSP before paying off the mortgage comes up every year. The usual answer is that you should contribute the maximum to your RRSP and use the tax refund to pay down your mortgage. Sounds like a good compromise doesn't it? This way, the finance company gets your investment money and it's up to you to be disciplined enough to actually use the refund to pay down your mortgage. Of course, that's easier said than done.

First of all, you need to be able to afford to pay down your mortgage. In other words, you mustn't need the refund for anything else, such as paying down other debt or taking a much needed vacation. Second, usually you can only pay down a mortgage when the finance company allows you to. Often that's only once a year and is limited to 15 to 20 percent of the outstanding balance. You have to be very disciplined and make sure you put the refund in a safe place until then.

The reality is that investing in an RRSP and using the tax refund to pay down the mortgage is usually not a compromise at all. The people who send this message are, in fact, simply wanting you to invest in an RRSP. Period. I am saying, pay down the mortgage instead. Period.

Another Day Older and Deeper in Debt?

If you focus all your resources and efforts on your RRSP and not on eliminating your debts, you'll probably still be left with those mortgage payments, car loan, or lease payments, and maybe even credit card balances when you retire. I have said it before, but it bears repeating: you will need to save a lot more money for retirement if you have to continue making all those payments.

From the bank or finance company's point of view, of course, your being in debt at retirement is ideal. Think about it. They get commissions and fees on all your RRSP contributions from the time you start to invest until you retire. They lock you into as much debt as possible: a mortgage, car loans or lease payments, credit card debt, and perhaps a home equity line of credit for good measure. You continue paying them even after you retire. That way, they'll also "work the spread" and make money off the deposits from other people who are funding your loans. And if they are winning on both sides of the balance sheet — investments from you and loans to you —who is losing? You guessed it. You are.

An Alternative Strategy

Now, for a radical thought. If paying off all personal debt before you retire is a good idea, why not focus on paying it all off even sooner? Why not forget RRSP contributions altogether until you pay off all debt, including your house mortgage?

Consider the rate of return on your debt with this strategy. For example, suppose you have a house mortgage at 6 percent, a car loan at 8 percent, and a credit card balance at 19 percent. Simply by paying off your debts instead of investing in an RRSP, you can realize a guaranteed after-tax return of between 6 percent and 19 percent, and there is no risk related to this rate of return.

Now, let's consider this strategy in the case of Joe and Karen Hart.

The Harts: Investing in RRSPs Versus Paying Down the Debt

If Joe and Karen continue to spend more than they make, any financial strategy will almost certainly be doomed to failure. But they are determined to get their spending under control, and want to know, therefore, whether they will do better by investing $8,000 a year ($4,000 each) in RRSPs (scenario 1) or paying down their mortgage by $8,000 a year (scenario 2).

They begin their calculations as of December 31 of last year, when they had no credit card debt, and make the following assumptions.

- Cash in the bank will not change since they spend everything they make—but no more.
- The house will rise in value at an average rate of 2 percent a year.
- The RRSPs will grow at an average rate of 5 percent per year.
- The mortgage rate will remain at 6 percent annually.
- Their marginal personal tax rates are 40 percent.
- The tax savings on the RRSP contributions will be reinvested in those RRSPs, i.e. they have sufficient contribution room.

Here is a comparison of the two scenarios after 11 years (see Table 1).

At first glance, the RRSP strategy looks like the winner since the net worth is $45,798 higher. But the Harts have to look closer than that. If they ignore the cash and the house value (since they are the same in both cases), the RRSP scenario shows a total RRSP value of $256,774, less mortgage debt of $119,002 for a net amount of $137,772. The debt pay-down scenario shows a total RRSP value of $91,974, with no mortgage. The difference is the $45,798, but there are other important factors to consider.

Table 1

	31 Dec (last year)	Scenario 1 31 Dec (Year 11: RRSPs)	Scenario 2 31 Dec (Year 11: debt paid)
Assets	$	$	$
Cash in bank	714	714	714
House (principal residence)	275,000	341,928	341,928
RRSP: Joe (market value)	36,900	145,512	63,112
RRSP: Karen (market value)	16,875	111,262	28,862
Total Assets	329,489	599,416	434,616
Liabilities			
Household mortgage	200,000	119,002	0
Total Liabilities	200,000	119,002	0
Net Worth (assets - liabilities)	129,489	480,414	434,616

Scenario 1 shows a higher RRSP value, but to access those funds the Harts would have to pay taxes on any withdrawal. To pay off their mortgage, they would have to cash in $198,336 of their RRSPs, pay $79,334 in tax at 40 percent, and be left with the required $119,002. That would leave them with only $58,438 in RRSPs versus $91,974 for the debt pay-down scenario. The higher amount of net worth is deceptive because a large portion of it is pre-tax.

With the debt pay-down strategy, the Harts' mortgage will be paid off in 11 years (in fact, in ten years and seven months). That will leave them with more than nine mortgage-free years. During those last nine years, they will have an extra $1,424 per month to invest. That's the money that will no longer be going to the mortgage, and it adds up to more than $17,000 a year. Now, they can begin to focus on their RRSPs in earnest.

Here's the way things look for the Harts after 20 years (see Table 2).

Table 2

	31 Dec (last year)	Scenario 1 31 Dec (year 20: RRSPs)	Scenario 2 31 Dec (Year 20: debt paid)
Assets	$	$	$
Cash in bank	714	714	714
House (principal residence)	275,000	408,635	408,635
RRSP - Joe (market value)	36,900	289,699	298,494
RRSP - Karen (market value)	16,875	236,566	242,361
Total Assets	329,489	935, 614	950,204
Liabilities			
Household mortgage	200,000	0	0
Total Liabilities	200,000	0	0
Net Worth (assets - liabilities)	129,489	935,614	950,204

The debt pay-down scenario shows a net worth slightly higher than for the RRSP scenario—a difference of $14,590. So, after 20 years, the Harts would arrive at a similar point but would have taken a very different journey. The debt pay-down option, however, has two major advantages: it reduces the risk that the Harts could lose their house during the nine years of mortgage-free living, and there is less risk related to investment returns. How much confidence do you have that the markets are going to post better returns than the interest rate on your debt? Are you willing to stake your future on it?

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