

# ADVISOR'S EDGE REPORT

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STRATEGIC INTELLIGENCE FOR ADVISORS

BY MARK NOBLE

## PRODUCT ALLOCATION GAINS CURRENCY

Wealth in retirement should be distributed across three different silos.

**NEWS** Advisors looking to demonstrate the value of advice to clients can now point to retirement income



NOBLE

Groundbreaking work by Canadian personal finance expert Moshe Milevsky is changing the way portfolio creators are conceptualizing boomer retirement and creating a lucrative new income stream for advisors.

Milevsky, professor of finance at York University, in addition to being executive director of the IFID Centre and president and CEO of the QWeMA Group, recently

held a webinar—sponsored by Manulife Financial—on the need to allocate a retiring client's wealth across products rather than asset classes.

Most clients, and a high number of advisors, still think of an asset class as the key determinant of a retirement portfolio's risk protection. The very crude rule of thumb for the last three decades has been that a client aged 60 or older should have a portfolio with a fixed-income allocation of 40% or more.

The concept: Dividends and

interest from the fixed income pay for expenses in retirement and the equities portion creates income sustainability by growing and slowly converting into income.

But Milevsky points out last year's events show a portfolio without sufficient guarantees to protect against a negative sequence of returns—especially during the earlier stages of retirement—can drastically reduce the longevity of a retiree's income.

He's developed a new risk measure, the Sequence of Returns Downside Exposure (SORDEX)

ratio, which measures how vulnerable a plan is to abnormal market conditions (see, "Retirement sustainability," below).

An advisor could create a traditional investment portfolio for a retiree with ostensibly strong income sustainability under an expectation of normal market fluctuations, but Milevsky says a Black Swan event—arguably what happened in late 2008—could decimate one of these portfolios. So, it's imperative to create a portfolio with the wealth clearly distributed across three product classes:

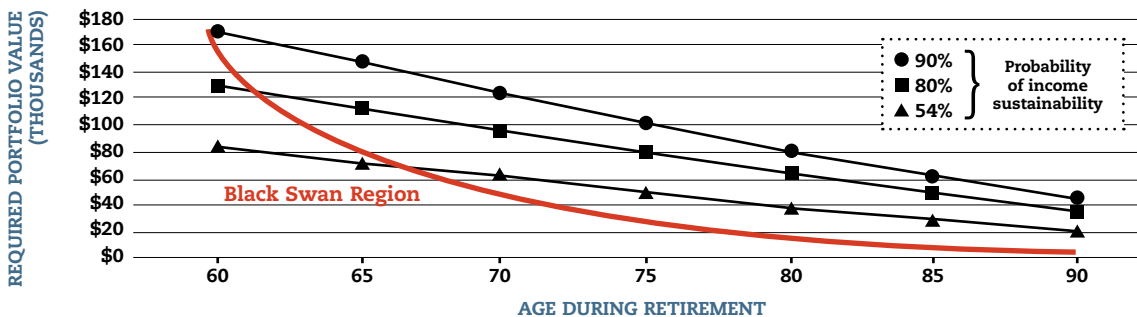
- › traditional annuities, such as single premium income annuities (SPIA);
- › variable annuities with a lifetime benefit, such as a GMWB; and
- › traditional securities-based portfolios (systematic withdrawal portfolio).

"People should allocate their wealth in retirement across three different silos—mutual funds,

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### RETIREMENT SUSTAINABILITY

Spending: \$5,000 (Inflation Adjusted) Per Year; Asset Allocation: 80% Equity / 20% Cash



### FACEOFF

#### PARTICIPANTS:

- › Frank Wiginton, CERTIFIED FINANCIAL PLANNER, TRIDELTA
- › Ed Rempel, CERTIFIED FINANCIAL PLANNER, ED REMPEL & ASSOCIATES

MODERATED BY KANUPRIYA VASHISHT

## TFSA versus RRSP

**NEWS** Which is better?

**Ed Rempel:** For most clients, some sort of combination of the two is usually the best strategy. When deciding which, it comes down to two main factors: First, what your marginal



VASHISHT

tax rate is today versus what it's going to be after you retire. Second, what you use your tax refund for.

How you use your RRSP tax refund is a big part of the planning strategy. Most Canadians

tend to spend their refunds. For best results, however, you can either invest the refund into an RESP or TFSA or follow a gross-up strategy.

Take Rob, for example. He's expecting a \$10,000 bonus in February. Effectively, he only gets \$6,000 after tax. But he could borrow \$4,000 from a line

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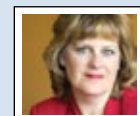
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Advisors and industry executives across Canada share their wisdom and experiences.

BY AKUA CARMICHAEL

## Henson Trusts

Support special needs without jeopardizing ODSP benefits.

**TAX** Special attention must be paid to planning for the needs of disabled beneficiaries, some of whom will be dependent on their parents for most, if not all, of their lifetimes. Issues concerning financial support, housing, healthcare, education and employment of the disabled beneficiary must be addressed and a comprehensive plan put in place.

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## DOLLARS AND SENSE

**FOR THE FIRST TIME**, content from our annual Dollars and Sense Survey will appear in the December issues of both *Advisor's Edge* and *Advisor's Edge Report*. The magazine will focus on "What Clients Want" and explore how advisors can best communicate the value of advice to clients; the paper will look at "What Advisors Need," and detail top strategies to help deliver superior service.

## NEWS

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## TFSA versus RRSP

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of credit or take out a loan and make a \$10,000 contribution to his RRSP, then get back the \$4,000 in a refund and repay the loan.

An RRSP only really keeps up with the TFSA if

you're grossing-up every single year—if you retire at the same tax bracket as your earning years, the RRSP is 10% behind the TFSA.

It's a planner's dream if senior clients have a balanced portfolio of both RRSPs and TFSAs when they retire. We could do a lot of planning around how much money to take out of each to keep our clients in a lower tax bracket.

**Frank Wiginton:** The TFSA has very little benefit at this stage, but when we plan out 25 to 30 years it will become a powerful tax-controlling tool. At this point an RRSP still seems a better option for most people in a 30% tax bracket or higher.

A majority of our clients are retired or nearing retirement. When we plan 25 years out—depending on their age—we look at the estate planning aspect and how we can use the TFSA to reduce the lifetime tax and death tax. We also see the TFSA as a good option for people who generate very low income.

After a certain level of income, RRSPs can give you a much better value. Many times we build out our plans where we actually withdraw more than the minimum out of RRSP accounts to draw them down, so there's very little remaining on second death.

That allows us to control tax rates for our clients and keep them in

a very low tax bracket over their retirements. Often they don't need that money, so we build it up in their TFSAs. That money, upon second death, can transfer to charities, heirs or beneficiaries tax-free.



WIGINTON



REMPER

**Ed:** Each client's needs and goals are different. However, if I were to make a generalization, I'd say the RRSP is still the main savings vehicle because most of our clients are in higher income brackets. Right now, the biggest shortcoming of the TFSA is it only allows a \$5,000 annual contribution. Most people need to save more than that for retirement.

Most people tend to think they're going to be in a lower tax bracket when they retire, but when you include the four different claw-back programs that could kick in at retirement—most seniors at income levels up to \$105,000 (except those between \$20,000-\$35,000) are in one claw-back program or another (in addition to income tax)—they might effectively be in an even higher tax bracket than when they were working. So it takes a bit of planning to determine each client's individual circumstance before deciding which is a better vehicle.

You don't want to build too huge an RRSP, because then it's very hard to stay in a low tax bracket when you retire. That's when TFSAs can be useful before retirement (when it is clear the client will retire with a taxable income between \$20,000-\$35,000)—just before and after

retirement—to make sure clients are in the right marginal tax bracket. For people over age 65, only those with a taxable income between \$22,000-\$36,000 will actually be at a marginal tax bracket below 40% after you include the four clawback programs (GIS, age credit, GST and OAS).

Sometimes it's better to put very little into an RRSP before your client retires and build up a tax-free savings or a non-RRSP account, especially for the low income clients, and then have them withdraw their income at low tax rates when they turn 65 and are eligible to collect the GIS.

## Ideal candidate for TFSAs?

**Frank:** I'd say the lower-income group, or younger clients who don't have enough money to max out their RRSPs and little contribution room. Such clients might not get a tax refund, but the \$5,000 is a saving opportunity. If they invest every single year and do that for 35 years, at a 6% annual rate of return, it grows to \$557,173. If you put that amount in an RRSP, they'd end up paying more tax in retirement. Even if they got a 15% refund on their RRSP each year, when they withdraw from the RRIF they may pay 25% tax on it because they're taking out larger amounts and their taxable income goes up. They may end up paying 10% more using an RRSP versus a TFSA.

It might make sense to carry forward RRSP contribution room ten years from now when they might have substantially higher income, and would fall

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## AT A GLANCE

BY ADVISOR STAFF

## FUND INDUSTRY HIT WITH REDEMPTIONS

The Canadian mutual fund industry was hit with redemptions in October, with investors pulling out somewhere between \$262.2 million and \$762.2 million, according to the Investment Funds Institute of Canada.

Net industry assets at the end of October were between \$569.3 billion and \$574.3 billion, down 1.87% from September's total of \$582.7 billion.

SEARCH: IFIC

## ETFs CONTINUE TO GATHER STEAM

The net inflows into ETFs versus traditional mutual funds continue to be quite large, to the point that ETF providers are not asking if but rather when will ETFs hit \$100 billion in assets under management in Canada?

SEARCH: ETF

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## NEWS

## TFSA versus RRSP

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in a higher bracket. They could then move money out of the TFSA into their RRSP to get bigger tax credits.

**Ed:** I agree. For people with low income, say under \$40,000, a TFSA is generally a better option. It's also a better option for people who have a very small or really large RRSP, or have a reasonable RRSP plus a generous pension, because you want to keep your clients in low-income brackets on retirement and avoid building up too huge an RRSP.

If a client intends to retire early,

planning becomes interesting and could favour either one of these options, depending on how you approach it. If someone retires at 55, you've got 10 years before the OAS pension and claw-backs kick in. During those 10 years, one strategy would be to take money out of the RRSP and save it in a TFSA account for after the client turns 65. At that point you're probably going to be in a higher tax bracket than you'd be between 55 and 65. Although most of our clients between 55 and 65 end up doing some odd jobs or working part time as consultants. In that case you don't want to take out too much from the RRSP because they're

not really in that low a bracket.

**Frank:** Some of our clients want to retire at 55 and we encourage them to take money out of their RRSPs at that stage to start shrinking the RRSP. If they don't need the money, we suggest they put it into a TFSA so it continues to grow tax-free. Vice versa, there may be clients who want to keep their income low because they take a consulting job or maybe they're trying to keep their tax rate as low as possible until they retire. I can generate \$40,000 for free by taking money out of a client's TFSA account or take money out of his or her RRSP and pay tax on it. It's up to the planner running the

numbers to show clients the effects of prudent planning long term.

The whole situation changes yet again with pension decisions. If a client wishes to retire at 55, but defer a pension to age 60, that changes all the math. The pension increases in value because it's deferred five years.

**Will RRSP's popularity take a hit?**

**Frank:** Because the TFSA is an additional tax-free vehicle I do see RRSPs taking a hit down the road. It's still five to eight years off; however, and will depend on how the government changes the rules on TFSAs as it starts to learn more about these accounts.

**Ed:** There's a big difference in perception between people who're getting professional planning advice and average Canadians. From a planner's perspective, close to half of Canadians would be better off with TFSAs than with RRSPs. For the general public, however, most people will continue to buy RRSPs because they get a tax refund and probably use TFSAs as an emergency fund. But people getting professional advice will gravitate toward TFSAs as retirement-planning vehicles.

**Frank:** Thirty to 40 years down the line, the TFSA contribution amounts will get substantial. That's when planners will be able to control income and tax brackets by taking out part of the money from RRSP accounts and the rest from TFSA accounts. There will be all kinds of opportunities to save tax.

This is one of the best things the government has done since the creation of the RRSP to encourage people to save money. Having said that, one of the biggest drawbacks I see in the TFSA is the ease of taking that money out. When people put money into an RRSP, they have the mentality they aren't allowed to touch it. With the TFSA they can take the money out any time without paying a penalty or taxes. Consequently, the TFSA loses its effectiveness as a saving tool.

**Ed:** That's so right. If the TFSA is a better option for a client, but the client keeps dipping into that account, then maybe it isn't the right option because it won't get the client where he or she wants to go. If you take out \$10,000 now with the promise to put it back in two years, and think it's the same thing, it isn't because you've missed a couple of years of growth, especially because you'll be tempted to take it out at the worst time. So if your clients are going to keep dipping into their TFSA accounts, it's the wrong growth vehicle for them.

**Frank:** Another thing advisors and clients need to be cautious of is the withdrawal fee for TFSA accounts. A majority of institutions charge upwards of \$50 per withdrawal. So if your clients have to make emergency withdrawals that are unavoidable, that's one thing, but if they keep dipping into this account they would incur a \$50 fee every time. That would chew up any income they hope to make in interest. <sup>AER</sup>

**KANUPRIYA VASHISHT** is

associate editor of *Advisor's Edge* and

*Advisor's Edge Report*.

kanupriya.vashisht@advisor.rogers.com