YOU ASK, WE ANSWER

Almost everyone faces these pension dilemmas

WISE TO TAKE IT SLOW

BY DAVID PHIPPS

Question My wife and I are retired pensioners. She is 60 and I am 64 years old. We both retired at 60, and hence took a 30% cut in our CPP, and in my case, also in my company pension. My wife does not have any company pension. Of my company pension, about $22,000 is non-inflation adjusted defined benefit, which will reduce to 60% of its value if I predecease my wife. Our house is mortgage-free and we also have RRSPs (about $300,000).

Our current gross pension income is about $38,000 per year. Next year, I shall be entitled to OAS of about $5,700 before taxes. Both my wife and I also earn about $8,000 through part-time work, but we also have to spend quite a bit of that money on travel to earn that. We manage our money wisely, but it would be nice to have some extra to spend.

In addition to the above, we are getting about $450 per month from about $80,000 of the RRSP money by way of dividends paid by two mutual funds: Acuity High Income and Clarington Canadian Income. I was thinking of converting all of the remaining RRSPs into either or both of the above funds and that way we could have another approximately $1,100 per month income. But I am afraid of making a bad decision that may impact us adversely in the future. Would you please comment on my dilemma?

Answer You are facing two of the most common retirement planning questions: how much money can you draw from your investments without compromising your future financial security and how to properly invest your retirement savings.

You indicate that you would like to supplement your pension income by starting to take an income from your RRSPs, but are concerned that this may adversely affect you in the future. You are wise to proceed cautiously. There are a number of factors that argue for restraint in how rapidly you deplete your savings.

A pension that is not indexed with inflation will lose its spending power over time. Each year you will need to take more and more from your retirement savings just to keep the current spending power of your pension constant.

While on average women live longer than men, in your situation you must keep in mind that your wife has no pension, your pension will be reduced by 40% upon your death, and you are older than your wife. This suggests there could be many years during which your wife will have to support herself on the reduced pension. Caution in retirement planning is especially important to ensure there are adequate savings available to support the longer life-spans of women.

The pace of medical advancements means you may live longer and the draw on your retirement savings may be greater than expected. The longer you need to draw on your savings, the less you can draw each year for any given rate of return.

How much you draw from your savings today will depend on a number of issues, including what rate of return you expect to receive on your savings, how many years you expect to live, and an assumed rate of inflation. The best approach is to sit down with your advisor and work through a number of different retirement scenarios to see the impact of different rates of return and different mortalities on your capital.

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The higher the rate of return on your investments, the larger the percentage that you can take as an income today. However, the higher the rate of return on your investments, the higher the risk will be of capital loss. A compromise has to be found to fit your investment risk tolerance to your need for income.

You indicate that at present $80,000 of your $300,000 is in two income funds and you are thinking of putting the whole portfolio into the income funds. While the recent excellent returns of income funds may make them attractive, as always you must step back and ask if something is too good to be true. Many income funds have been generating returns of in excess of 15% per year for a number of years. This extremely high return should send up a red flag that these portfolios are not low risk. As an example, while many large pension plans limit their exposure to income trusts to 5% of assets, many income funds have as much as 35% income trusts.

Please note that if you are investing within your RRSP you will not benefit from the tax-advantaged income stream that is often promoted as one of the benefits of income funds. The income distributions from these funds are taxed advantageously when held outside an RRSP since some of the income is usually a return of capital. This defers that taxation of a portion of the earned income each year until a later date. However, in your situation this advantage is lost as all payments taken from your RRSP are taxed at your highest marginal tax rate.

To structure a sound investment portfolio, take a look at the approach used by most pension plans and all of the asset allocation programs offered through almost every financial institution. Most of these portfolios use a minimum of eight and sometimes as many as 15 different portfolio managers. Each manager is mandated to invest in a different asset class or investment style, and the percentage of the portfolio allocated to each manager is dependent on the investment objectives and risk tolerance of the client. Diversification across a broad range of asset classes is the only sure way to lower the short-term volatility of a portfolio.

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