Investments: Paying Mortgage or RRSP?

Do You Pay Down Your Mortgage Or Invest In An RRSP?

By: Joe the Investor

It turns out that the answer to this question is very personal and not hard and fast. There are a number of factors to consider such as your mortgage rate, your rate of return on RRSP (Registered Retirement Savings Plan) investments, and the time remaining until you must collapse your RRSP. There are also intangible factors like how you feel about risk, loss and volatility, time and effort expended on investing, and whether this should be minimized or not. It is possible to do both – alternating between paying the mortgage only in some years, and emphasizing the RRSP in other years. This article is to make you aware of these factors as they apply to your situation, allowing you to make more informed decisions.

To decide how to allocate among the two options, there are a series of questions that need to be answered. People tend to put money in separate "buckets", and treat them as separate, but in actuality all of your money is really in one bucket. As an analogy, if you pour liquid into a tank, and there is a leak at the other end of the tank, what is in the tank is the net result of what is being poured into it and leaking out of it. In terms of money, the net income generated is what you are earning on investments, less what you are paying in debt interest. Your financial situation should be considered as a unit to make decisions that benefit the whole picture.

As for assumptions, this article assumes you have both a mortgage and an RRSP, and you can afford to invest in your RRSP over and above what you are paying on your mortgage. If you have a mortgage but no RRSP, the question might be "should I start an RRSP or not?" A second assumption is that your TFSA (Tax Free Savings Account) is not part of the decision, as the tax treatment of the TSFA is different than an RRSP. As a third assumption, taxes will be disregarded in terms of comparing mortgage rates to investment returns. The basic reasoning behind this is many possibilities exist with respect to taxes. When you contribute money to an RRSP, you get a tax refund for the money deposited. When you withdraw money from the RRSP later on, you will pay taxes on the *whole amount* being withdrawn. The tax rate may differ between these two dates, and your income situation and the timing of the withdrawals will also affect the tax rate. The longer the money sits in an RRSP without being withdrawn, the greater the effect of compounding, and the less of an effect taxes will have in terms of whether an RRSP is worth having or not. Should you lose money investing in an RRSP, the situation would be much worse, as you may be taxed even if you lose money on your investments depending on how you withdraw the funds. If you decide to keep the RRSP until it needs to be converted into a RRIF (Registered Retirement Income Fund), there will not be a one-time tax bill on deregistering the RRSP, as the taxes would be spread over your time of retirement. Since, there are so many possibilities, the tax effect is ignored, but should be considered on an individual basis as part of a long term financial plan. A tax calculator is provided below for information

about your current tax rate (1). Lastly, the interest paid on the mortgage in this article refers to *only the interest amount* – it is not including the principal. The principal on a mortgage is paying back the loan, and you own a house or property in exchange for that loan.
The key question of this article is "How much do I pay on my mortgage, compared to how much do I earn in my RRSP?" If your RRSP return exceeds the rate of return (or interest rate) on your mortgage, or you make more money in your RRSP then what you pay out in interest for your mortgage, then put as much money into the RRSP as you can. This assumes the RRSP return is higher than the mortgage return on a consistent basis (I would use 5 years as a time period), after all fees and losses. If the reverse is true, pay down your mortgage as much as possible, and forgo the RRSP contributions until this is no longer true. The phrase "until this is no longer true" could mean your mortgage is paid off, your investment returns have increased, or your priorities have changed for a variety of reasons. This question should be revisited each year or when your financial picture changes substantially (a divorce, children being born, children leaving home, job loss, illness, a new home, a large one-time expense, a large change in your debt situation, an inheritance, or a large investment gain to name some examples).

For the mortgage, the rate could be fixed, but if it is variable, you should look at 5 years of interest rates to get a better idea instead of the last year only. The idea is to know what the mortgage rate will be in the future. This may be easy to figure out, if the rate is locked in for so many years. However, you may have a large change in the interest rate once you renew if it rises or falls dramatically. If this is true for you, then assume the present rate for now, but use a higher rate when the renewal date approaches.

For the RRSP, look at the return you have achieved over the last 5 years after fees and losses. Looking at the RRSP side of the equation, your return would have to be consistently better than this mortgage rate. The easiest way to do this is calculate the total of how much money you contributed to your RRSP over the last 5 years, and take the latest total market value and subtract the two figures. Divide this difference by the number of years that you are using as an estimate – in this case 5 years. This calculation is very approximate, especially if you have large variation in contributions over the years. If you have large annual changes in your RRSP balance, I would do this calculation each year. Find the sum of the gains or losses for each year to calculate how much you made net of all of the money you contributed and all the fees paid out. If you withdrew money from your RRSP over the last five years, this should be subtracted from the money you contributed, since this money reduces the book value of your account. If you subtract present total market value less all the money you deposited and withdrew from your RRSP account, and as an example have a total of $20000 over 5 years, this is an average of $4000 per year. If the balance after all the money deposited or withdrawn over the 5 years amounted to $40000, then you have a return of about 10% per year ($4000/$40000). It should be noted that this method is not factoring in the effect of compounding, so it is not entirely accurate. Since the numbers being input are used to estimate a future decision, and these numbers are uncertain, they serve to provide an approximation of what to consider in the decision process, as more exact numbers are not likely to make a difference in the decision.

So far, the calculations are the only thing considered. What about other factors like time expended to make this decision, effort to manage money, and stress/risk with respect to volatility and losses? If you manage the money yourself, and it takes a fair amount of time, and it causes stress, and the returns are not that high, is it worth to manage it? A mortgage paid down is risk free, requires no research, wastes no time and results in little energy expended. You know exactly what the return will be because it is written in the contract (unless it is a variable rate mortgage). You also know your fees of discharge, transfer, appraisal, renewal, and any other fees which should also be accounted for in this calculation. RRSP Investments will take more time to research, make trading decisions, and deal with market volatility. If you use an advisor or broker, the time spent with them and making sure they are doing a good job is time that you must factor in. The same applies with your mortgage broker or your bank with changes in your mortgage.

For most people, money has a psychological and emotional component to it. People make decisions about money based on habits. All of the blind spots in people's mindset: fears, passions, beliefs and so forth are evident in their relationship with their money. The decision to have an RRSP or a mortgage may well be coming from earlier beliefs, and how money is invested also comes from these beliefs – so the best decision would also feel appropriate and have a sense of integrity and consistency for you. If it doesn't, the numbers are likely not telling you the whole story, and you should ponder the question a bit further to see what the blind spot is that is causing this feeling. The conclusion is that the decision is indeed personal, and will fit your situation well if handled properly.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what these options are.

Sources:

(1) Tax Calculator provided by Ernst and Young http://www.ey.com/CA/en/Services/Tax/Tax-Calculators-2011-Personal-Tax

(2) http://www.getobjects.com/Components/Finance/TVM/fva.html