Is cashing in investments to pay off debt ‘financially stupid’?

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Heading into retirement laden with debt isn’t a comforting thought, but there are plenty of Canadians who are in, or inching toward, their golden years owing money.

Nearly 60 per cent of retired Canadians hold some form of debt, a 2012 CIBC poll found. And, when no longer earning an income, paying off debt can be a strain.

Here’s one strategy to clear the way for less stressful sunset years: Sell off some of your investments in your 50s and 60s and use the cash to pay down or eliminate debt.

But is it advised? That depends.

There’s no rule of thumb for this one, and financial experts say the decision to unload mutual funds or other assets to get rid of mortgage or credit-card debt is one that calls for careful consideration.

Interest rates
The move could make sense if the interest rate on the debt exceeds the expected return of the investment. However, this is often hard to answer, according to retirement and investment planner George Christison, founder of IFM Planning Services and the InvestingForMe website.

“It’s too simplistic because it ignores taxation on income earned to pay interest expenses and on monies withdrawn from tax-sheltered accounts such as RRSPs and RRIFs,” Mr. Christison says. “Most Canadian investors have the majority of their savings and investments sheltered inside an RRSP, so they can’t ignore taxation. … The after-tax calculations and analysis would need to conclude that it’s not a financially stupid decision. For the majority of Canadians, cashing in an RRSP to pay down debts would be financially stupid.”

The theory pitting rate of return versus interest rate has other flaws, Mr. Christison says, because it ignores the investment costs, such as management expense ratios (MERs), total expense ratios (TERs), commissions, and asset fees, which are paid annually.

“It also assumes investment returns are consistent and lineal, just like the interest costs on debt, which they are not,” Mr. Christison says. “It also assumes that investors actually know what their investment rates of returns have been and are going to be in the future, which most don’t.”

Type of debt
If, however, your investments consist largely of low-yielding GICs or Canada Savings Bonds, or the rate of return is otherwise definitely less than the interest on the loan, it could be appropriate to sell in certain circumstances, says Annie Kvick, a North Vancouver fee-only financial planner with Money Coaches Canada. The type of debt plays a role in the decision: Credit-card interest rates of about 19 per cent can be crippling if you’re carrying a significant balance, while mortgage rates remain low.

“It makes sense to sell investments if there is no other solution,” Ms. Kvick says.

She adds other scenarios where selling may suit:

- Your investments are too risky and you’ve been wanting to sell them anyway.
- You don’t have an emergency fund.
- The debt load is too much to handle and with your current income you’ll sink even further into debt.
- You can create a capital loss that will erode a capital gain.

By contrast, there are instances where selling investments to get out of the red would be considered illogical.

“It does not make sense to sell investments if you can live frugally for a while to pay it off, say over one to two years, possibly borrowing money from family members,” Ms. Kvick says.

“It wouldn’t make sense if the investment’s real rate of return outperforms the interest rate on the debt. Can you create income to pay it off through things like garage sales, hobbies or rental income? It would also not make sense if you would reverse back to old habits and have more credit available only to accumulate the debt back again.”

Psychological effects

Debt’s effect on the psyche has to be factored in to the decision as well. For some, it may be more important to get rid of debt-related worry than hang on to all of their investments.

“It may make sense if you can’t sleep at night and the debt is causing too much stress,” Ms. Kvick says. “There would be peace of mind.”

On the flip side, selling investments could come with its own psychological effects. Mr. Christison says, “After decades of being told we need to save for retirement, selling investments to pay off debt would be a big emotional hurdle for most of us to overcome.”

“I think [that mindset is] summed up perfectly by that now-famous bank slogan, ‘You’re richer than you think.’ But the problem with that way of thinking is that no matter how much debt we have, our retirement savings make us feel richer than we actually are. Accumulated savings help us to build up and emotionally manage our debt loads.

“So the numbers would need to say we’re not going to hurt ourselves financially and we would need to be emotionally okay with selling investments and paying off debts, which is a very, very rare combination,” he says.

Mr. Christison cautions that if people do plan on selling investments, they should ensure they’re still following a targeted investment mix – consisting of bonds, GICs, stocks, real estate, private shares, and so on – that is established through the development of a broader, written financial plan.

“Ideally, I think a person should make the transition into retirement with no mortgage, no car payments and no consumer debt.”