Personal Finance

Unable to invest now? No worries

How a "save later" strategy can fulfil your retirement needs.

By David Aston | 14/02/17

*Editor's note: This week on Morningstar.ca, we present our **Focus on RRSPs**, where we go over what every investor needs to know about Canada's most popular savings program. Along with an explanation of RRSP basics, we will look at important issues such as whether it makes sense to defer savings, the life-cycle approach to retirement contributions, and ways to go beyond the traditional RRSP. Finally, our manager research analysts will present their favourite funds to hold in a retirement account. Check back all week for more insights from Morningstar's experts.*

When you're in the throes of the financial "crunch years" trying to simultaneously cover high day-care costs and enormous mortgage costs, it's easy to get discouraged. It can be a struggle just to make ends meet. You may well wonder when and how you'll ever be able to save for retirement.

For many Canadians, it makes more sense to focus first on the mortgage and child-rearing costs, and then save for retirement later. "Saving for retirement is the deferrable one," points out Malcolm Hamilton, retired actuary and current fellow at the C.D. Howe Institute. "You can't say 'I'm going to have my children in my 60s when I can afford them,'" says Hamilton. "And it doesn't make sense to raise your children and then, after they leave home, buy a nice big house."

The strategy to save later can create a sizeable retirement nest-egg just as effectively as a constant savings strategy, provided you take full advantage of the opportunity to save when the time comes.

While for many people the strategy to defer savings comes down to common sense, you'll still need to ignore a contrary stream of ads, surveys and advice from the investment industry telling you otherwise. "What it does, unfortunately, is needlessly frighten people about their future prospects," says Hamilton.

Getting less crunched

The good news is that if you can just get through the crunch years with your financial head above water, your financial situation and ability to save generally begins to improve fairly quickly. When your kids reach school age, you generally are able to cut your day-care costs sharply or have the opportunity for a stay-at-home parent to return to work. The size of your mortgage debt gradually declines, even if you just make regular payments. Meanwhile your salary generally grows at least with inflation, but you may get larger salary increases due to promotions or recognition of growing work experience. "You go through a transition where a lot of the bills drop away and now you can make up for lost time," says Hamilton.

Of course when your capacity to save opens up, you need to take full advantage of it. "I'm always reminding clients, 'you have the crunch period now, but as soon as that eases off, let's start putting something toward retirement,'" says Sheila Walkington, financial planner and co-founder of Money Coaches Canada. "It's real easy to get caught up in having extra money and just spend it."

After the crunch

When it becomes time to save, you have to decide how best to do it. One of the classic debates in personal finance is whether it is better to pay off the mortgage first and then save after the mortgage is fully paid off, or just make regular mortgage payments and make building up retirement savings your priority. A third option is the classic Canadian compromise of making a big annual RRSP contribution and then applying the tax rebate to the mortgage.

Saving in different forms is still saving, so they're all good options. But which one works best will depend on how effective each one is at motivating you to save. Walkington favours making saving for retirement the priority while just making regular mortgage payments, since it imposes the discipline of regular mortgage payments. However, as Walkington points out, you should make sure the regular mortgage amortization will pay off the mortgage by the time you plan to retire.

If you hate debt, you may instead choose to pay down the mortgage quickly and defer saving for retirement until after the mortgage is fully paid off, an approach that appeals to Hamilton. However, as Hamilton says, when the mortgage is paid off, you must be able to redirect into savings the amount that used to go to the bank to pay the mortgage, instead of just expanding your lifestyle.

The compromise option of large RRSP contribution plus applying tax rebates to pay down the mortgage will appeal to Canadians who like to see steady progress toward both objectives.

Whichever" save later" strategy you choose, understand that you will need to save more each year in a concentrated period than if you saved constantly over your entire working career. Fortunately, while the ability to save for retirement tends to open up gradually, many Canadians are able to save prodigious sums later in their working careers. "You could be amazed how much you can save," says Hamilton.

The maximum point of "super-saving" often occurs when you have reached your peak earning years, have fully paid off your mortgage and your children are financially self-sufficient. At that point, typical middle-class Canadian couples should be able to save 20% to 25% of their gross income if they're not contributing to RRSPs, or 30% to 40% when most of it is through RRSP contributions that include investment of the tax rebates. (Note that you will need some unused RRSP contribution room from earlier on if you're going to save the full amount in RRSPs.) Aggressive savers in top tax brackets who are saving primarily through RRSPs can save even more.

Number-crunching

Here's a simplified example of how a "save later" strategy can succeed in building retirement savings just as well as a constant-saving approach. The classic constant-savings strategy made famous by David Chilton in *The Wealthy Barber* is to save 10% of your income throughout your working years. We compare that to a strategy where the mortgage is first paid off and then saving for retirement is done in a concentrated period in the last few years before retirement. We consider the example of a couple of the same age with strong income growth who achieve a moderate degree of affluence in their middle years. The couple earns: $70,000 combined at age 25 when they start working, $125,000 at age 35, and then reach peak earnings of $169,000 at age 50, which they continue to earn until retiring at age 65. (We provide all figures in "real" dollars that remove the impact of inflation and thus reflect current purchasing power. We also assume a conservative annual "real" return on savings of 3%.) In that case, saving a steady 10% from age 25 until retirement will result in "real" savings of close to $1 million, enough for an affluent above-average retirement. (While $1 million is a nice sum to attain, it should be clear no one "needs" that much to retire. Most Canadians retire very comfortably on far less.)

Under the "save later" strategy, we assume the couple buys a home at age 35, focuses first on paying off the mortgage, which they accomplish in 15 years at age 50, and then devote the remaining 15 years until retirement to building a nest-egg. In that case, they can achieve the same $1-million nest-egg by saving 32% of their income in the last 15 years before age 65. If they were able to save at that rate for only the last 10 years before age 65, they would still amass a comfortable nest-egg of $630,000.

That illustrates how a save-later strategy can work just as successfully as a constant savings approach in building a nest-egg, using reasonable assumptions. To be sure, real life isn't as neat and tidy and predictable as financial modeling suggests. As you work through your savings years, you will need to adjust your plans as you go. If fortune smiles on you, you might be able to retire early, have a few luxury items in your retirement, or leave a big bequest for your kids. If you're not as fortunate, you might have to work a little longer, find a comfortable retirement that fits within a moderate budget, or leave a smaller bequest to your kids.

The "save later" strategy works best if you get through the crunch years and start saving diligently at a reasonably young age. It also helps if you achieve a high salary in your later years, both because there is more raw potential for savings and because you'll earn a higher tax rebate from RRSP contributions.

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