FINANCIAL FACELIFT

Should Theodore and Violet pay off their mortgage?

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Theodore, 40, and Violet, 34, are looking ahead to the day they can quit work and escape to the country.
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Theodore is 40 and Violet 34, but already they're looking beyond their successful careers to a day when they can quit work and escape to the country. There they'd build a dream home – a farmhouse on some acreage they own. The new house would cost anywhere from $800,000 to $1-million, Theodore writes in an e-mail.

Theodore would like to retire from his $142,000-a-year position at age 60. Violet would retire from her $76,000-a-year job at the same time. Both work in the education field and both have work pension plans. As well, they have some self-employment income and gifts from parents.

Short term, they plan to renovate their modest city house using cash they have set aside and a $100,000 gift from their parents. They plan to keep the house even after they build the new one. In a year or so, Theodore will take a sabbatical and Violet will take six months off to accompany him on his travels.

Their retirement spending target is $150,000 per year after tax, although they are willing to work longer or live on less.

"Should we pay off our mortgage, which is up for renewal next year likely at a higher interest rate?" Theodore asks. "Are our retirement goals realistic considering our plan to build a house?" They also ask whether the investment fees they are paying (0.7 per cent to the adviser plus a 1-per-cent management expense ratio) are worth it.

We asked Barbara Knoblach, a certified financial planner at Money Coaches Canada in Edmonton, to look at Theodore and Violet's situation.

What the Expert Says

Theodore expects his salary to rise about 4 per cent a year on average, Ms. Knoblach says. If he retires at age 60, he will have 31 years in the defined benefit pension plan, so he can expect a pension of about $94,400 a year in future dollars. Violet expects her salary to rise about 3 per cent a year, so she can expect about $23,300 a year. She'll have 23.25 years in the pension plan.

Theodore and Violet also have personal retirement savings. "They maximize their tax-free savings accounts each year and fill up their RRSP contribution room," the planner says. They each contribute $5,000 a year to their RRSPs.

As well, Theodore puts $2,500 a month into his non-registered investment account for the down payment on their future farmhouse. His goal is to save $500,000 so the mortgage on the new house will be small enough that they can pay it off before he retires in 20 years. They are paying off the mortgage on their existing house aggressively.

The mortgage on the city house will be around $100,000 at renewal time, Ms. Knoblach says. Theodore, who is debt-averse, is considering tapping his investment account to pay it off in full at renewal time. “The goal of paying off the mortgage is evidently in conflict with their other goal of accumulating a $500,000 down payment for the farmhouse,” the planner says.

If Theodore withdraws $100,000 to pay off the mortgage, skips contributing during his sabbatical year and then resumes again in 2026, it would take them until 2032, when Theodore is 50, to save up $500,000.

“As their goal is to have the mortgage on the farm property paid in full by the time Theodore is age 60, it is recommended that they start building the new house sooner rather than later,” Ms. Knoblach says. Paying off a $500,000 mortgage in 10 years would require monthly payments of $5,000, assuming an interest rate of 4 per cent. She recommends they direct surplus funds to their non-registered account to accumulate the down payment more quickly, and let the mortgage on the city house “pay out in due course.”

Is their retirement spending goal realistic?

First, the planner looks at the “base scenario” where Theodore and Violet decide not to build the new house. They continue saving in their RRSPs, TFSAs and non-registered account. At Theodore’s age 60 and Violet’s age 55, they start their pensions. They start Canada Pension Plan and Old Age Security benefits at age 65. They nearly reach their target, “attaining after-tax spending power in the range of $146,000,” Ms. Knoblach says.

In the second scenario, Theodore withdraws $500,000 from their non-registered account in 2030 and they begin building the farmhouse. They will have a mortgage of $500,000, which they amortize over 12 years to Theodore's retirement. With a 4-per-cent interest rate, their mortgage payments will be $4,370 a month. They continue contributing to their registered accounts but make no further contributions to the non-registered account.

In this scenario, they could reach after-tax spending power in the range of $114,900 a year, "substantially lower than their current expectation," the planner says. "Nevertheless, it will provide them with a comfortable standard of living if they manage to be debt-free by retirement." They could also consider renting out the house in the city for extra income.

In scenario three, they both work an extra five years, Theodore to age 65 and Violet to age 60. They earn significantly higher pension entitlements, contribute to their investment accounts for five more years and they will be entitled to higher CPP benefits, the planner says. As well, they spend five fewer years drawing down their savings and they will have time to amortize the mortgage on the farmhouse "in a more leisurely manner."

They could achieve spending power in the range of $148,000 a year.

As to fees, before jumping to a conclusion on their investments, it is worthwhile analyzing the rate of return of the adviser-managed portfolio and comparing it to the return of a portfolio with a similar asset allocation that consists of low-fee exchange-traded funds, Ms. Knoblach says. "It is worthwhile maintaining the portfolio as is if the return after fees matches or outperforms the return that can be obtained with a couch-potato portfolio." If Theodore and Violet are concerned about investment fees, or if they think they might drift off course, they could use all-in-one exchange-traded funds, which automatically rebalance to a target allocation. Alternatively, they could open an account with a robo-adviser, or online portfolio manager, which will manage a passive investment portfolio at a significantly lower cost than a portfolio that is actively managed, the planner says.

Client Situation

The People: Theodore, 40, and Violet, 34.

The Problem: Can they afford to build the farmhouse of their dreams and still retire early with $150,000 in spending? Should they pay off their mortgage?

The Plan: Let the mortgage run. By the time Theodore is 48 they should have saved up $500,000, at which point they can start building the new house. Be prepared to spend substantially less in retirement or work five years longer.

The Payoff: A clear-eyed look at the trade-offs their plans entail.

Monthly net income: $14,095.

Assets: Cash $75,000; his TFSA: $130,000; her TFSA: $110,000; his RRSP: $130,000; her RRSP: $25,000; non-registered: $220,000; estimated present value of his DB pension $780,000; estimated present value of her DB pension: $181,600; residence: $520,000; farmland: $305,000. Total: $2.5-million.

Monthly disbursements: Mortgage $3,000; property tax $325; water, sewer, garbage $40; home insurance $125; electricity $60; heating $80; maintenance $400; car lease $250; fuel $110; parking, transit $50; groceries $750; clothing $250; gifts, charity $380; vacation, travel $320; dining, drinks, entertainment $325; personal care $100; club membership $25; sports, hobbies $150; subscriptions $70; other personal $250; drugstore $15; health, life, disability $190; communications $115; RRSPs $835; TFSAs $1,085; non-registered savings $2,500. Total: $11,795.

Liabilities: Mortgage $160,000.

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