Turbocharge your RRSP

Falling behind? It's not too late to catch up. These seven tips will help put your RRSP into overdrive.

By Sarah Efron | From MoneySense Magazine, February 2011

1: Get your boss to help out
The first thing to do to boost your savings is to have a good look around for any free money on offer. It's amazing how many people will do almost anything for a raise, but when their employer offers to pour money into their RRSPs, they don't even bother filling out a few forms.

If your company offers a defined benefit pension plan, join. If you can get into a group RRSP plan or defined contribution pension plan where your company matches part of your contributions, run—don't walk—to HR to sign up. Why? Because if you don't, you're turning away free money that will help you reach your retirement goals faster.

Employee stock plans are another great way to get a big return on your investments, provided you don't concentrate too much of your net worth in your company stock. (Otherwise you'll be doubly vulnerable if the company runs into trouble.)

"It is shocking that very educated professionals do not take maximum advantage of these types of programs," says financial educator Talbot Stevens. "I would put that at the top of the list for most people—even ahead of normal RRSPs. If you put a dollar in, and the employer will give you another dollar, that's a tough return to beat."

2: Make it automatic
Sure, You may have heard the expression "pay yourself first"—meaning that every time you get paid, you immediately put a portion of that money into your savings—but do you actually do it? "Often people invest on an ad hoc basis—when they have the cash and when they're in the mood," says Stevens. "Sadly, both conditions have to exist at the same time or nothing happens."

Make 2011 the year that you actually set up an automatic savings plan to stash money in an investment account every time your get your paycheque. You won't ever see the money and be tempted to spend it, and it will snowball every month. You'll also benefit from "dollar-cost averaging"—meaning that you'll buy more shares in mutual funds or index funds when they're cheap (because your $500 automatic purchase, say, will cover more units), and fewer when they're expensive. Once your money is invested, leave it there to grow. "It should be sacrosanct money," says Tom Hamza of the Investor Education Fund.

If you feel like you're barely making ends meet as it is, start small. Even taking $40 off each biweekly paycheque will add up to more than $1,000 a year, which is a good start. Besides, just setting your savings plan up is a great way to overcome that inertia. Once you reach your mid-50s, the kids move out and the mortgage is paid off, you'll be able to drastically increase the amount. "Remember, you'll be going into what will be the highest earning period of your life," says Hamza. "Time is still on your side, but you need to take action now."

If you have no idea whether you're saving enough, it may be time to create a proper financial plan. (See "Three Magic Numbers" for help on coming up with some approximate savings goals in the meantime.) At first, you might be intimidated to realize you'll need to save, say, $400,000 for retirement. But it won't be so hard: consider that if you start saving $600 a month at age 40 and get a 6% return on your investments, you'll hit your target by age 65. But be careful: people who feel pressure to get high returns often fall into the trap of choosing overly risky investments—a strategy that can have potentially disastrous results.

3: Rely on your RRSP

Holding your retirement investments in a tax shelter so they can compound tax-free is one of the best ways to turbocharge your savings. But which one should you use? A TFSA or an RRSP? Luckily, if you're a typical middle-class family, the answer is simple: just go with an RRSP.

RRSPs work best when there's a big income differential between when you put the money in and when you take it out. Why? Because the money you put in isn't really tax-free, you just get to put off paying taxes on it until you take it out. The idea is that you put the money in your RRSP during your peak earning years, when you're in a fairly high tax bracket. If you're like most middle-class folks, you'll be in a lower bracket when you retire.

However, this logic breaks down if you're earning less than $40,000 a year. You're already in a low tax bracket, so you're unlikely to be paying less tax in retirement. Plus the retirement income from your RRSP could result in clawbacks on government benefits. RRSPs are also not always ideal for high-net-worth individuals or workers with generous pensions, as they may have higher incomes during retirement than when they were working. Both of these groups might be better off using a TFSA.

4: Reinvest your tax refund

For many people, the biggest motivation to invest in RRSPs is the juicy tax refund that follows a few months later. It's like a present from the government to reward you for being wise enough to save for retirement, right? So it's okay to spend it on a spontaneous vacation down south. Sorry to ruin the fun, but this rosy interpretation of RRSPs isn't based on reality.

That's because your tax refund is really only the government returning a tax overpayment to you. So instead of having that money throughout the year to invest it yourself, you've been lending it to the government for free. You can avoid this by planning the amount you want to contribute to your RRSP during the year and telling your employer in advance. Then the company can reduce the amount of tax taken off of each paycheque, freeing up more cash flow for you to put directly into your RRSP. (You'll be asked to fill out form T1213 from the Canada Revenue Agency.)

The other dark side of the RRSP refund is that the government is only giving you back your money temporarily. Don't forget that you will pay tax on the money when you pull out your RRSP in retirement. The refund isn't a tax break, just a tax deferral. This means that when you put $1,000 in your RRSP, you don't actually have $1,000 worth of retirement savings. It's true that your $1,000 will benefit from tax-free compounding, often for decades, but consider this: If you are in a 40% tax bracket in retirement, when you withdraw that $1,000 from your RRSP or Registered Retirement Income Fund (RRIF), you will only get $600 after tax.

The best plan is to accelerate your retirement planning by using the refund to make an RRSP contribution for the following year. This will take a big bite out of the amount of money you need to put aside each month for retirement savings. "If you use the entire refund for something like a holiday, what you're doing is putting more pressure on your weekly or monthly budget," says Hamza. "If you do that, you're more constrained because you used all that money to treat yourself once. If you spent it in April, by June you've forgotten about it. It's better to have the freedom on a regular basis to put it where you want to put it."

5: About that raise …

Another great way to build your savings faster is to take full advantage of salary increases or other new sources of money. "If you get a raise, you can treat it like found money and divert it into your RRSP," says Patricia Domingo, investment and retirement planner at RBC. You're already accustomed to living on your previous salary, so you won't miss the new money if it's automatically shoveled into your savings. This will prevent your spending from drifting upwards with your income.

Hamza says this simple strategy is one of the easiest ways to save, particularly if you're young and have years of annual salary increases and promotions ahead of you. "Over time, putting together a regular stream of funds from various sources, including raises, cost of living increases and bonuses, can cover a significant portion of your long-term needs."

There's another trick for people who are paid biweekly: twice a year there's a "three paycheque month." As bills are typically paid monthly, this will give you some free cash for your savings. Also, if you receive an inheritance or another lump sum, consider putting it in your RRSP. For large amounts, it might be best not to claim it all in one year. Talk with a financial planner about maximizing your refunds by spreading out deductions over several years.

6: Borrow to save

It may sound strange to save and borrow simultaneously, but if you do it right, you can catch up on your saving quickly. Most financial planners agree that an RRSP "top-up loan"—borrowing to boost the amount you are investing—is a sound strategy as long as you pay off the debt quickly. "It's a no-brainer," says Stevens.

Here's how it works: Say you're in a 40% tax bracket and you have $6,000 to put into your RRSP. You top up your contributions with a $4,000 loan from your financial institution and put a total of $10,000 into your RRSP. A couple of months later you get your tax refund of $4,000, which you use to pay back the loan. The $10,000 starts compounding in your RRSP right away, and you won't be tempted to blow the refund on things you don't really need.

Even if you can't pay back the entire loan immediately with the tax refund, RRSP loans that are paid off within a year can still be smart. If your investment returns end up lagging the interest rate on your loan, you can still come out ahead, because after you apply your refund to the loan, the outstanding balance will be less than the money invested in your RRSP.

Typically, financial institutions offer RRSP loans at prime (currently 3%), or prime plus 1%. Many allow you to defer payments for 120 days, so you'll get your tax refund before payments are due. However, interest still accrues during this time period. Another way to borrow the cash is to use a line of credit secured by your home. (Unfortunately, interest on RRSP loans is not tax-deductable.)

The key to RRSP loans is creating a plan to pay off the loan quickly and being disciplined enough to stick to it. A good plan should lead you to the point where you are saving for the current year, rather than taking out loans to "save" retroactively. "The challenge is that if a client gets an RRSP loan and pays it back during the year, then by the same time next year, they don't have any money to put into their RRSP again," says Karen Collacutt, a money coach and financial planner in Barrie, Ont. "It can lead them to taking out a loan again. They need to get ahead and make contributions going forward or they end up in a bit of a cycle."

On the more controversial side of RRSP borrowing is the "catch-up loan." With this strategy, an individual borrows a larger sum, say $25,000—enough to use up all of their accumulated RRSP room. They get a large refund back, apply it against the loan, and then pay off the rest over a period of, say, five years.

To find out if this would make sense in your situation, you'll need to do some number crunching and take a close look at your tax bracket. If you put a large amount in your RRSP in a single year, and it reduces your taxable income enough to knock you into a lower tax bracket, you'll get a smaller refund then you anticipated.

Catch-up loans can be a good strategy for people who are more likely to pay off debt than save for the future. "Once you start that RRSP catch-up loan, it locks you into a higher level of discipline and commitment than most people apply to their savings," says Stevens. However, if you're uncomfortable with debt, this isn't a strategy for you.

Because catch-up loans can take a long time to pay off, investors need to be patient. "Usually by the third year, people say 'I got my refund three years ago, but I'm still paying off this stupid loan,'" says Collacutt. "However, as long as the market's doing okay, they still see the impact in their RRSPs and they're generally feeling fine."

However if your investments tank, you could be in for a bumpy ride. "Then it's a huge issue, as suddenly the client owes more than what the investments are worth," says Collacutt. You can reduce the chances of that by being fairly conservative with your investments inside the RRSP. When you're doing the math, make sure your strategy will work even if your returns are low. You'll want to walk through several scenarios with your financial planner. And remember: financial firms profit twice by enrolling you in these schemes—first from the interest on the loan, and again from the sale of investments—so don't let them pressure you into a strategy you're not comfortable with.

7: Focus on your home … for now
It's that classic conundrum: You're behind on your RRSPs, but you've got a huge mortgage to pay off too. Which one should you focus on first?

We can help: Even if you do feel like you should be catching up on your RRSP, paying your mortgage first is often the winning move.

Many people think that RRSPs are the way to go because you get a tax refund. But according to Malcolm Hamilton, a retirement expert at human resources company Mercer, this logic is faulty. "This simple analysis is flat-out wrong, because it gives you credit for the money you get back with your tax refund, but it doesn't punish you for the fact that when you take the money out, you pay tax."

Instead, Hamilton says you should compare the rate of return on investments inside an RRSP with the interest rate you're paying on your mortgage, while taking risk levels into account. "The highest risk-adjusted rate of return will almost always be repaying the debt," he says. "The rate of interest you pay on borrowing is virtually always higher than the interest you earn on savings."

How can that be? After all you're getting 8% on your RRSP investments and the interest on your mortgage is just 4%. Simple: you have to compare apples to apples. The interest rate on your mortgage is a sure thing, while the return on your investments is not. To be fair, you have to look at what kind of risk-free return you can get in your RRSP, which would be a GIC, at about 3%.

Keep in mind that if you focus on paying off your mortgage when you're in your 40s, then you can take all the money you were ploughing into your home and use it to build an RRSP nest egg rapidly. Just be prepared: this requires some discipline, and you'll need to resist the urge to upgrade to a pricier home.

In the end, your individual circumstances will determine which strategy works best for you. If you have a low interest rate on your mortgage, or you're fairly certain you'll be in a lower tax bracket upon retirement, that gives RRSPs an edge.

However, if you're not sure which strategy is best for you, don't fall into the 'analysis paralysis' trap. "If you feel more comfortable with one strategy than the other, I would go with that," says Hamilton.

"Regardless of whether you put your money into an RRSP, TFSA, or your mortgage, they're all good things to do."