THE BEGINNER'S GUIDE TO saving AND investing FOR CANADIANS

Grow and protect your wealth with the help of Canada's top personal finance bloggers and online experts

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The Beginner's Guide to Saving and Investing for Canadians

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INTRODUCTION

Welcome to The Beginner's Guide to Saving and Investing for Canadians. This book is designed to help Canadians make better decisions about their money.

We know there are already countless books and articles about saving and investing, but we believe this one is unique. For the first time, it brings together the collective experience of Canada's foremost personal finance bloggers and online publishers, each of whom writes about his or her particular area of expertise.

First, **Krystal Yee** (the blogger behind givemebackmyfivebucks.com) shows you how to create a budget. Few people enjoy budgeting, but this may be the most important step of all, because no financial plan will

Saving and investing requires lifelong learning. Visit the authors' blogs and join the growing community of Canadians who are taking control of their financial lives

work if you're spending more than you earn. As Krystal writes, the key is understanding that budgeting may involve short-term sacrifices, but in the long run it will allow you to reach your life goals sooner.

Once you've got your monthly budget in shape, **Jim Yih** (retirehappyblog.ca) explains where to save your money. If you've ever been confused about defined benefit pension plans, group RRSPs, education savings, Tax-Free Savings Accounts and all of the other accounts available, this chapter will bring some clarity.

The next two chapters explain how to build an investment portfolio to grow your wealth. While most Canadians invest by buying mutual funds or individual stocks, **Ram Balakrishnan** (canadiancapitalist.com) begins by laying out the case for index investing, a strategy that can deliver higher long-term returns with lower costs, less risk and less stress.

If you're willing to be more active with your portfolio, **Frugal Trader** of Million Dollar Journey (milliondollarjourney.com) will show you how to become a dividend investor. By investing in stocks that pay regular dividends, many Canadians have built a stable portfolio that will generate a reliable stream of tax-advantaged income to fund their retirement.

Finally, **Glenn Cooke** (lifeinsurancecanada.com) shows you how to protect yourself and your family using insurance. The insurance industry relies heavily on marketing techniques, and Glenn cuts through the hype and emotion to explain basic insurance principles that will help you determine what coverage is most suited to your needs.

When you're done reading, you'll be well equipped to start building—or rebuilding—your financial future with knowledge and confidence. But always remember that saving and investing requires lifelong learning. Any time you need more information or support, visit the authors' blogs and websites and join the growing community of Canadians who are taking control of their financial lives.

CHAPTER 1

making a BUDGET

By Krystal Yee
givemebackmyfivebucks.com

When most people think of budgeting, they think of something boring and time consuming. But budgeting can be a fulfilling and empowering experience. Taking control of your money is the first step to financial freedom. It can help you get out of debt, save for the retirement of your dreams, and plan for life's expected—and unexpected—expenses.

If you've ever counted down until your next payday, played the balance-transfer game, or charged groceries to your credit card knowing you wouldn't be able to pay it off by the end of the month, chances are you aren't budgeting. And you probably wish you were.

For most people, budgeting doesn't come easy. You might account

When you live beyond your means, you'll be paying interest on purchases that might have been made months, or even years, ago

for expenses such as your rent, cell phone bill, and car insurance—but what about the invisible expenses that you just can't seem to track? The evening latte with a friend, a short cab ride downtown, or having pizza delivered because you're too tired to cook—these small expenses deplete your money faster than you think, and will quickly eat away at any budget. You tell yourself, "I'll put away a little bit on my next payday," but that never happens.

In order to get out of debt and start saving, you have to stop the cycle. Believe me, it's worth the effort. To help you get motivated, here are a few of the benefits I've gained from budgeting and living a debt-free life:

Your paycheques are yours. When you're debt-free, your money belongs to you and no one else. You won't owe money to family, the government, credit card companies, or the bank. You will get to choose how every dollar you make is spent, saved, or invested—and nobody else will have the right to dictate how you allocate your expenses. It's a liberating feeling.

No more stressing about the bills. You don't have to stress out about transferring money between accounts in order to make ends meet, and you won't be anxious about paying your rent, or having enough money for groceries. You will be to able stop worrying, slow down, and actually enjoy what life has to offer.

You are no longer stealing from your future. When you live beyond your means, you'll be paying interest on purchases that might have been made months, or even years, ago. It's a hard pill to swallow.

Understanding where your money goes and living debt-free means living in the present, and being able to look towards the future.

You can achieve your dreams. Not having a grasp on your personal finances limits your options. So many doors open for you when your finances are no longer holding you back. Whether it's pursuing a new career, giving to charity, buying that dream car, travelling, or retiring early—when you live within your means, you will be able to do whatever you want to do in life.

FIGURE OUT WHAT YOU'RE WORTH

As you navigate through life, there is a good possibility you'll become distracted by acquiring possessions in order to feel successful—like a car, a place of your own, or that home theatre system you've been dreaming of buying. But the items you own don't do anything to indicate your financial well-being—that's where your net worth comes into play.

Understanding your net worth will give you a good indication of your financial situation. If you're in debt, it will allow you to grasp whether you're moving in the right direction. It will also give you an idea of just how much work you will need to do in order to turn your finances around. If you don't have any debt, knowing your net worth will help you prioritize where your money is going—especially when creating a household budget.

Calculating your net worth is as simple as adding up what you own, and subtracting what you owe:

Assets – Liabilities = Net Worth

Assets include the balance of your savings accounts, investments, retirement home, as well as the value of your house and car(s). Some people choose to include the value of other items that can be liquidated—such as bicycles, televisions, or a baseball card collection. If you're just starting out, don't worry about what to include and exclude.

Just make sure that you keep it consistent over time. If you decide to include depreciating assets into your net worth equation (like a car), make sure to account for its depreciated value every time you update your net worth.

Your liabilities are anything you owe money on—like your mortgage, car loan, credit card debt, student loans, personal loans, or any money you owe to your RRSP (for the Home Buyers' Plan or Lifelong Learning Plan).

DETERMINE YOUR GOALS

If you create a budget without understanding its purpose, there is no incentive to succeed. That's why so many people fail at budgeting: they end up making poor financial decisions because they aren't driven by long-term goals.

The good thing is that setting goals is simple. Take some time to identify your short, medium and long-term goals, as well as how you plan to achieve them, and how much it will cost you.

Short-term goals. What do you want to accomplish in the next year or two? Maybe you would like to pay off a nagging credit-card debt, or find ways to trim your household spending by $50 or $100 a month. It's easy to talk about these goals, but unless we write them down and create a plan to achieve them, we will never reach them.

Medium-term goals. Looking ahead three to five years, can you think of a financial goal you hope to accomplish? Maybe it's getting out of student loan debt, choosing a new career path, or saving for a down-payment on a home.

Long-term goals. Many young people give little thought to their retirement goals. To them retirement is decades away, and a lot can happen in the meantime, but it's still worth including long-term savings in your budget.

After identifying your goals, you'll need to prioritize each item on your list. Decide on the timeframe you want to achieve each goal, and estimate how much it will cost. Then create a step-by-step plan to achieve it.

Now take a look at that list. How will your current financial situation help you achieve any of your goals? Are you saving enough money, or are you barely scraping by? This might be a difficult question to answer, because while your spending patterns today might not help you achieve your goals, they certainly help to satisfy your immediate desires.

Every time you choose to buy something you don't actually need, you are subconsciously agreeing to put off your goals in favour of immediate satisfaction.

True, it can be hard to defer gratification in pursuit of longer-term goals. But that's why you need to attach a sense of meaning to your saving. If you start budgeting and saving simply to reach a certain dollar amount, it's going to be hard to stay motivated. Creating specific goals so that each dollar you save has meaning behind it will ensure a greater chance of success.

MAKE A DEBT REPAYMENT PLAN

The first step to take charge of your money. The best way to do that is to create a budget. The key to creating a successful one is calculating how much debt you owe. All of it. Stop making excuses—if you have debt then it's because of the decisions that you've made in your life. And the sooner you acknowledge that, the easier it will be to come up with a repayment plan.

Start by creating a list of everything you owe—including student loans, any amount owed to family, and debt in collections. Don't stop there. Obtain your free credit report from both Equifax and TransUnion to make sure you haven't forgotten about any unpaid debts or loans from your past. It's better to start off with a complete picture of your financial situation and deal with it now instead of finding out later.

> Contact all of your creditors to try to negotiate a lower interest rate. You may be surprised to learn that some credit card providers will lower your rate on request

For each debt, record the following:

- Name of debt
- Total amount owed
- Minimum payment
- Interest rate

Now contact all of your creditors to try to negotiate a lower interest rate as soon as possible. You may be surprised to learn that some credit card providers will lower your rate on request. If you have a lot of credit-card debt, consider making an appointment with your bank to consolidate your debt into a line of credit with a lower interest rate.

Think twice before transferring balances on high-interest credit cards to cards with a lower teaser rate. You can see how this plan could go horribly wrong: if you can't refrain from using your credit cards, you will end up with more debt once the teaser rate expires. Only attempt the balance-transfer manoeuvre if you can control your spending on both the new and the old card. Then, cut up the old credit card so you aren't tempted to rack up the balance again.

Okay, now it's time to create a debt-repayment strategy. Consider the following approaches: the debt snowball and the debt avalanche. Let's take a look at an example of how these two strategies work.

Suzanne has $23,000 in debt spread over five different creditors. (*See Figure 1: Suzanne's debts, on opposite page.*)

She wants to create a plan to become debt-free so that she can save for her dream wedding. She creates a budget, and after satisfying the minimum-payment obligations, she has an extra $200 each month to put towards debt. Where should she direct that money? Here are the two popular plans of attach.

Debt snowball method: Using this method, Suzanne will list all of her debts in ascending order, from smallest to largest balance. After covering the minimum payment on every debt, she will then apply the extra $200 each month towards the smallest debt until it is paid off. Once that debt is paid in full, she will add the old minimum payment and the extra $200 from the first debt and apply it to the second-smallest debt.

Here are her options:

MasterCard	**$233.75/month ($33.75 minimum payment + $200)**
Store credit card	**$64.58/month**
Line of credit	**$45/month**
Visa	**$165/month**
Student loan	**$166.67/month**

Once she has paid off her MasterCard, she will take the $33.75 minimum payment and the $200 extra payment and move onto the

FIGURE 1: SUZANNE'S DEBTS

DEBT	BALANCE	INTEREST RATE	MINIMUM PAYMENT
Visa	$6,000	21%	$165/month
Line of credit	$3,000	6%	$45/month
Student loan	$10,000	8%	$166.67/month
MasterCard	$1,500	11%	$33.75/month
Store credit card	$2,500	19%	$64.58/month

next smallest debt, which is her store credit card. This would give her $298.33 to go towards that $2,500 balance. Once that is paid off, she will move onto the line of credit, applying the same method.

By the time she reaches her student loan the amount she is paying each month will have grown substantially—like a snowball rolling down a hill. Using this method, Suzanne will be debt-free in 41 months, having paid $5,043.02 in interest.

Debt avalanche method: The debt avalanche method is similar to the snowball method, but instead of paying debt according to balance amounts, Suzanne will tackle the debts in order of their interest rates, from highest to lowest:

Visa	**$365/month ($165 minimum payment + $200)**
Store credit card	**$64.58/month**
MasterCard	**$33.75/month**
Student loan	**$166.67/month**
Line of credit	**$45/month**

Suzanne would concentrate on paying off the Visa first, because it has the highest interest rate. Then, once she has paid it off, she will take the $165 minimum payment and the $200 extra payment and put it towards the debt with the next highest interest rate, which is her store credit card.

Using the debt avalanche method, Suzanne will be debt-free in 39 months, having paid $4,454.74 in interest.

There is a lot of debate about which is the best debt reduction strategy. The debt snowball plays into the sense of accomplishment we feel when we achieve small goals. By paying the smaller debts first, Suzanne will be able to eliminate the number of creditors faster, giving her the motivation she needs to keep going. It's best suited to people who are strongly influenced by emotion and prefer quick, tangible results. It is also an effective method if all your debts have similar interest rates.

However, the debt avalanche is the rational and mathematically correct method. If Suzanne implements the debt avalanche method, she will pay $588.28 less in interest, and will be debt-free two months sooner than with the debt snowball method. It will work for those who understand that it is the most cost-effective debt-repayment strategy.

Check out the website unbury.me to calculate whether the avalanche or snowball method will work best for you.

CREATE YOUR BUDGET

Budgeting is a lot like dieting—it feels like deprivation when not done properly, and most people stop doing it as soon as it starts to feel uncomfortable. However, it is the very first thing you need to do in order to get out of debt and start saving. The problem is, most people can't be bothered to track their spending, so they end up quitting the budgeting process before they even see the benefits.

What's coming in? Start by taking a hard look at how much cash you have coming in each month. Aside from what you earn from your full-time job, this can also include money you earn from a part-time job, freelance gigs, government assistance, child support, or any other form of reliable income.

Many people find ways to make extra cash each month, but they treat it as "found money" that they can spend frivolously. However, if you have a financial goal, or debt to pay off, any extra income should be put towards those goals instead.

The aim is to estimate how much you earn, but for some this might be tough. If you are self-employed, commission-based or have irregular income, you might find budgeting to be frustrating because it's hard to predict how much money you'll actually make. There are generally two methods of projecting your income in order to create a successful budget:

- Average monthly income. Add up your monthly income from the past year and divide by 12.

> Keep track of every dollar you spend for one full month. This process might be tedious, but it's important to know where your money is going before you can create a realistic budget

- Minimum monthly income. Take the lowest-earning month you have had in the past 12 months and base your budget on that amount.

If you are basing your budget on your minimum monthly income, then you should never make less than that amount. But if for some reason you have a bad month, you will already know what you are willing to cut out of your budget, based on your priorities. If you still can't cover your monthly expenses, you have the added cushion of knowing you are living on last month's income, and in a worst-case scenario, you have your emergency fund in place. (*For more on creating an emergency fund see page 24.*)

What's going out? It is extremely important to understand exactly where your income is going, so the next step to creating a successful budget is to list all of your fixed expenses. These are the items in your budget that don't fluctuate each month—such as your rent or mortgage, condo fees, car payments or insurance.

Once you've figured out your monthly fixed expenses, you need to prioritize them according to importance, and when they are due each month. (*See Figure 2: Sample monthly expenses, on opposite page.*)

It's important to note that your housing costs (which include rent/mortgage, condo fees, and property tax) should not exceed 35% of your income. This is the rate the banks use to determine how much debt you are able to afford.

After you have assessed your fixed expenses, it's time to move onto your variable expenses—such as food, home improvement costs, entertainment, personal care and travel costs. Figure out, based on your income, how much you think you should be spending in each category.

You will also need to make a list of irregular expenses that you will incur during the year, such as medical prescriptions, sports league fees, etc. These expenses will be a lot tougher to calculate, but try to make a reasonable estimate. Once you've come up with a list of irregular expenses, add it up, and divide the amount by 12. This is an additional amount you will need to set aside each month. (*See Figure 3: Budget worksheet, on page 21*).

Track your spending. Now, it's time to spend one full month keeping track of every dollar you spend. Whether you write it down in a notebook, type it into your smartphone or log it into a spreadsheet, you need to keep track of every purchase you make, without exception. This process might be tedious, but it's important to know where your money is going before you can create a realistic budget.

Nowadays, everything can be automated—your paycheques, savings, RRSP and investment contributions, as well as all of your monthly bills. But while you think you're making your life easier by automating everything, you might be doing more harm than good.

FIGURE 2: SAMPLE MONTHLY EXPENSES

EXPENSE	AMOUNT	MONTHLY DUE DATE
Rent	$1,400	1st
Home insurance	$25	28th
Car payment	$250	14th
Car insurance	$125	26th
Cable/internet	$90	5th
Gym membership	$65	15th

Automating all of your finances can lead to bad spending habits because you aren't conscious of where your money is going.

Sitting down to pay your bills might take an extra hour each month, but it really forces you to see where your money is going, and catch any billing mistakes. It helps you have a better relationship with your finances, and you might realize that you're paying for a lot of things that you just don't need or value.

Are you overspending? Once you've figured out how much you spend each month, the next step is to subtract your actual monthly spending from your monthly income. How does it compare to the budget you had created?

If you have a negative number, don't panic. Take a look at how much you've been spending on discretionary items. Based on what you need to do to achieve your short-term and long-term goals, you will need to make some big decisions. Have you been spending too much on groceries? Is there something you have budgeted that you can really do without? Do you really need a data plan with your smart phone? Is it important to have satellite TV? Can you cut back on your restaurant spending?

We all have things that we like spending money on, and sometimes we get in the habit of spending more than we can afford. We convince ourselves that it's okay because a better job is around the corner, an annual bonus will cover the expenses, or because we think we deserve it. But the truth is, no matter how much money you make, there will always be something unattainable on your wish list. Even millionaires can't afford everything they want.

EARN MORE MONEY

If, after you've made the necessary cuts to your budget, you're still seeing red or you don't have enough left over in your budget to reach your goals, it probably means you aren't earning enough money. If that's the case, you can improve your situation by bringing in extra income. This can be anything from taking on a part-time job, selling items you no longer use, or any other creative way you can think of to earn more money. Even if you only have a couple of hours each week to spare, find a job that fits into that time slot—like tutoring, teaching music, or shovelling snow.

Working a part-time job isn't just for those struggling to make ends meet—it can also be for those people who are serious about boosting their income on a more permanent basis. But taking a second job means sacrifice and dedication. You can't add additional hours to each

FIGURE 3: BUDGET WORKSHEET

EXPENSES	BUDGET	ACTUAL SPENDING	DIFFERENCE
Rent/mortgage			
House insurance			
Car payment			
Car insurance			
Medical and health care			
Utilities			
Internet/television			
Food			
Entertainment			
Clothing			
Travel			
Car and transportation			
Personal care			
Miscellaneous			
TOTAL EXPENSES			

> Set up a monthly automatic savings plan, where your money gets transferred from your chequing account into a savings account each time you get paid

day, so you will have to cut out other activities. It'll take some getting used to, but your sacrifice will help you reach your goals sooner.

Get organized. For most people, time management is the most challenging aspect of a second job. Take a week and break down your daily schedule into one-hour time blocks. Write down everything you do during the day, and see what you can cut out. You'd be surprised at how much time you have when you cut out the activities in your daily routine that aren't productive.

Set boundaries. The biggest risk to taking on a second job is burn out. If you find yourself regularly working 70 to 75 hours a week, you might want to scale back and create a better work-life balance. Make sure to set aside time for yourself and your family—and make that time count. Go on family outings or take a yoga class instead of sitting at home watching television.

Avoid conflicts of interest. Make sure there is no conflict of interest between your regular day job and your part-time job. For example, it might be considered a conflict of interest if you start freelancing for a competitor, or if your second job is within the same industry as your full-time job.

Find a fulfilling job. Instead of opting for a position that is similar to your day job, try to find something different. A change of scenery might help make the transition into a new lifestyle a little bit easier. Additionally, it can be a good idea to find a job that helps you succeed with a personal goal. Whether you want to improve a skill, indulge your hobbies, or make new friends, try to look for that when you're job hunting.

Save all of your income. If your plan is to use the extra money to give yourself a lifestyle boost, then all of your hard work is going to waste. Putting all of the money from your part-time job towards your financial goals will mean that you'll see positive results—which will give you the motivation to keep on going.

TIPS FOR SAVING MONEY

We all know what we have to do in order to save money—cut down variable expenses, increase our income, and create a budget. But according to a recent Certified Public Accountant survey, almost half of Canadian workers are unable to save even 5% of their net pay—so how many of us are actually putting that knowledge to work?

There are several steps you can take to hold onto more of your cash. Here are four proven tips that will supercharge your savings:

Pay yourself first: This is the single best way to ensure that you reach your savings goals. Instead of saving whatever money you have left over at the end of each month, set up a monthly automatic savings plan, where your money gets transferred from your chequing account into a savings account each time you get paid. Because the transfer is automatic, you will never "forget" to manually transfer the money, and you won't be tempted to spend it. Make sure to increase your savings rate as your income increases.

Life happens, so remember to save when the going is good. This leaves the rest of your money for everyday life expenses. And at the end of the month, if you have a surplus of money, you can tuck that cash into another separate savings account, where you can feel free to spend on anything you want—like a vacation, a concert, or a weekend ski trip with your friends.

Deposit your extra paycheques. If you get paid biweekly, then there are two months each year where you get paid three times. Instead of spending that money on a large purchase or splurging on a vacation, deposit the entire paycheque into your savings account before you even have time to think about what you want to spend it on.

Save your savings. Think of the last time you used a coupon, taken advantage of a sale, or shopped around for cheaper car insurance. Now think about what you did with the money you "saved." You might have congratulated yourself for being a smart consumer, but chances are, you turned around and used that "savings" to buy something else instead.

For example, if you buy a $100 sweater at 50% off, the $50 you saved on the purchase will probably just get absorbed into your monthly spending. So what have you actually saved? The next time this happens, try stashing those "savings" into a high interest savings account instead.

Make sure you don't receive a tax refund. Seems counterintuitive, doesn't it? But if you regularly receive a tax refund at the end of the year, you should submit a T1213 form from the Canada Revenue Agency. This form will let you adjust your withholding tax, so instead of receiving a refund at the end of the year, you will get that money on your paycheque—money that you can put to work sooner (*we'll go into this in more detail in Chapter 3: Investing Wisely, page 45*).

If you are eligible to receive GST/HST refunds, or any related programs, stash that money into a savings account as well. It may not be as fun as buying a new pair of shoes or going to a concert, but you'll be happy you have some cash in the bank should an emergency arise.

PREPARE FOR EMERGENCIES

Even if you've created a budget, you still need to plan for the unexpected, and that includes having an emergency fund.

If you're in debt, it can be tempting to throw every penny towards your creditors. However, it's when you're in debt that your emergency fund is most important. Remember that no matter how stable your job might seem, or how good your health is, nobody is immune to emergencies.

Most personal finance experts recommend keeping a minimum of three to six months worth of basic living expenses, but the truth is, how much you end up saving will vary based on your budget. For example, a single 20-something will have very different expenses compared to someone with a mortgage and a family. Even a few hundred dollars is a good start.

Instead of saving cash, some people keep a line of credit open for emergencies. But the obvious problem with using credit is that you will eventually have to pay it back. And if you are forced into an emergency, why would you want to face the added stress of piling on debt? An emergency fund is meant to act as a cushion. If you stumble, it will be there to catch you, no strings attached. You won't have to worry about payment schedules, interest rates, or mounting debt.

Relying solely on credit when you're at your worst means that you will always be living on the edge. Having a sum of money in the bank gives you options. Not only will your own money give you a solid sense of financial security, but there is something to be said about the confidence it will give you—knowing that you can stand on your own two feet and handle virtually any situation that comes your way.

Krystal Yee is a freelance writer and blogger with a strong background in social media marketing and graphic design. Born in Victoria, B.C., she earned a scholarship to play field hockey at Central Michigan University, and through careful budgeting, she was able to eliminate her $20,000 of student debt just 12 months after graduating. Krystal has developed a passion for financial independence, which she shares at Give Me Back My Five Bucks (givemebackmyfivebucks.com), one of Canada's most popular personal finance blogs. She has been featured in major media outlets such as The Toronto Star*, Moneyville.ca, Yahoo! Finance, Wall Street Journal Online and MSN Money. She now lives in Vancouver.*

CHAPTER 2

WHERE TO save your MONEY

By Jim Yih
retirehappyblog.ca

Canadians have not been good savers for a long time. Not only has the savings rate been on the decline since it peaked in 1982 at over 20%, it's been below 5% since the late 1990s.

One of the problems is that saving money is not a natural habit. Very few people come out of the womb with the savings gene. Saving money is a learned behaviour, and few people are given the opportunity to learn it properly. You don't get much of a financial education in school, and it's rare to find programs in the workplace. That means most are left to learn about saving money at home. Unfortunately, most parents are not good savers themselves, and many never talk to their kids about money.

It’s important to understand the difference between an account and an investment. Think of an account as a bucket, and an investment as something you carry inside the bucket

WHY SAVE MONEY?

I guess the answer to this question really depends on your goals. Some people save to spend—they are planning to buy a car, or a house, or shoes, to take a vacation, or to renovate the kitchen. Some people save for their children’s education. Others are saving for retirement. And yes, believe it or not, there are some people that are just saving because they can’t spend all their money.

The first step in saving is to know what you will use the money for. This will help determine the appropriate savings vehicle. For example, if you are saving money for your child’s education, then a Registered Education Savings Plan (RESP) will likely be the best tool. If you’re saving for a holiday, you would never use an RESP. Instead, a Tax-Free Savings Account (TFSA) would be much more appropriate. Saving for retirement is probably the most complicated, because you could use a Registered Retirement Savings Plan (RRSP), a TFSA or several other options.

The key point for now is that saving money for your future is best done when you have a clear idea of your goals.

CHOOSING AN ACCOUNT?

Before we go further, it’s important to understand the difference between an account and an investment. This idea is often misunderstood by people who are starting their savings journey. One way to understand the difference is to think of an account as a bucket, and an investment as something you carry inside the bucket.

The various account "buckets" in Canada include the ones we just mentioned—RRSPs, TFSAs, RESPs—as well as Registered Retirement Income Funds (RRIF), Locked-in Retirement Accounts (LIRA), and plain old non-registered (taxable) accounts. Each of these is governed by a different set of rules that spell out how much you can contribute, when you can withdraw the money and how the growth and income are taxed.

An investment is a type of asset that you hold inside one of these buckets. For example, with the money in your RRSP bucket, you can buy a whole range of investments, such as mutual funds, stocks, bonds, Guaranteed Investment Certificates (GICs), exchange-traded funds (ETFs), and many others.

Let's quickly walk through the four main accounts you can use to save money:

Registered Retirement Savings Plan: The RRSP was created back in 1957 and is primarily used to save for retirement. The incentive to use a RRSP is really tax-driven: when you put money into an RRSP, your contribution qualifies for a tax deduction. Any investment growth is tax-deferred until withdrawal. But when you eventually take money out of your RRSP (usually in retirement), it is fully taxable. You can also make early withdrawals from RRSPs to buy your first home or to pay for your own education. Your RRSP contribution limit is determined by the amount of income you earn.

Registered Education Savings Plan: The RESP is designed specifically to help you save for a child's education. RESPs are attractive because of the Canada Education Savings Grant: for every dollar you contribute to the RESP (to a maximum of $2,500 per child per year), the government will contribute 20 cents.

As long as the money stays in the plan, there is no tax on any investment growth. Later, when the money is withdrawn to pay for your child's education, the growth is taxed in the child's hands, so there is usually little or no tax.

Tax-Free Savings Accounts: The TFSA is the newest type of tax sheltered account, as it was just introduced in 2009. Unlike the RRSP, there is no tax deduction for contributions. However, all investment growth is completely tax-free, and you can withdraw money from a TFSA any time without any tax consequences. The maximum contribution is currently $5,000 per year for anyone over 18, although that amount is indexed to inflation so it will go up over time. If you withdraw money, you get that contribution room back the next year.

Non-registered account: A non-registered account is just a general investment account. It offers no tax deduction on contributions, and all of the growth is taxable: interest income, dividends, and capital gains have different tax treatments, but the Canada Revenue Agency takes a slice of each. In most cases, you would only use a non-registered account when your TFSA contribution room is all used up. As you can see, different accounts have different tax treatments and different rules. That also means different accounts will be more appropriate for different savings objectives. You can save money more effectively if you choose the type of account that is the best match with your savings goal.

SAVING FOR RETIREMENT

Retirement is supposed to be the best years of your life. Some call it the "golden years." It can only be golden if you have enough money.

The cold, hard reality is most people need to save for retirement. Government benefits like Canada Pension Plan (CPP) and Old Age Security (OAS) are generally not enough. Combined CPP and OAS might be a little more than $1,500 per month, but most people don't qualify for the maximum benefit. The average is about $1,000 per month, and I don't know many people who could live off that—even really frugal people.

Workplace savings plans are usually the best place to save for retirement. In fact, a 2011 survey by Fidelity Investments suggests that more than half (55%) of current respondents say they would not be saving for retirement if their employer did not offer a savings program. The study also found that 19% of these respondent have no retirement savings at all outside of their employer's plan.

Let's review the different workplace savings plans:

Group RRSPs are one of the most common workplace plans. They are very similar to individual RRSPs, except they are administered on a group basis by the employer. Employees make contributions to the group RRSP directly from their paycheque, and the tax savings from the contribution can be applied immediately. Some employers even match a percentage of the employee's contribution.

Defined Benefit (DB) Pension Plans pay employees a future retirement benefit that is known in advance, based on a formula that incorporates years of service, salary and a pension factor. In most cases, the contributions to the plan are shared by both the employee and the employer. These contribution amounts can change depending on whether the plan is sufficiently funded to meet its future obligations.

DB pension plans really reward long-term employees. People who retire with a defined benefit pension tend to have more stable, guaranteed income in retirement. Unfortunately, outside of the public sector there are fewer and fewer DB pension plans today, because they are costly to administer and the funding liability is shared by the employer.

Defined Contribution (DC) Pension Plans are becoming much more common because they are less costly and there is no funding liability on the employer. Under a DC plan, the future benefit is unknown: it depends on how much money is put into the plan and the rate of return earned on the investments—which means that employees bear the market risk.

What is "defined" in this plan is the amount of the contributions, usually expressed as a percentage of income. For example, an employee

If you don't have access to a workplace savings plan, an RRSP is often the best option for retirement savings. RRSPs help you reduce your current taxes to encourage you to save more

might contribute 5% of their salary and the employer will match that contribution, which brings the total pension contribution up to 10% of that individual's pay.

Deferred Profit-Sharing Plans (DPSPs) are similar to DC pension plans, whereby an employer distributes a portion of pre-tax profits to selected employees. However, unlike a pension plan, employees do not contribute to the DPSP.

Pooled Registered Pension Plans (PRPPs) are the new kids on the block when it comes to workplace savings programs. The federal government introduced PRPPs in 2011 to address the concern that millions of Canadians do not have a workplace pension plan, although the first pooled-plans aren't expected to be available until 2013. PRPPs are a type of defined contribution pension plan designed to help smaller businesses and self-employed entrepreneurs save for retirement. The idea is that smaller employers can pool resources with other businesses to enjoy a cost-effective pension plan that is easily administered.

SAVING WITH AN RRSP

For people who do not have access to a workplace savings plan, an RRSP is often the best option for retirement savings. RRSPs help you reduce your current taxes to encourage you to save more. When using RRSPs, there are two key tax benefits. First, when you make a contribution, you get an immediate tax deduction equivalent to your marginal tax rate. And second, any investment growth is tax-sheltered until it's withdrawn from the plan.

Your allowable RRSP contribution for the current year is the lower of:

- 18% of your earned income from the previous year, or
- The maximum annual contribution limit ($22,970 for 2012, rising to $23,820 for 2013) for the taxation year, minus
- The pension adjustment, which represents the value of any pension benefits accruing from participation in a registered pension plan or deferred profit sharing plan

RRSP contribution room can be carried forward to future years. If you are unable to maximize your RRSP contribution this year, you are allowed to make up the difference later. After processing your tax return, Revenue Canada sends a Notice of Assessment, which includes your contribution limit for next year. This document also shows your unused contribution room. You can also get this information by calling your local Tax Information Phone Systems (TIPS) number. Be sure to have your social insurance number and previous tax return ready.

You're allowed a $2,000 lifetime overcontribution if you're aged 18 or older. Your overcontribution can be used as a deduction in future years, but any amount in excess of $2,000 will be charged a penalty of 1% per month.

For most people, earned income for RRSP purposes is the amount in box 14 on their T4 slips. Earned income also includes self-employed net income, CPP/Quebec Pension Plan (QPP) disability payments and net rental income. Income sources that do not qualify as earned income include investment income, pensions (including DPSP, RRIF, OAS, and CPP/QPP income), retiring allowances, death benefits, taxable capital gains and limited-partnership income.

You don't necessarily need cash to make an RRSP contribution. You can contribute a security (such as a stock or mutual fund) you already own outside your RRSP. The "in kind" contribution is equal to the fair market value of the security when contributed. The security is deemed to have been disposed of (sold) at time of contribution. Be aware that this can have tax consequences. If you are selling an investment at a profit it could trigger capital gains tax.

You can make an RRSP contribution any time of the year, but the deadline for the current tax year is 60 days after the end of the previous calendar year. In other words, if you make an RRSP contribution in January or February 2013, you can include it on your 2012 tax return. Always consult with your financial institutions about how they are able to accommodate deadlines. The last year you may contribute to your RRSP is the year you turn 71.

WHEN YOU SHOULD USE AN RRSP

After being in the financial industry for 20 years, I realize that there are a lot of people who invest in RRSPs but don't really know why. Most people use RRSPs for the tax deduction, but that's a little shortsighted. There's more to making good RRSP decisions than just getting a tax deduction. Remember that down the road, when you take the money out of the RRSP, you have to pay taxes right back to the government.

So how do you know if you should use RRSPs? Here's my simple formula to help you use them properly: if your marginal tax rate (MTR) at the time of contribution is greater than your expected marginal tax rate at the time of withdrawal, then the RRSP will always give you a benefit. Most people earn less income in retirement than they did while they were working. That's why most people will benefit from the RRSPs.

Obviously, the ideal situation is to invest the money when you are in a high marginal tax rate and then take the money out when you subject to a lower marginal tax rate. Let's say, you are in a 36% MTR and you invest $1,000 in an RRSP. The government gives you a $360 tax refund as a result of that contribution. If you are in a 25% MTR when you take the money out, you do not have to pay back the $360, you only have to pay back $250. That's an 11% benefit on top of any investment returns you may have made. That's how to use the RRSP properly and to your advantage.

Every province has its own tax brackets and marginal rates. Knowing your tax rates will help you to make good RRSP decisions. For example, Larry earns $41,000 this year and expects that his income will grow to $46,000 next year because he is getting a promotion. If he would move into a higher tax bracket at $42,000, then a $1,000 contribution this year might be worth 25%, but waiting until next year to claim the contribution will save him 32%, so he should delay his contribution. (The benefits of deferring deductions will be explained in more detail later in the chapter.)

It's important to recognize the other benefit of RRSPs: the compounding of the tax-deferred income inside the account. When you make money on the investments, you do not have to pay tax on that growth, as long as the money stays inside the RRSP. The more time you have, the more valuable tax deferral and compounding become. For example, someone who is young and just starting to work may not be in a high tax bracket. Their best earning years may be ahead of them, suggesting that they will be in higher tax brackets down the road. I would argue that for this person, the magic of compounding over the long term outweighs the value of the tax deduction.

My advice to young people is to develop a long-term savings habit by putting money into their RRSPs on a regular basis. Developing the habit of saving for the future instead of saving to spend is the best financial habit you can develop.

WHEN YOU SHOULD NOT USE AN RRSP

RRSPs are not the ideal retirement savings vehicle for everyone. There are a few reasons why an RRSP may not be right for you:

- If your income is too low (generally less than $10,000) you will not benefit from the tax deduction.

Even if you have a low marginal tax rate, you will save around 25% in tax. In a higher tax bracket, the RRSP might save you as much as 46%

- If you will be in a higher tax bracket in retirement than when you are working. It's rare, but it happens, especially if you have a generous pension.
- If you have too much money in RRSPs already. For example, George worked in the tech industry at the right time. His RRSP grew to over $1.5 million, mostly because he had tech stocks and sold them at the right time. He now has a huge future liability because he will have to pay tax on all the money earned. There is no point putting more into RRSPs.

RRSPs are one of the best savings vehicles for retirement because of their tax benefits. That said, more and more people are questioning whether RRSPs really make sense, given the other ways you can put your money to work. Let's consider two of the most common RRSP debates.

RRSP VS. MORTGAGE

Making an RRSP contribution and paying down your mortgage are both good choices—they're certainly better than spending the money on things that give you no financial gain. I've seen so many different calculations to determine which is better, and the winner depends on the assumptions you use.

Let's compare the financial benefit of the two alternatives. First, assume that mortgage rates are 6%. You might think that paying down the mortgage means that you forego paying 6% in the future, and therefore the mortgage paydown has a financial benefit of 6%. But because of income taxes, you actually need to earn more than a dollar to pay down a dollar of debt—in fact, at a 32% tax rate you need to earn about $1.50. Therefore, paying down the mortgage has a pre-tax equivalent of 8.8% (6%/(1-32%)). Remember, the higher the interest rate on the mortgage, the more attractive it is to pay it down quickly.

Now let's look at the RRSP. Even if you have a low marginal tax rate, you will save around 25% in tax. In a higher tax bracket, the RRSP might save you as much as 46%. Given the choice, I would take that 25% to 46% saving over an 8.8% saving. Granted, this example is overly simplistic because you will have to pay tax down the road when you take the money out, but you also get the benefit of tax-deferred compounding as long as the money stays in the RRSP.

Doing both might make the most sense. You can do this by making the RRSP contribution first, and then using the tax refund to pay down the mortgage. For example, let's assume I have $10,000 and I am paying a 30% marginal tax rate. By contributing to the RRSP, I should save $3,000 in taxes. Once I get the refund, I should then take the $3,000 and pay down the mortgage. I have created $13,000 of use out of $10,000.

RRSP VS. TFSA

As we've seen, the downside of RRSPs occurs when you take money out, because you then have to pay the tax. With TFSAs, you do not get a deduction when you put the money in, but you still get the benefit of tax-sheltered investment growth, and you also don't have to pay tax when you take the money out.

To properly compare RRSPs and TFSAs, you have to look at the tax consequences when the contribution goes in to the plan and when the money comes out. With the RRSP, a $1,000 contribution might only cost you $700 of after-tax income because of the refund. But when you take it out and pay the tax, you might only net $700. With the TFSA, you get no tax break up front, but when you take out $1,000, you get to keep the full $1,000.

So, which type of account is best for someone saving for retirement? As with our previous question about RRSPs vs. mortgage payments, the answer depends on your situation. Here's a rule of thumb to follow:

- If your marginal tax rate at the time of contribution is higher than your expected marginal tax rate at the time of withdrawal, then RRSPs have the advantage.
- If your marginal tax rate at the time of contribution is less than your expected marginal tax rate at the time of withdrawal, then TFSAs have the advantage.
- If your marginal tax rate at the time of contribution is equal to your expected marginal tax rate at the time of withdrawal, then neither has the advantage.

Maybe the best solution is to do both, just like in the mortgage example above. Put the money in the RRSP and use the tax savings to contribute to the TFSA.

RRSPs: THE SMALL PRINT

Some of the rules surrounding RRSPs can be a bit complicated, but it's important to be familiar with them.

Withholding taxes. If you make an early withdrawal from an RRSP, be aware of withholding tax. Essentially, the government says that any withdrawals less than $5,000 will be subject to a withholding tax rate of 10%. For example, if you take out $4,000 from your RRSP, you will only get $3,600, because $400 (or 10%) will be sent to the Canada Revenue Agency for taxes withheld at source. If you take out a lump sum between $5,000 and $15,000, you will be subject to 20%

withholding, and any withdrawals greater than $15,000 will be subject to 30% withholding.

The most important point to stress is that the withholding tax rate is not your marginal tax rate. Often people will try to minimize withholding tax, thinking that will be their total tax bill, but they get surprised at the end of the year with additional taxes owing.

Deferring deductions. Most people invest in an RRSP with the intention of using the tax deduction immediately. What they don't realize is that they can save the deduction for a future year. Why would you want to do that? In case you'll be in a higher tax bracket a year or two down the road. Why not just make the contribution at a later date? Because once the money is in the RRSP, you take advantage of tax-deferred investment growth.

Reduce tax deductions at source. Most people who contribute to RRSPs throughout the year wait until they file their tax return to collect their refund. Although that feels good, what you're actually doing is giving the government an interest-free loan with your hard-earned money. That's pretty generous. To avoid that, you can file a request with the Canada Revenue Agency and get less tax deducted from your paycheques. That way, your tax refund will be spread out over every paycheque and you'll have the money more quickly to spend or reinvest. Of course, you have to make sure you're disciplined enough to save any extra money you see on your paycheque.

RRSP loans. If you don't have the money to put into RRSPs, most financial institutions will gladly lend it to you. If you borrow $10,000 at 5% to contribute to your RRSP, it will cost you $270 in interest if you pay it off in one year. Even though you cannot deduct the interest on loans for RRSP contributions, this is a relatively small price to pay considering the tax benefit you will get. Depending on your marginal tax rate, you are likely to get somewhere between $2,300 to $4,600 in tax savings. Add in the tax-deferred growth inside the RRSP and you've got a pretty solid investment.

Be careful about extending the term of the loan for longer than a

> Spousal RRSPs give people the opportunity to push retirement income from a spouse in a high tax bracket into the hands of a spouse with lower income

year. This would make your payments smaller, but it would also mean you would have to pays more interest over the longer term. In the same example as above, the payments on a $10,000 RRSP loan at 5% for one year would be $856 per month, and your total interest cost would be $273. If you spread that out over two years, your monthly payments would drop to $439, but the total cost of interest goes up to $529. Here the benefit of the tax deduction still outweighs the cost of the loan, but if you extend the loan to five years, you wind up paying about $1,300 in interest and borrowing is less attractive.

Spousal RRSPs. In addition to opening an RRSP for yourself, you can contribute to one in your spouse's name. The ideal situation for spousal RRSPs is when there is a wide disparity of post-retirement income between partners. Spousal RRSPs give people the opportunity to push retirement income from a spouse in a high tax bracket into the hands of a spouse with lower income.

Back in October 2007, the federal government introduced pension-splitting rules that allow retirees a chance to give some of their pension income to their spouse. Although the rules primarily benefit Canadians who are part of a formal pension plan, it can also help people who have converted their RRSP into a Registered Retirement Income Fund (RRIF) or an annuity.

Those over the age of 65 can give their spouse up to 50% of their RRIF or annuity income for tax purposes. (Prior to age 65, the only way to take advantage of pension splitting is if you have income from a pension plan.)

Pension splitting is great news for couples in retirement, because it means a lot of potential tax savings. Prior to the pension-splitting rules, the main way retirees could split income was through spousal RRSPs. Does this mean that spousal RRSPs are obsolete? Not necessarily. Spousal RRSPs may have lost some of their allure, but there are still situations where they provide a valuable benefit, especially for those planning to retire and draw income before age 65.

Everyone has unique circumstances so plan accordingly. When in doubt seek help and advice from professionals.

SAVING FOR EDUCATION

Although there are different ways to save for your child's education, the best way is usually the Registered Education Savings Plan. An RESP is a special account where contributions can earn a generous grant from the government. There is no tax receipt issued for the contribution, and the contributions can be withdrawn tax-free. All of the growth inside the account is also tax-sheltered, and when it is withdrawn it is taxed in the hands of the student.

The big carrot for RESPs is the Canada Education Savings Grant (CESG). For every dollar you contribute to an RESP, the government will provide a 20% grant, up to a maximum of $500. (To maximize the grant, you would have to contribute $2,500.) Higher grants are available for low-income families.

There is no requirement to contribute the maximum to RESPs every year, because every Canadian child under 18 accrues a CESG entitlement each year. Any amount not contributed towards the CESG can be carried forward into the future, but you can only collect a maximum of $1,000 in CESG in any one year.

There is no annual contribution limit, but the maximum lifetime amount is $50,000. If you contribute more than this, you may have to pay a tax on the excess. The maximum CESG that you can earn in total is $7,200. Based on the 20% grant, that means the total contribution eligible for the maximum CESG is $36,000.

TAKING MONEY OUT OF AN RESP

Once your child is enrolled in a qualifying educational program, they can start receiving payments from the plan. When it's time to take money out of the RESP, you specify whether the funds will come from contributions or accumulated income or both. Contributions are the money you put into the account. Accumulated income is everything else: the CESG and growth on the investments.

Withdrawals of the subscriber's contributions are not taxable. Withdrawals of the accumulated income are taxable in the student's hands. Since most students have little or no other income, they will likely pay little or no tax.

If you take the accumulated income out of the plan, it is considered an Educational Assistance Payment (EAP). When making a withdrawal, you should specify how much of the funds will come from contributions and how much from accumulated income. It is best to take out as much of the accumulated Income as possible.

The maximum you can take out in the first 13 weeks of schooling is $5,000. (Students who need more than $5,000 in the first 13 weeks can apply to Human Resources and Skills Development Canada.) Following the 13-week period, the beneficiary can receive any amount in Educational Assistance Payments. Remember that EAPs only include the interest and the grant. You can always withdraw as much of your contributions as you need to pay for a child's education.

The subscriber (usually a parent) is in control of the RESP. It is the subscriber who requests the withdrawal. The beneficiary (or student) has no control over the money. When the subscriber makes the request for a withdrawal, he or she can have the funds sent to the subscriber or the beneficiary. There is nothing stopping the subscriber from withdrawing the funds and giving it to the beneficiary at their discretion. The subscriber is not obligated to give the money to the student all at once. Getting money out of the RESP requires paperwork so subscribers may want to take out larger amounts and give it to the student as needed.

When you take money out of RESPs, you will have to provide proof of enrolment. (Different financial institutions can have different criteria.) Once you get the money, the government does not stipulate what you can use the funds for. You can use the money for books, rent, food, tuition, transportation or whatever you want.

If the beneficiary does not go to school, there are three options:

- You may change the beneficiary. In a Family Plan, the new beneficiary must be under 21 years of age and related to the subscriber by blood or adoption.
- If you have room, you can contribute up to $50,000 to your or your spouse's RRSP (only if the RESP has been open for at least 10 years and the beneficiary is at least 21 and is not pursuing higher education). You'll also have to pay back any CESG money back to the government.
- You can redeem the original contributions in the plan tax-free, paying back the CESG. Any accumulated earnings are subject to a 20% penalty and tax is payable at your highest marginal tax rate (or you can donate the investment earnings to an educational institution of your choice).

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CHAPTER 3

investing WISELY

By Ram Balakrishnan
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Once you have established a regular savings habit and have set aside some cash to meet life's inevitable emergencies then you are ready to invest your savings. But before you commit a single penny to an investment, you need to put together a sensible long-term strategy.

It is important to keep in mind that only truly long-term savings belong in your investment account. By long-term, we mean at least 10 years, and preferably 20 years or longer. If you are saving for a house or a new car that you are planning to buy in the next six months, your downpayment should be kept in a savings account, not your long-term investment portfolio.

> When it comes to investing, there is no such thing as a free lunch. You should be wary of any investment that promises high returns with low risk

Similarly, if your child is heading to university in a couple of years and you have saved up some money to help with tuition, the funds should be kept in guaranteed investment certificates (GICs) or bonds that will mature closer to when you need the money. But if you are a young adult saving for a retirement that is decades away, or you are saving for a newborn's education, you are most likely looking to invest for the long-term.

YOUR PORTFOLIO'S BUILDING BLOCKS

Before we show you how to implement a long-term investment plan, we have to learn a little bit about the major building blocks of a portfolio. These building blocks are called asset classes, and there are three key ones:

Cash refers to holdings in chequing accounts, savings accounts, cashable GICs, money market funds and Treasury bills (T-bills). Cash (or cash equivalents) has no risk in the sense that the value does not fluctuate. But since it is a riskless asset, the returns from cash will also be very low. Cash may be an ideal place to temporarily park your savings, but over the long-term you will see very little growth from the cash portion of your portfolio, especially after you adjust for inflation.

Bonds are simply IOUs. The bond issuer (a government or a corporation) borrows your money and in return promises to pay you interest for a certain period of time, at the end of which the issuer will return your original investment. Unlike cash, bonds are not completely riskless.

Investors will see fluctuations in the value of their bond holdings based on prevailing interest rates. Bonds issued by corporations also have credit risk—the possibility that the issuer does not make either interest or principal payments as promised. However, bonds compensate investors for taking some risk. Bonds will typically have higher returns than cash.

Stocks are a fractional ownership in a business. They entitle the owner to a claim on a portion of the business's assets and earnings. Stocks are traded on an exchange and they can fluctuate in value quite a bit from day to day, or even minute to minute. In other words, stocks are quite risky—riskier than bonds—but they compensate investors by typically providing a higher return over the long-term.

UNDERSTANDING RISK AND RETURN

When it comes to investing, there is no such thing as a free lunch. You should be wary of any investment that promises high returns with low risk. You can only obtain a higher return by taking on more risk. Conversely, if you want lower risk, you'll have to accept a lower return. Stocks are riskier than bonds, which are in turn riskier than cash. At the same time, stocks have delivered higher returns than bonds, which in turn have higher returns than cash.

Between 1900 and 2011, Canadian T-bills—cash equivalents—returned 4.7% per year, with a standard deviation of 4.6%. (Standard deviation is a popular measure of risk: the higher the percentage, the more the investment's value fluctuates.) During the same period, Canadian bonds returned 5.3% per year with a standard deviation of 10.4%, and Canadian stocks returned 8.9% per year with a standard deviation of 17.2%.

Inflation during the same 112 years clocked in at 3.1%. After adjusting for inflation, the real rates of return between 1900 and 2011 were

1.6% for cash, 2.2% for bonds, and 6% for stocks. (*See Figure 4: Risk and return, on opposite page.*)

The difference in the annual rates of return between cash, bonds and stocks may seem small, but compounded over the long term, the investment results are dramatically different. A person who invested $1 in cash in 1900 would have an inflation-adjusted $5.92 in 2011. The same amount invested in bonds would have grown to $11.44. And a single dollar invested in stocks would have grown to $500 after 112 years.

PUTTING TOGETHER AN INVESTMENT PLAN

Now that we are familiar with the basic portfolio building blocks, it is time to put together an investment plan. The most important part of an investment plan is figuring out a sensible asset allocation policy. Asset allocation is simply a fancy term for the proportions in which cash, bonds and stocks will be mixed together in your portfolio.

You may wonder why we should bother to mix the various asset classes at all. We saw in the previous section that stocks have knocked the ball out of the park compared to bonds. That's true, but the splendid returns from stocks came with a big catch: stocks can and do fall precipitously in value.

Just think back to the fall of 2008. On September 2, 2008, the S&P/TSX Composite Index of Canadian stocks opened at 13,558. It closed that month at 11,752, a loss of 13.3%. Stocks continued to slide through October of that year, at the end of which the index stood at 9,672, a loss of another 17.7%. Stocks carried on their dismal showing into early 2009 until the market bottomed out at 7,566 on March 9. The total loss since the previous fall: 44.2%.

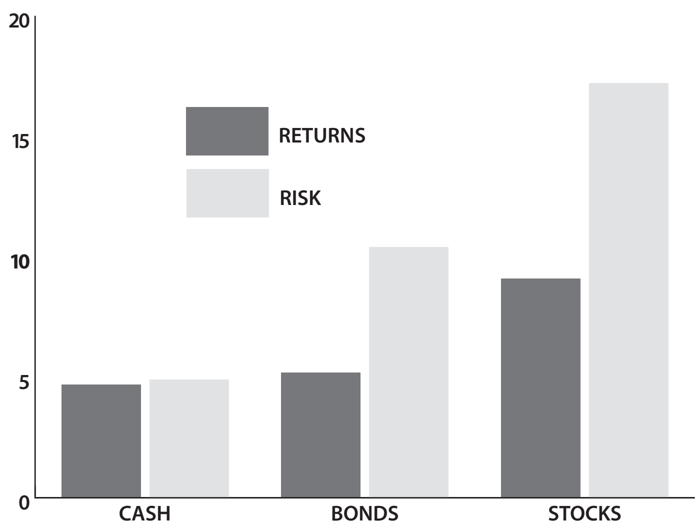
An investor who had originally allocated a portion of her assets to bonds and cash would have seen a much lower loss than the investor who had allocated 100% to stocks. During the same period in 2008–09 that saw stock values cut in half, Canadian bonds had positive returns of 3.5%.

It's not just during the most recent market crash that stocks and bonds moved in opposite directions. Historically, stocks and bonds have shown a tendency to move out of step with each other, especially during periods of stock market stress. That makes sense, because investors fleeing the stock market find refuge in the safest securities they can find, which almost always turn out to be government bonds.

The benefits of long-term ownership of stocks will only accrue to those investors who are able and willing to hold on to their stocks through such periods of dramatic declines. Since most investors tend to panic when markets fall, you should carefully consider how much of a decline in stocks you'll be able to tolerate. And it is best to be conservative about your estimate.

One further consideration is your capacity to take risk. The rule of thumb is to allocate your age in bonds and cash. If you are 40 years old, then, you might put 35% of your portfolio in bonds and 5% in cash. But this is just a starting point. You may want to make changes to your bond allocation based on your personal circumstances.

FIGURE 4: RISK AND RETURN



Source: Credit Suisse Global Investment Returns Yearbook 2012

> Deciding on the split between risky stocks and low-risk bonds is hardly an exact science. If you haven't experienced a bear market, it is best to be conservative with your risk tolerance

For example, if you work in a very volatile industry, periods of market stress will likely coincide with economic uncertainty, which in turn increases the risk of a job loss. An investor who works in the automotive industry, for example, might decide to increase her allocation to bonds relative to her age. Another investor who has a stable job with the government might decide to decrease his allocation to bonds because his income stream is far more stable.

Deciding on the split between risky stocks and low-risk bonds is hardly an exact science. If you haven't experienced a bear market, it is best to make conservative assumptions about your risk tolerance. And if you find out later that you had underestimated your risk tolerance in a bear market when stocks are falling fast and furious, you can always boost your allocation to stocks. After all, it will probably be an excellent time to do so.

PASSIVE INVESTING

The next major decision you have to make is whether you want to actively manage your assets or passively let the markets do the work for you.

Active management refers to switching between different asset classes based on market conditions, or selecting the securities within an asset class that one believes to be undervalued. Passive management, on the other hand, refers to investing in the markets as a whole. For example, a passive investor would own as broad a selection of bonds and stocks as possible with the aim of tracking these markets as closely as possible. Often passive investments will track well-known market indexes such as the S&P/TSX Composite (Canadian stocks), or the S&P 500 (U.S. stocks).

The justification for passive investing is simple arithmetic: investors as a group will earn market returns. In other words, we cannot all be above average. The excess returns obtained by one active investor must come at the expense of another active investor. Moreover, investing is not free. There are many mouths to feed: the money manager who picks stocks on your behalf, the intermediaries who keep the stock market functioning smoothly, the broker who executes your trades, and even the government, which wants a cut of your profits. A passive investor aims to earn market returns while minimizing these expenses, and by doing so will beat the vast majority of active investors.

I think passive investing should be the default starting point for most investors. Here are some reasons why:

Low cost. A passive portfolio is far cheaper than one that is actively managed. Canadian equity mutual funds charge fees that can exceed 2.5% a year. A comparable passive investment will cost the investor 0.5% or less. In other words, an active portfolio has to outperform a passive portfolio by 2% before fees just to break even.

Low turnover. Many active managers buy and sell stocks frantically in an effort to beat the market. All this furious activity adds to the cost: trading commissions bid-ask spreads and likely substantial capital gains taxes. In contrast, passive investments such as the major stock market indexes often make only very small adjustments, reducing costs even further.

Better investor behaviour. Basic arithmetic dictates that active funds, as a group, will lag market returns because of fees and expenses. Retail investors fare even worse. A number of studies have established that due to performance chasing—buying into a "hot" mutual fund or panicking and exiting stocks near market bottoms—retail investors trail even the average mutual fund returns. Performance chasing isn't limited to active investors, but passive investors appear to be less prone to it.

Transparency. An investor is sometimes entirely unsure what she owns with some mutual funds. A Canadian equity fund might have a portion in cash and a portion invested in U.S. or international stocks. Figuring out your actual asset allocation from a motley collection of mutual funds is a time-consuming and frustrating affair. Most passive investments are a model of simplicity. If you invest in a fund that tracks the S&P/TSX Composite Index, you can be sure that 100% of your money is in Canadian equities.

Low effort. If you invest in individual stocks, you need to spend a lot of time reading annual reports, keeping tabs on the competition and checking out analyst reports. If you already have a day job, you are competing with thousands of really smart money managers who pick stocks for a living and have vast resources at their disposal. You'll also have to agonize over when to buy and sell and worry about keeping your emotions in check. Despite all your efforts, you may still lag the market, perhaps badly. A passive portfolio provides freedom from all that effort, because all a passive investor aims to do is capture as much of the market as possible.

OPENING AN INVESTMENT ACCOUNT

Now that you have decided on an asset allocation and (hopefully) are sold on the merits of passive investing, you'll need to open either a discount brokerage account or a mutual fund account to implement your portfolio.

The primary building blocks of a passive portfolio are index mutual funds and exchange-traded funds (ETFs). Index mutual funds are similar to regular mutual funds in that they hold stocks or bonds. However, rather than trying to select market-beating securities, the manager simply tracks an index. For example, the TD Canadian Index e-Series mutual fund (fund code TDB900) tracks the S&P/TSX Composite Index by holding all of the 260 or so stocks in the index, in the same proportion. An investor can expect this mutual fund to track the underlying index very closely, trailing by only the fund's low fees of 0.33% per year.

ETFs are also like mutual funds, but the difference is that they trade on a stock exchange and their prices fluctuate throughout the trading day. ETFs typically charge lower fees than index mutual funds, but an investor buying or selling ETFs will be charged trading commissions. For example, the iShares S&P/TSX Capped Composite Index Fund (which trades on the TSX under the ticker symbol XIC) tracks the same index as TDB900, but it is slightly cheaper at 0.27% per year. However, an investor buying XIC will be charged a trading commission.

A discount brokerage account allows you to build your portfolio out of a wide menu of items, including ETFs, index mutual funds, GICs and even individual stocks and bonds. A mutual fund account, typically offered by one of the big banks, will offer a far more limited set of investment options: typically mutual funds offered by the bank's own mutual fund subsidiary.

The type of account to open will depend on your portfolio size—if your balance is less than $25,000 and you don't expect it to grow significantly anytime soon, it might be cheaper to build and maintain your portfolio exclusively out of index mutual funds. You'll pay slightly more in annual management fees, but you'll avoid incurring trading commissions and administration fees that are charged on account with a lower balance.

If your balance is larger, it may be cheaper for you in the long run to build your portfolio primarily out of ETFs. Most discount brokerages lower the trading commissions for households with large account balances (typically $50,000 or more) and will also waive most administration fees. Here are a couple of tips on what you should look for in a discount brokerage:

> The cash portion of your portfolio should be absolutely safe. You should also look for cash investments that do not carry fees of any kind, including penalties for early withdrawal

- The first place to look for a discount brokerage is the bank where you have your main chequing account. Though it is possible to move money in and out of a discount brokerage owned by another bank, this is easier to do with your current financial institution
- You may want to look beyond just the brokerage with the cheapest trading commissions. It may be cheaper in the long run to have an account with a broker that offers ways to lower currency conversion costs, investment products that offer a higher yield on cash holdings, or a wider list of securities whose dividends can be reinvested

INVESTING CASH

The most important consideration for the cash portion of your portfolio is that the holdings should be absolutely safe. You should also look for cash investments that do not carry fees of any kind, including penalties for early withdrawal.

The options for the cash portion of your portfolio depend on whether you are talking about a registered account (such as an RRSP) or a taxable, non-registered account. In a registered account, your cash options include T-bill mutual funds (also called money market funds) and high-interest savings accounts.

T-bill funds typically hold short-term debt issued by the federal and provincial governments. If you invest in a T-bill fund that is offered by the asset manager associated with your brokerage, you'll typically pay no fees to buy and will have no minimum holding periods.

These days, many brokerages offer high-interest savings accounts to clients. These savings accounts are bought and sold just like mutual funds and do not require a minimum holding period. The savings accounts typically pay a much higher interest than T-bill funds. The savings accounts are also very safe because they are eligible for coverage through the Canadian Deposit Insurance Corporation. The Renaissance High Interest Savings Account (ATL5000) is an example of a high-interest savings account available through discount brokerages. At the time of writing, ATL5000 paid an interest rate of 1.25%.

Do not keep a large cash balance in your brokerage account, because you'll receive zero interest on it.

INVESTING IN BONDS

Since the goal of passive investing is to invest in as broad a market as possible, a fund that tracks the universe of Canadian bonds is a very good choice. Here are a few options:

- TD Canadian Bond Index e-Series (TDB909)
- iShares DEX Universe Bond Index Fund (XBB)
- Vanguard Canadian Aggregate Bond Index ETF (VAB)
- BMO Aggregate Bond Index ETF (ZAG)

One school of thought holds that investors should keep their bond durations short in the belief that the slightly higher returns on longer duration bonds does not offer enough compensation for the much larger increase in risk. (Duration is a measure of a bond's sensitivity to interest rate changes.)

Though bonds are low-risk, they do fluctuate in value. If interest rates rise, bond prices will fall, and if interest rates drop, bond prices will rise.) If you subscribe to this idea, the following products will fit the bill for the bond portion of your portfolio:

- iShares DEX Short Term Bond Index Fund (XSB)
- Vanguard Canadian Short-Term Bond Index ETF (VSB)
- iShares 1-5 Year Laddered Government Bond Index Fund (CLF)

A ladder of guaranteed income certificates (GICs) is also suitable for the bond portion of your portfolio. A GIC ladder is constructed by dividing your bond allocation into five portions and investing each in a GIC maturing in one to five years. When the one-year GIC matures in 12 months, an investor will roll over the maturity value into a new five-year GIC.

A ladder of GICs is comparable to a short-term bond with a few key differences. Unlike a bond fund, GICs are not usually liquid—that is, you cannot convert them to cash until maturity. However, GICs will usually offer a better yield than short-term bond funds.

INVESTING IN STOCKS

If you picked passive investing as a strategy, then buying stocks is extremely simple. You don't have to read the business pages or keep up with the constant chatter on BNN. You simply pick an index that covers as much of the stock market as possible and invest in funds that aim to track that index.

The following products are suitable for the Canadian stock portion of passive portfolios:

- iShares S&P/TSX 60 Index Fund (XIU)
- iShares S&P/TSX Capped Composite Index Fund (XIC)
- Vanguard MSCI Canada Index ETF (VCE)
- BMO Dow Jones Canada Titans 60 Index ETF (ZCN)
- TD Canadian Equity e-Series Index Fund (TDB900)

However, there is another key decision you have to make: how much of the stock portion should be allocated to Canada? This question is contentious. Some people believe that Canadian investors should put as much as 80% of their allocation in foreign stocks for the following reasons:

- Canada makes up just 5% of the global stock market, and as Canadian investors are already heavily exposed to the vagaries of our own economy—we earn salaries in Canadian dollars and often own homes here—they can mitigate their risk by allocating a major portion to foreign securities. The experience of Japanese investors in recent times reinforces this point. With Japanese stocks losing 40% of their value over 20 long years, a Japanese investor who put most of his portfolio in domestic stocks would have fared a lot worse than one who had diversified globally
- The Canadian stock market is concentrated in just two sectors, financials and resources, which together account for 80% of our entire stock market. Investors should have exposure to other sectors such as health care, technology and consumer goods, which are well represented in international stock markets
- Since stock markets are not perfectly correlated with each other, investors can lower their portfolio volatility by adding foreign stocks.

The other side of the argument agrees that diversification is a benefit, but contends that there is very little volatility reduction once the allocation to foreign stocks crosses 50%. Moreover, Canadian stocks offer tax benefits that are not available to foreign stock holdings. Dividends from eligible Canadian corporations are taxed at favourable rates, whereas dividends from foreign stocks are taxed at marginal rates.

I think that Canadian investors choosing a passive strategy should opt for a high allocation to foreign stocks mainly because the Canadian market is concentrated in just a couple of sectors. Foreign stocks

> The steep appreciation of the Canadian dollar against the U.S. dollar has led many investors to conclude that it is best to hedge the currency exposure when investing in foreign stocks

include those trading in the U.S., other developed market in Europe, Australia and the Far East (referred to as EAFE markets) and fast growing emerging markets such as China.

The easiest way to gain exposure to the entire world stock market is through an ETF such as the Vanguard Total World Stock ETF, which trades in the U.S. under the ticker symbol VT. The MER of the fund is just 0.25%.

Investors with large portfolios might want to break down their foreign stock allocation into the U.S., EAFE and emerging market components and place the smaller pieces in the most tax efficient location possible. The easiest way to split between various foreign stock markets is to divide the funds based on each market's actual weighting in the world stock markets. As of early 2012, the weighting of various regions in the world stock markets (excluding Canada) is roughly 45% United States, 40% Europe, Australia and Far East, and 15% emerging markets. The following products are good options:

U.S. stocks

- Vanguard Total Stock Market ETF (VTI)
- TD U.S. Index e-Series (C$) (TDB902)

EAFE stocks

- Vanguard MSCI EAFE ETF (VEA)
- TD International Index Fund e-Series (TDB911)

Emerging markets

- Vanguard MSCI Emerging Markets ETF (VWO)

HEDGING CURRENCY EXPOSURE

The steep appreciation of the Canadian dollar against the U.S. dollar in recent years has led many investors to conclude that it is best to hedge the currency exposure when investing in foreign stocks. The vast majority of foreign stock ETFs that trade on the TSX use currency hedging. For example, the iShares S&P 500 Index ETF (XSP) provides exposure to the S&P500 index but hedges away the exposure to the U.S. dollar. At first glance, the ETF sounds promising. After all, a depreciating U.S. dollar drags down U.S. stock returns for the Canadian investor.

Unfortunately, the currency-hedged ETFs have not delivered on their promise. Though their MERs are low, investors who dig a little bit deeper will find that these ETFs have large tracking errors (a measure of how closely an index fund tracks the underlying index). Also, investors holding currency-hedged ETFs for the foreign stock portion of the portfolio experience more volatility than direct foreign stock holders.

Currency-hedged ETFs do have one advantage. Since they trade on the TSX, a Canadian investor can buy and sell them in Canadian dollars and do not have to incur hefty retail foreign currency conversion charges.

ALTERNATIVE ASSETS

Investors with large portfolios can diversify even more by allocating some assets to non-traditional investments. Two of these asset classes are especially noteworthy:

Real estate income trusts (REITs) allow investors to play landlord by offering an easy way to invest in shopping malls, commercial properties and rental apartments. Best of all, there will be no midnight service calls. Though REIT holdings generate income in your portfolio, they can fluctuate substantially in value, and so investors contemplating an allocation to REITs should do so in the equity portion of their portfolio. Products that offer exposure to this asset class are the iShares S&P/TSX Capped REIT Index Fund (XRE) and BMO Equal Weight REITs Index ETF (ZRE).

Real-return bonds (RRBs) are a special type of government bond that offer investors inflation protection by adjusting the principal amount for changes in the consumer price index (CPI). The fixed coupon rate of RRBs applies to the inflation-adjusted principal, so the interest payments will also reflect changes in the CPI. The iShares DEX Real Return Bond Index Fund (XRB) and BMO Real Return Bond Index ETF (ZRR) can be used to obtain exposure to this asset class.

REBALANCING

As soon as an investor builds a portfolio according to their asset allocation policy, market forces cause it to go out of balance. For example, let's say you started out with a 60% allocation to stocks and 40% to bonds.

If bonds remained flat but stocks decline 15%, the stock allocation will fall to 56% and the bond allocation will increase to 44%. Unless an investor takes action to correct this imbalance, the asset allocation can drift far from the plan over time.

Rebalancing can be done in a couple of ways. Investors can pick a calendar date and annually sell holdings that are significantly over their target and buy holdings that are under their target with the proceeds. Another option is to rebalance every time new savings are added to the portfolio.

Rebalancing is an important step—often it takes a strong stomach to add new money to a holding that has fallen in value sharply, and it is also harder to sell a holding that is on a tear. However, the discipline of rebalancing is critical to the long-term success of a portfolio.

SAMPLE PORTFOLIOS

Aggressive

Portfolio built out of index mutual funds
(suitable for accounts up to $25,000)

Cash	**5%**	**TD Canadian T-Bill (TDB167)**
Bonds	**15%**	**TD Canadian Bond Index e-Series (TDB909)**
Canadian stocks	**30%**	**TD Canadian Index e-Series (TDB900)**
U.S. stocks	**25%**	**TD U.S. Index e-Series C$ (TDB902)**
EAFE stocks	**25%**	**TD International Index e-Series (TDB911)**

Portfolio built out of ETFs
(suitable for accounts over $25,000)

Cash	**5%**	**Renaissance High-Interest Savings (ATL5000)**
Short-term bonds	**10%**	**Vanguard Canadian Short-Term Bond (VSB)**
Real-return bonds	**5%**	**BMO Real Return Bond (ZRR)**
Canadian stocks	**25%**	**Vanguard MSCI Canada (VCE)**
U.S. stocks	**25%**	**Vanguard Total Stock Market (VTI)**
EAFE stocks	**20%**	**Vanguard MSCI EAFE (VEA)**
Emerging Markets	**5%**	**Vanguard MSCI Emerging Markets (VWO)**
REITs	**5%**	**iShares S&P/TSX Capped REIT (XRE)**

Balanced

Portfolio built out of index mutual funds
(suitable for accounts up to $25,000)

Cash	**5%**	**TD Canadian T-Bill (TDB167)**
Bonds	**35%**	**TD Canadian Bond Index e-Series (TDB909)**

Canadian stocks	**25%**	**TD Canadian Index e-Series (TDB900)**
U.S. stocks	**18%**	**TD U.S. Index e-Series C$ (TDB902)**
EAFE stocks	**17%**	**TD International Index e-Series (TDB911)**

Portfolio built out of ETFs
(suitable for accounts over $25,000)

Cash	**5%**	**Renaissance High-Interest Savings (ATL5000)**
Short-term bonds	**25%**	**Vanguard Canadian Short-Term Bond (VSB)**
Real-return bonds	**10%**	**BMO Real Return Bond ETF (ZRR)**
Canadian stocks	**18%**	**Vanguard MSCI Canada ETF (VCE)**
U.S. stocks	**17%**	**Vanguard Total Stock Market ETF (VTI)**
EAFE	**15%**	**Vanguard MSCI EAFE ETF (VEA)**
Emerging Markets	**5%**	**Vanguard MSCI Emerging Markets ETF (VWO)**
REITs	**5%**	**iShares S&P/TSX Capped REIT ETF (XRE)**

Conservative
Portfolio built out of index mutual funds
(suitable for accounts up to $25,000)

Cash	**10%**	**TD Canadian T-Bill (TDB167)**
Bonds	**50%**	**TD Canadian Bond Index e-Series (TDB909)**
Canadian stocks	**15%**	**TD Canadian Index e-Series (TDB900)**
U.S. stocks	**12.5%**	**TD U.S. Index e-Series C$ (TDB902)**
Int'l stocks	**12.5%**	**TD International Index e-Series (TDB911)**

Portfolio built out of ETFs
(suitable for accounts over $25,000)

Cash	**10%**	**Renaissance High-Interest Savings (ATL5000)**

Short-term bonds	**40%**	**Vanguard Canadian Short-Term Bond (VSB)**
Real-return bonds	**10%**	**BMO Real Return Bond (ZRR)**
Canadian stocks	**15%**	**Vanguard MSCI Canada (VCE)**
U.S. stocks	**10%**	**Vanguard Total Stock Market (VTI)**
EAFE stocks	**10%**	**Vanguard MSCI EAFE (VEA)**
REITs	**5%**	**iShares S&P/TSX Capped REIT (XRE)**

Ram Balakrishnan is the creator of Canadian Capitalist (canadiancapitalist.com), a long-running personal finance blog. Now published under the MoneySense *magazine banner, the blog has been featured in* The Globe and Mail, Financial Post, The Toronto Star *and other national publications. He is also the co-founder of Canadian Money Forum (canadianmoneyforum.com), a popular bulletin board for personal finance enthusiasts. Trained as an electrical engineer, Ram believes deeply that most investors are best served by using broadly diversified, low-cost portfolios.*

CHAPTER 4

dividend INVESTING

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In Chapter 3 you learned about one of the smartest ways to invest your money—that is, to index your portfolio. The strategy is best for those investors who would rather remain passive and earn market returns while beating most actively managed mutual funds.

But what about the investor who is interested in being a little more active with a portion of their portfolio, or who is looking to increase their income in a tax-efficient manner? That's where dividend investing can come into play.

Dividends are payments that companies make to their shareholders, typically quarterly. Because Canadian companies pay dividends with after-tax earnings, they are eligible for a significant tax credit.

From 1900 through 2011, the market has produced a compounded annual return of approximately 9%, almost half of which came from dividends

Dividend investors specifically pick stocks or ETFs that pay a dividend. Some simply buy the highest-yielding stocks in the market—although this is not recommended. A second strategy—called dividend growth investing—is to choose stocks that have a history of increasing their dividends, which potentially gives the investor an annual "raise." From 1900 through 2011, the market has produced a compounded annual return of approximately 9%, almost half of which came from dividends. If you are a long-term investor and you like a particular dividend company, then you can be paid handsomely just for waiting.

Companies that pay sustainable dividends are typically established, blue-chip firms with steady and predictable revenues with a conservative growth rate. Dividend growth stocks are companies that have a history of increasing their dividends. A popular U.S. example is Johnson & Johnson, which has been paying a dividend since 1944 and has increased its dividend annually for the past 44 years. An iconic dividend growth stock on this side of the border is Fortis Inc. This utility has paid a dividend since 1972 and has consistently increased its dividend every year for the past 20 years. This section of the book will hopefully provide you with a better understanding of dividend investing.

BASIC DIVIDEND CONCEPTS

Before we get into the meat of dividend investing, let's get familiar with some of the common terms used.

Annual dividend: The dollar amount per share that is paid each year to stockholders. For example, if BMO has an annual dividend of $2.80, it means that they will pay you $2.80 for every share that you own. You can find out the current annual dividend by visiting the company's website.

Yield: The percentage of the annual dividend relative to the current stock price. If BMO is paying out $2.80 and the current share price is $58, then the yield is 4.8% (annual dividend/current price).

Date of record: Dividend-paying companies typically distribute their payments quarterly. When they declare their dividend, they name a "date of record," and all investors who own the stock on that date will receive the dividend. Investors need to account for the settlement time. It takes three days after the purchase of a stock for the transaction to settle (i.e. for you to officially own the stock). That's where the ex-dividend date comes in.

Ex-dividend: The ex-dividend date is two days before the date of record. If an investor purchases a dividend-paying stock before the ex-dividend date, the investor will be entitled to receive the dividend. If the investor is looking to sell a dividend stock but would like to receive the upcoming dividend distribution, he or she would have to sell on or after the ex-dividend date to remain on the date of record.

Cum-dividend: The time before the ex-dividend date is known as cum-dividend. Investors who purchase a stock that is cum-dividend will receive the distribution.

Stock purchase plans (SPPs) and dividend reinvestment plans (DRIP): Some companies offer an SPP, which is an opportunity for investors to make regular purchases of shares in small amounts with no commission or fees. In addition to that, through DRIPs, the dividends are reinvested into partial shares without fees. Some dividend companies offer discounts for SPP/DRIP purchases.

Synthetic DRIP: This type of DRIP is offered by most brokerages, who will reinvest your dividends by buying new shares without any fees. The catch is that the cash distribution has to be enough to purchase at least one share (i.e. no partial shares). So if the dividend stock pays quarterly and you want to take advantage of a synthetic DRIP, you need to own enough of that stock so that the quarterly distribution will purchase one share.

TAX ADVANTAGES OF DIVIDENDS

Dividends from Canadian companies can be extremely tax-efficient compared with other forms of income in a non-registered (taxable) account.

Dividends get special treatment because they are paid with after-tax corporate dollars. In an effort to avoid double taxation, the government lowers the taxes payable by the shareholder because a portion of the tax has already been paid by the company. This is the reason why when you receive a dividend payment from a Canadian public company, you are eligible for the dividend tax credit.

The calculation of the dividend tax credit is somewhat complicated, but there are many tax calculators available on the web to help. In general, the credit means that dividends from Canadian companies are taxed at a much lower rate than other types of income, especially for people in the lower tax brackets.

For the 2012 tax year in Ontario, for example, someone earning $40,000 would pay just 3.77% tax on eligible dividends, compared with 24.15% on interest and employment income. In Alberta, someone with an income of $42,000 would pay no tax at all on his or her dividends.

Remember that only dividends received from public Canadian companies are eligible for the dividend tax credit. Dividends received from foreign companies are fully taxable. For all intents and purposes, you can treat foreign dividend income as interest income.

Taxes on dividend income can be avoided completely (or at least deferred) by holding stocks in a tax-sheltered account, like an RRSP or TFSA. However, given the tax-efficiency of dividends, it may make sense to keep them in a non-registered account, especially if you have used up all of your RRSP and TFSA contribution room.

This is where asset location can be considered. Asset location involves determining the most tax-efficient way to hold your securities, based on how each asset is taxed and the account you're using to hold it. Let's take a look at various investment types and their tax consequences:

- Canadian dividends, as discussed, are eligible for the dividend tax credit, which makes this type of income tax-efficient in a non-registered account.
- Foreign dividends are taxed at your full marginal tax rate in a non-registered account (if you are in the 40% tax bracket, you will pay $40 in tax for every $100 in dividends). In TFSAs, foreign dividends face a withholding tax of 15%, but this does not apply in an RRSP.
- Bonds, GICs, savings accounts and money market funds pay interest, which is taxed at your full marginal rate in a non-registered account.

If you have a diversified portfolio of Canadian stocks, foreign stocks, bonds and cash, it makes sense to spread these assets across different accounts to minimize your tax (assuming that your tax-sheltered accounts are maxed out).

Usually this means holding the most heavily taxed asset classes (bonds, GICs and cash) in your RRSP or TFSA wherever possible. You should also consider holding U.S. stocks in an RRSP to avoid the high taxation and the withholding tax on the dividends. Canadian dividend stocks, on the other hand, can really be placed anywhere. If there is no tax-sheltered room available, then putting them in a taxable account is palatable due to the low taxation of eligible dividends.

> Most dividend ETFs follow a particular index and will provide you with some diversification by holding a basket of stocks in exchange for a small annual fee

DIVIDEND ETFS

One of the easiest ways to be a dividend investor is through ETFs. Most dividend ETFs follow a particular index and will provide you with some diversification by holding a basket of stocks in exchange for a small annual fee (the management expense ratio, or MER). As the Canadian market is relatively small, there are only a few ETFs that cover Canadian dividend stocks. The most popular are offered by iShares and BMO:

iShares S&P/TSX Canadian Dividend Aristocrats Index ETF (CDZ), with an MER of 0.67%, follows the dividend growth strategy by replicating the performance of the S&P/TSX Canadian Dividend Aristocrats Index. To qualify as a Dividend Aristocrat, a company must increase its dividend for at least five consecutive years.

iShares Dow Jones Canada Select Dividend Index Fund (XDV) has an MER of 0.53% and tracks the Dow Jones Canada Select Dividend Index. This index is made up of 30 of the highest-yielding companies in the Dow Jones Canada Total Market Index. The index also uses a rules-based methodology including an analysis of dividend growth, yield and average payout ratio.

BMO Canadian Dividend ETF (ZDV), with an MER of 0.36%, has been designed to provide exposure to a yield-weighted portfolio of Canadian dividend paying stocks. The fund does not track an index, but uses a rules-based methodology that considers the three-year dividend growth rate, yield, payout ratio and liquidity.

As mentioned, foreign dividends are subject to higher taxation in non-registered accounts, so it makes sense to keep U.S. and international stocks in tax-sheltered accounts. However, you may still want to diversify into the global markets to get exposure to some of the largest dividend stocks in the world. Here are some suggestions. (Note that all but the first of these ETFs trade on the New York Stock Exchange and must be bought and sold in U.S. dollars.)

iShares S&P U.S. Dividend Growers ETF (CAD-hedged) (CUD), tracks the S&P High Yield Dividend Aristocrats Index, which includes the 60 highest dividend-yielding U.S. companies that have increased their dividends for at least 25 consecutive years.

Vanguard Dividend Appreciation ETF (VIG) is made up of U.S. companies that have a record of increasing dividends over time. It includes blue-chip stocks such as Exxon Mobil, Microsoft, General Electric and Johnson & Johnson. MER: 0.18%.

Vanguard High Dividend Yield ETF (VYM) tracks an index of U.S. companies that are characterized by high dividend yields. Its top holdings are similar to those of the Vanguard Dividend Appreciation ETF. Management expense ratio: 0.13%

PowerShares ETF Trust Dividend Achievers Portfolio (PFM) has an MER of 0.61% and tracks a diversified group of U.S. dividend paying companies that have increased their annual dividend for 10 or more consecutive years.

PowerShares ETF Trust International Dividend Achievers Portfolio (PID) follows the International Dividend Achievers Index, which identifies non-U.S. companies that have increased their dividend for five or more consecutive years. Companies in the United Kingdom, Canada, Japan and the Netherlands are among the top holdings. MER: 0.58%

WisdomTree International LargeCap Dividend Fund (DOL) is made up of 300 large-cap dividend-paying stocks outside the U.S. and Canada, including companies in the United Kingdom, France, Japan, Germany and Australia. MER: 0.48%.

WisdomTree International Dividend Top 100 Fund (DOO), with an MER of 0.58%, includes the 100 stocks in WisdomTree International LargeCap Dividend Fund with the highest yield.

PICKING INDIVIDUAL DIVIDEND STOCKS

If you're an investor who would rather purchase individual dividend stocks, then more due diligence is required. Here are some elements to consider for the dividend investor:

- Are you looking for stocks with high yield? Consistent dividend growth? Or just quality companies that pay a dividend?
- Are the dividends sustainable based on the payout ratio?
- What companies are going to end up on your watch list?
- What is your buy point? Sell point?

Investing for yield is simply purchasing the highest-yielding dividend stocks you can find. You can do this by using a stock screener with dividend yield as one of the criteria. (Note that some income trusts and REITs are able to pay out more than their earnings by distributing return of capital.) However, you must exercise some due diligence. Look at the dividend history, earnings track record and the payout ratio. If you come across a stock with a yield that is too good to be true, it likely is. While buying a stock with 15% yield might seem attractive initially, there are pitfalls in chasing yield, and it can be a short-sighted investing strategy.

The issue with sky-high yields is that they can result in payout ratios that are unsustainable. The payout ratio is the percentage of company earnings that is distributed in dividends. The dividend payout ratio, in its most basic form, is calculated as dividends paid divided by earnings. In some cases, the company pays out more in distributions than earnings, which is a red flag in my books.

The payout ratio will tell you how much of the company's net income dividends are chewing up, which is relevant in evaluating the sustainability of the dividend. Payout ratios will vary by industry: utilities with steady and predictable cash flow may have a relatively high payout ratio, while banks and financial companies will be in another range. If earnings are poor (resulting in a higher payout ratio), there is a probability of the dividend being reduced or eliminated at the whim of management if they decide they need to conserve cash.

The higher the payout ratio, the higher the likelihood that the distribution will be cut. Not only does this mean that the distribution will be lower for the investor going forward: in most cases, the price of the stock drops as well. For example, in 2011 Superior Plus (SPB) was paying a dividend yield of 13%, or $1.62 per share, with an unsustainable payout ratio. Shortly after, due to weaker earnings, they decided to slash the dividend to $1.20 per share. The result? An 8% sell-off the very next day.

The easiest way to learn a company's payout ratio is to visit a website that does the calculations for you, such as stockhouse.ca. However there are times when the ratios are not updated with the most recent earnings. If you want to manually calculate the payout ratio, you'll need to pull the earnings and dividends data from company financial statements.

If we look at TD Bank, Google Finance tells me that in the most recent quarter, TD had a $1.70 of earnings per share (EPS) and paid a dividend of $0.68 per share. In this case, the payout ratio for the quarter was 40% ($0.68 / $1.70 × 100%), which is fairly low for a bank. In addition to looking at the quarterly numbers, it's best to review annual reports in case the quarter was an anomaly. In this case, for the trailing

If the yield of a stock starts to get irrationally high, look into the company to see if there is a risk of a dividend cut by reviewing their earnings, expected earnings, and payout ratio

four quarters, TD has a payout ratio of approximately 42%. As mentioned, it's prudent to compare payout ratios by industry—in this case, compare the payout ratios of the Big Five Canadian banks.

DIVIDEND GROWTH STOCKS

Dividend growth investing is a strategy that selects stocks based on their track record of increasing their dividends over time. Although the initial purchase yield may be lower, it's a great strategy for buy-and-hold investors as it gives raises to loyal shareholders over time.

How do you find dividend growth stocks? The easiest way is to check out the holdings of an ETF that follows an index of dividend growth stocks. I've listed some of them in the ETF section above, including iShares S&P/TSX Canadian Dividend Aristocrats Index Fund (CDZ) for Canada. For U.S. stocks, you can use iShares S&P US Dividend Growers Index Fund (CAD-Hedged) (CUD) or Vanguard's Dividend Appreciation ETF (VIG).

Since investing purely for yield may be risky, consider using a combination of dividend growth and yield. To do this, narrow down the list of strong companies based on a history of dividend growth, but only make a purchase when that particular stock reaches a yield threshold. Remember, as the stock price falls, the yield will rise.

By picking a yield threshold, you are waiting for the stock price to fall to a certain level before buying. How do you determine the yield threshold? By going back through the history of dividend payments and figuring out the average yield over the years. A great tool for this is the website ca.dividendinvestors.com, which shows you the current yield and average yield. Another tool for this is Yahoo! Finance's historic prices tool. You can select "dividends only," which will list distributions over the past several years (depending on the stock). Yet another way is to use BigCharts.com and set the "lower indicator" to "yield." It will graphically show you what the yield has been in recent history.

Once that is determined, it's up to you to choose a yield threshold, but a safe bet may be to pick a slightly above-average yield, which can then be converted into a target stock price (annual dividend/yield). The higher above the average, the longer you may have to wait until the stock hits your price. Warning though: if the yield of a stock starts to get irrationally high, make sure to look into the company to see if there is a risk of a dividend cut by reviewing their earnings, expected earnings, and payout ratio.

LIVING OFF YOUR DIVIDENDS

One popular strategy for early retirement is to build a dividend portfolio big enough to support your everyday living expenses. As you have seen, dividend income is extremely tax-efficient, and the tax benefits are even greater if you have no other income.

Say, for example, that a 40-year-old Ontario investor has done really well for himself and has built a portfolio of $1,000,000 in dividend stocks yielding 4%. He lives a simple life and the distributions of $40,000 per year are more than enough to pay for his lifestyle. If the $40,000 was through regular salary, he would pay about $5,700 in annual income tax, or an average tax rate of 14%. However, due to the tax-efficiency of eligible dividends, our investor would pay just $600 in tax. If he managed to increase his eligible dividends to $80,000 per year, he would pay $6,800 in tax, or an average rate of just 8.5%.

If an investor has no other income, he or she can receive a significant amount of dividends without paying significant tax. These amounts change every year, but these are current for 2012:

PROVINCE	DIVIDEND INCOME	TAX PAID
Newfoundland and ELabrador	$57,000	$952
Nova Scotia	$42,000	$967
Prince Edward Island	$52,000	$955
New Brunswick	$57,000	$955
Ontario	$52,000	$996
Manitoba	$55,000	$890
Saskatchewan	$57,000	$951
Alberta	$57,000	$944
British Columbia	$57,000	$943

Income tax increases with dividends greater than these thresholds, but will remain significantly lower than the equivalent employment income. As well, these numbers are for a single investor—the situation gets even better when there is a spouse with no other income, as the spousal tax credit can be used to reduce tax even further.

THE DOWNSIDES OF DIVIDENDS

While there are many benefits of living off dividend income, there are also a number of risks and implications. The biggest risk, of course, is in the case of a company reducing or even cutting their dividend. This can happen if earnings are not keeping up with the expected dividend payout and the company needs to conserve cash. Losing an income stream while in retirement can be the cause of sleepless nights!

To help mitigate this risk, it helps to pick a stock that has both a history of increasing dividends and a reasonable payout ratio. Another way to reduce this risk is to own a basket of dividend-paying stocks or an ETF instead of a concentrated portfolio with just a few positions.

Dividend stocks, like all stocks, are also at risk from market meltdowns. In 2008–09, there was no place to hide. For the dividend investor, while portfolio values dropped, the income stream remained. Having said that, you need the stomach to make it through volatile times or dividend investing may not be the best option.

Another major drawback of dividends is that it works against income-tested seniors' benefits. For example, Old Age Security (OAS) is a federal government program that pays a monthly benefit (adjusted to inflation) to people 65 and over. For 2012, the maximum OAS benefit is $540.12 per month or $6,481.44 annually.

However, if a senior's income reaches a certain level, the government will start to claw back some of the benefits. The current clawback is 15% of each dollar of income over $69,562, and OAS is completely eliminated for incomes over $112,772. For example, if you are receiving OAS in 2012 and you have $75,000 in income, then you will have to pay back 15% of your income $69,562, or $815.70 (($75,000 – $69,562)*15%).

The problem with receiving dividends during your senior years is that the government "grosses up" dividend income. For example, $20,000 in Canadian dividends is considered $27,600 of income, which could be just enough to push a senior over the upper OAS limit when accounting for other income sources. With the gross-up at 38% in 2012, seniors can receive a maximum of $50,400 in dividends without affecting OAS payouts (assuming no other income).

Frugal Trader is the pen name of the writer behind Million Dollar Journey (milliondollarjourney.com), one of the first successful personal finance blogs in Canada. Based in eastern Canada, Frugal Trader started the blog in 2006 to chronicle his goal of reaching $1 million in net worth by the time he turns 35 in 2014. Along the way, he has attracted more 17,000 subscribers, making the blog one of the most widely read in the country.

CHAPTER 5

buying THE RIGHT insurance

By Glenn Cooke
lifeinsurancecanada.com

Most Canadians have a pretty good handle on their house and car insurance. But when it comes to life and disability insurance, trying to figure out what's right is as difficult as selecting a new cell phone plan.

To fix that, we're going to strip away all the marketing hype and get down to basic insurance principles. In doing so, we'll be able to properly determine how much insurance we need, as well as what type.

It's fairly simple, really. When we buy insurance, we want to protect ourselves from a catastrophic financial loss. Before buying any insurance, we need to apply those three tests—catastrophic, financial, and loss:

> One confusion that often arises with life insurance is a failure to distinguish between the event that caused the loss, and the actual financial loss itself

Catastrophic. For a loss to be catastrophic, it needs to be larger than we can reasonably budget for or handle through an emergency fund. If your house burns down, can you just grab $200,000 to build a new one, while also covering your existing mortgage? Probably not. A $200,000 loss for most of us is catastrophic, and that is a reason to carry house insurance. However, if we'll need to replace a $50 appliance when it breaks, should we carry insurance on that? No, because a $50 loss is not catastrophic.

Financial. We need to be able to quantify the loss. If an event happens, how much in real dollars was lost? If you can't specify an amount, or make a reasonable estimate, then you are likely dealing with an emotional loss, not a financial one. One example is buying life insurance for a child. Clearly, the loss of a child is as terrible as it gets—but the loss is not financial. If you want to purchase insurance for emotional reasons, that's your right—just don't let a salesperson convince you that an emotional purchase is part of a sound financial plan.

Loss. For insurance to be worthwhile, there has to be a risk of actually losing something. This sounds obvious, but you'd be surprised how frequently we insure things something we don't actually lose. For example, let's consider mortgage insurance. Catastrophic? Absolutely. The cost of a house isn't something we can cover with our emergency fund. Financial? Yes again. We can put a number on the value of our mortgage. But what about loss? If you die, what about your mortgage is lost? Nothing. Your mortgage was the same before you passed away as afterwards. Because mortgage insurance covers something that we don't lose, it fails our test of proper insurance.

Surely I'm not saying you don't need insurance to cover your mortgage. The answer is more subtle than that, and I'll explain more in the coming pages. But for now, I want you to challenge your assumptions about insurance purchases based on the above three principles.

THE IMPORTANCE OF LIFE INSURANCE

Now let's consider life insurance in the context of our third test. One confusion that often arises with life insurance is a failure to distinguish between the event that caused the loss, and the actual financial loss itself. If your house burns down, the event is the fire, but the loss is the financial value of your house. If you have an accident with your car, the event is the collision, and the financial loss is the value of your car. With life insurance, the event is your death, but what is the financial loss?

Not your mortgage, or your children's education costs, or any of the items often referred to in insurance needs calculations. What you lost was your paycheque. That paycheque is paying the mortgage and saving for university education for your kids. So that's it—we have found our loss. In fact, we really should rename this coverage "income replacement insurance." Because while the event is our loss of life, the insurable loss is actually our income.

One interesting difference with life insurance compared to other types of insurance (and this is what drives life insurance as an emotional sale) is that it's not you who suffers the financial loss. You're dead—you don't need your income anymore. With life insurance it's your family that suffers the financial loss.

Getting back to our three-part test, it's clear that the death of a breadwinner is catastrophic. For most of us, the amount of your paycheques between now and retirement is a huge number. It's likely to be the single biggest financial asset you have: bigger than the value of your home, your savings, or pretty much anything else.

What about the financial part? Hopefully, the answer is becoming clearer. You simply need to define the replacement value of your paycheque over time. The answer to the question "How much life insurance do I need?" is, "How much insurance will it take to replace my income for the required number of years?"

CALCULATING HOW MUCH YOU NEED

To get a very rough estimate of how much life insurance will replace your lost income, you can take your annual salary, multiply it by a percentage that you feel would replace your family's standard of living should you die, and multiply that by the number of years you want to replace the income for.

Let's say you make $50,000 per year (before taxes), you estimate that your family could maintain their standard of living with 60% of your gross income, and you feel that all of your children will be living independently in 20 years. The calculation looks like this:

$$\$50{,}000 \times 0.6 \times 20 = \$600{,}000$$

For a slightly more complex estimate, we have created a calculator available at savingandinvestingbook.ca. (Note that more complex calculators do not necessarily provide better accuracy. In fact, adding more assumptions into the calculation has the potential to decrease accuracy.) Here's the basic information you'll need to run the calculator:

- Your income (before taxes).
- The percentage of income you want to replace should you pass away. Single-income families may assume 80% of their income is needed to maintain their family's standard of living. Two-income families may feel that 60% of their income is sufficient.

- Inflation and interest rates. Conservative is best when doing estimates like this.
- The number of years you want to replace your income for. For complete insurance protection, you would assume the number of years until you would retire. That way if you died tomorrow the insurance benefit would produce a replacement income for the same timeframe as your employment. However, you may also try scenarios such as just enough years to get your youngest child through school and financially self-sufficient.

With estimates, there is no perfect answer, so try a variety of scenarios based on your comfort level with different inputs. If you determine that 60% replacement value for 15 years is sufficient for your circumstances, you'll now know how much insurance it takes to make that happen. If you decide 80% is more in your comfort range, and want to provide replacement for 25 years, then you'll need to purchase a larger amount of insurance.

If you have other insurance policies, such as coverage at work, simply subtract that from the total amount you've just calculated. But remember: if you subsequently lose that coverage through change of employment, you have 30 days to convert that coverage to an individual policy. Most employees are not aware of this provision, and many find out after the 30 days, at which point it's too late. The insurance available through this conversion is not normally attractive in terms of premiums, but if you're unable to pass a medical exam for a new policy, it's quite possibly the only option available. If so, make sure you take advantage.

Once you have an estimate of how much insurance you need, I normally recommend rounding up to some increment of $250,000—$500,000, or $750,000 and so on. That's simply because insurance companies provide price breaks at those points.

The important lesson here is that a $500,000 or $1 million life insurance benefit isn't like winning the lottery. It will likely provide just enough income to maintain your family's standard of living for a specific period. It's a common mistake to look at the amount of insurance

> If you are properly covered with life insurance, then you don't need mortgage insurance. If you should die, your beneficiaries will have enough money to make the mortgage payments

these calculators suggest and think that it's too much. Remember, the money may have to last decades.

Now let's go back to our mortgage insurance problem. Why do people carry mortgage insurance? It's because they haven't properly defined their loss. Where are your mortgage payments coming from now? Probably out of your paycheque. So if you pass away, your family receives a new "paycheque" from the life insurance proceeds, and they can continue making the mortgage payments upon your death. And they can also buy groceries, make the car payments, save for retirement, and the million other things we spend our paycheques on.

In short, if you are properly covered with life insurance, then you don't need mortgage insurance. If you should die, your beneficiaries will have enough money to continue to make the mortgage payments.

A common question I'm asked is whether it makes sense to immediately pay off the whole mortgage with insurance proceeds, rather than continue to make regular payments. I believe this might be a better use of the money, but the time to decide is after the event. It doesn't really impact the question of how much insurance we need today.

TERM VS. PERMANENT LIFE INSURANCE

Before I explain the various types of life insurance policies, let's clarify one important point.

Say that I have a $500,000 all-the-options life insurance policy, while my neighbour has a bare bones $500,000 policy. If we both die, can our spouses tell the difference? Of course they can't. Both beneficiaries receive the same $500,000 cheque. They can't necessarily tell you (nor will they care) what type of policy we had, or what company administered it.

Here's what we should take away from that: there are only two attributes that really matter when it comes to life insurance. They are the benefit and the premium. In our example, the death benefits of the two policies are identical, so the only thing my neighbour and I should care about is the price we paid to get that benefit.

Sure enough, the main difference between types of life insurance is the premium structure. More specifically, the different product types are really just variations on how we pay our insurance premiums over time.

How do those premiums work? Well, as with car and house insurance, those who are poor risks pay higher premiums. For life insurance, the most general risk is our age. Every year we're a little closer to dying—and that makes us all slightly worse risks every year. And if you're 40 years old, the probability of dying in the next year is the same no matter what type of life insurance policy you own. And if you keep that policy until you're 80, the probability of dying has greatly increased, and therefore your premiums should also increase.

In fact, if the costs were based purely on statistics, the premiums should go up every year as we get older. A 41-year-old is a little bit more likely to die than a 40-year-old, and an 86-year-old is quite a bit more likely to die than an 85-year-old. Insurance purchased like this is called one-year term: like your car insurance policy, the premiums would be adjusted annually based on your level of risk.

But for those that want insurance over long periods, buying a policy where the premiums escalate every year simply isn't practical. Enter the first of two broad categories of life insurance:

Term life insurance. With term life, the costs of coverage is levelled out over periods of several years. Let's say you're 40 years old and you buy a 10-year term policy. Rather than charging premiums that go up at age 41, 42 and so on, the insurance company charges you the average premium for the 10 years between ages 40 and 49. In other words, you pay a level premium annually during those 10 years. At age 49, if you renew for another 10 years, your premiums are going to increase, because you'll be charged the average cost for ages 50 to 59.

While there is a wide variety of term policies, the three most common are 10 years, 20 years, and 30 years. If you are looking at term insurance, you should select the term that best matches the time frame you need coverage—and assume that you won't need life insurance at the end of the term. This is because the premiums at the first renewal skyrocket. Life insurance companies use a different mortality table when pricing renewal premiums than they do for the first period of the policy. You should assume that the premiums at the end of the first term will be unacceptably high.

Many, but not all, term life insurance policies will have a clause called conversion. This clause allows you to change your term policy to permanent without taking a medical exam. You should only purchase a term policy that has this conversion clause—if you become uninsurable, this clause will be your only avenue to purchase insurance in the future.

One tip to keep in mind if you're trying to fit your insurance purchase to a budget: don't buy less life insurance to get the premiums down. Instead, buy a shorter term and keep the amount of insurance high. If you die, your beneficiaries won't care what type of insurance you had, only how much coverage you had.

Permanent life insurance. We've seen that term insurance simply takes increasing insurance costs and averages them out over longer periods. So what happens if we average these increasing costs over your entire lifetime? A policy structured like this is called permanent insurance. It's characterized by premiums that are level for your entire life.

Compared to term insurance, the premiums on a permanent insurance policy will be much higher in the early years. But because they never increase, eventually this type of insurance should have annual costs that are less than the true yearly cost of insurance.

If you want life insurance coverage for a known period—say, for 20 years until your kids move out of the house—then you should purchase term insurance. But if you want insurance forever, then a permanent policy will be a better option. Over the long run, it would be far more expensive to keep renewing 10- or 20-year term policies as you get older.

TYPES OF PERMANENT INSURANCE

Levelling premiums for your lifetime means the insurance company is charging you more in the early years than they need to meet costs, and less in future years. Let's use an example to illustrate.

Say the true cost of insurance is only $1,000 per year at your current age, increasing to $10,000 annually in 30 years. And let's assume our permanent life insurance policy has levelled these premiums to $3,000 per year. In the first year we're overpaying by $2,000, but in 30 years we're underpaying the true cost of insurance by $7,000.

No business can sustain a model where income is $3,000 per year and expenses are $10,000. So insurance companies are run differently from most other businesses. That additional money they collect in the early years doesn't go to profits, and it doesn't get spent. Instead, the insurance companies save the additional premiums inside your policy in a process called reserving. Later, when your premiums come up short, the insurance companies use those reserves to offset the higher insurance costs that result from your being older. In short, you pay more now to pay less later.

Should you cancel your policy, the insurance companies will refund a portion of that overpayment in premiums. Since they no longer need it to pay your premiums when you're older, they'll give some of it back to you. This refund is called a cash surrender value.

A permanent insurance policy that offers level premiums for life and a cash surrender value if you cancel is called whole life insurance.

If anything has contributed more to consumer confusion and anger

> Some whole life insurance policies have something called dividends. This term is confusing, because it has nothing to do with stock dividends

about insurance than the cash values of whole life policies, I don't know what it is. Through the years, the industry's marketing machine has done its best to convince consumers that cash surrender values are something other than a refund of their own premium overpayment. The policies are billed as "savings accounts" and "investments," or they're compared to "renting versus buying." All a salesperson needs to do is convince you that a permanent policy is like "owning" and a term policy is like "renting" and you'll be buying insurance for reasons other than to protect you from a catastrophic financial loss.

To make matters worse, some whole life insurance policies have something called dividends. This term is confusing, because it has nothing to do with stock dividends, which most people are familiar with. Insurance dividends are used to build very complex insurance and cash structures that are used in all sorts of marketing programs. The underlying problem is that they're not guaranteed. And if your policy structure is not guaranteed by the company, then you should assume it can be changed—and not to your benefit.

In the 1980s, consumer advocates came on strong against insurance companies that marketed cash surrender values, and whole life insurance developed a bad rap. There's nothing wrong with the policy itself—it's just a death benefit and a level premium. But the marketing clearly went awry, and the backlash from consumers was swift and furious.

Some of the more nimble life insurance companies later created a second kind of permanent life insurance. Like whole life, the premiums were level for life, but these policies had no cash surrender values. That not only removed the stigma of whole life, but the insurance companies could also lower premiums. This second type of permanent life insurance—characterized by level premiums for life and no cash value—is called term to 100.

Unfortunately, product names are designed by marketing departments to sell policies, and they can be confusing. Some companies call their whole life insurance policies "term to 100." Just remember that if it has a cash surrender value, it's likely whole life. If it has no cash surrender value, then it's term to 100, despite the name.

When term to 100 was introduced, it took off like a rocket. It was inexpensive, easy to understand, and consumers loved it. But since there was no longer any "investment" to discuss—life insurance companies love to discuss investments—the industry created another product called universal life insurance.

A universal life policy has both an insurance component and an investment component. Think of it like having an investment account out of which your insurance costs are deducted. Each month you make a deposit to the account and the company deducts the cost of the insurance. If the insurance payment equals the amount of your deposit, you're left with a $0 balance in the investment account. However, if your payments exceed the insurance costs, there will be some money left over in the account each month. That money is expected to grow and earn interest.

Now let's say you're going along each month, paying your insurance costs plus some top-up, and your investment in the account is growing. One day you stop paying premiums. No problem: the company simply continues to withdraw the insurance costs out of the investments that are sitting in the account. And they'll continue to do that each month until such time as the investments go to $0—at that point you are going to have to start paying the premiums again or your policy will lapse.

With universal life, there are two basic choices for your insurance costs. The first is annually increasing (just like the one-year term we discussed earlier), and the second is level, sometimes called term to 100.

Let's say we go with annually increasing insurance costs. That means the costs are low today, but get very expensive as we get older. But if we pay more than the cost of insurance today, we can build a balance in the investment account that will—hopefully—grow over time. Eventually the monthly insurance deduction is going to exceed what we are depositing into our account each month, but the shortfall will come out of our investments.

As long as the investments grow faster than the insurance costs, everything works well. But what if we assumed an 8% rate of return when we bought the policy? (Don't laugh—that was a common "conservative assumption" prior to 2008.) Then along comes a market crash that wipes out 30% or more of the investment account. There may still be enough money in the investments to pay the insurance costs this year, and maybe next year, but eventually the well can run dry. Now you have to make up these escalating insurance costs out of your own pocket. Since you're older now, the insurance costs are extremely high, and if your health has changed you may have no other option but to hang on to a very expensive policy.

This is why you should never purchase a universal life insurance policy that has annually increasing costs of insurance. If things go wrong—and they have in the past—you can end up with insurance costs that become unaffordable. If you have a universal life insurance policy, ensure that it has level insurance costs.

Here's a second scenario. Let's say you have a policy with level insurance costs, but each month you still put in enough money to top up the investments. Eventually you are going to have enough money in the investment account that you won't have to pay the insurance costs for the rest of your life. Great news, and works like a charm—again, until we have a year like 2008 and your investments get decimated.

If you've been assuming that in 20 years your insurance policy will be all paid up, you'll be faced with another unpleasant surprise: your policy is not paid up after all, because your investments didn't perform. However, now the worst-case scenario is that you have to start paying insurance costs again, and because those costs are level, you'll be paying the same premium you locked in when you purchased the policy. This is much better than being faced with ever-increasing insurance costs.

The insurance industry likes to market universal life's investment component, but I don't think you should mix life insurance and investments. Remember that we said insurance is designed to protect you from catastrophic financial loss—it is not an investment. Would you mix your retirement savings with your car insurance policy? Mixing investing and life insurance makes just as much sense, and you may be better served by using different advisors for each.

So, when is universal life insurance a good idea? It makes sense if you are seeking permanent insurance, purchase level insurance costs and only deposit enough to cover the insurance costs—that is, you don't use the investment portion. In effect you are treating this as a term to 100 policy. If it's cheaper than a straight term to 100 policy (and it often is), then universal life may be appropriate for you.

Here's a final tip: if you have a universal life insurance policy, consider depositing two or three months' premiums into one of the guaranteed investment options in your policy. This provides a backup in the event that you somehow miss a premium in the future. The insurance company will continue to withdraw premiums from this reserve, and hopefully that two or three months' leeway is enough for you to catch the mistake and correct it, thus avoiding the lapse of your policy.

CHOOSING THE RIGHT TYPE OF LIFE INSURANCE

You've determined how much life insurance you need. You know that your options consist of term life, and three types of permanent insurance: whole life, term to 100, and universal life. So what type should you get? Remember that all these insurance types are essentially the same—you are just paying the premiums differently over time. So the choice is simple: select the type of policy that best matches the length of time you expect to need life insurance.

If you are buying insurance to cover family income needs, then you're assuming you won't need coverage when you're older. Once the mortgage is paid, the kids are on their own, and you have lots of retirement savings you probably don't need any (or not nearly as much) life

> The only way a broker can get you cheaper rates is to shop more companies. Brokers cannot tell what health class you will receive prior to completing a medical exam

insurance. In this case, a term policy would be the right choice—it's cheap now, and when it gets expensive later, you can cancel because you don't need it anymore.

If you are purchasing insurance that you expect to keep forever—to cover burial costs, or to leave money behind to a beneficiary—then a permanent policy will be a better choice. The premiums will be higher than term insurance today, but they'll never go up, no matter how long you keep the policy. In the end, most people with young families will opt for term life insurance. This is also what most consumer advocates recommend, as it removes many of the complicated structures and sales strategies used by the insurance industry. People who are approaching retirement may look for a permanent policy to cover funeral costs and leave behind an estate.

It doesn't have to be one or the other. You can mix types of insurance in one policy: for example, you can purchase a policy with a base amount of permanent coverage and a larger, less expensive term coverage. This provides you with inexpensive coverage during the family years, and later in life leaves you with permanent coverage that you may want even after you retire.

SHOPPING AROUND

Once you know how much life insurance you need and what type of policy is right for you, the next step is simply shopping around for the best rate. The first thing you'll want to do is work with a broker. And not just any broker—find one who routinely deals not just with two or three companies, but with eight or 10, or more. Many brokers pool their clients into a small list of companies in order to increase their commissions—and that means you may not be getting the cheapest rates.

You should understand that brokers don't set the rates: insurance companies do. Rates from one company are the same no matter what broker you deal with. The only way a broker can assure you the lowest rates available is by dealing with all the companies, not just a chosen few. So make sure you're dealing with a broker who has no company loyalty and is prepared to shop as many companies as possible.

When you start shopping, brokers will provide you with a computer printout showing the rates from various companies. To provide these estimates, they need to assume that you fall into a certain health class. But brokers simply don't have enough information to determine your health class—the companies determine this after your medical exam. So during the quote stage, if you are in good health, assume a health class of "regular." Not only is that the rate you are most likely to receive, there's no downside to this assumption—if you qualify for cheaper rates (and few do) you'll receive them automatically after you apply.

Be wary of brokers playing the "cheapest quote game" by assuming you qualify for preferred or preferred-plus rates. The only way a broker can get you cheaper rates is to shop more companies. They cannot tell what health class you will receive prior to completing a medical exam.

Unless you're purchasing a multi-million-dollar policy, don't worry about the size of the insurance company, or the brand. All insurance companies are well regulated by the government, and of the few that have failed over the years, neither size nor brand recognition were good ways of predicting their failure. (In the rare event that an insurance company does become insolvent, several layers of industry and government safeguards are in place to protect consumers.) Small, little-known Canadian life insurance companies are as strong and stable as the large companies that run TV ads showing happy retirees riding motorcycles.

DISABILITY INSURANCE

There are three ways you can lose your paycheque. You can die, you can become unemployed, and you can become disabled. The first risk we cover with life insurance, while the second is handled primarily through government benefits. The third risk can be addressed with disability insurance.

Let me start by saying that nobody is happy about disability insurance. Consumers dislike the high premiums, and if you do become disabled, you can expect an inquisition during which you're continually questioned, prodded, and made to fill out forms. Insurance companies don't like disability much either: they have to be vigilant against fraud, or even claims by people who really should be nudged back to work. And the brokers are caught in between, trying to keep their clients happy.

Nonetheless, the loss of your paycheque from disability meets all of our criteria for catastrophic financial loss. And you are far more likely to become disabled than you are to die, so you must ensure that you have proper disability coverage. Disability and life insurance are the two foundations of a proper plan for most people.

It's important to note that we are going to be discussing long-term disability insurance, which is intended to cover you if you're completely unable to work for a long period of time. This is in contrast to short-term disability insurance and long-term care insurance. Proper disability insurance should cover you no matter how you became disabled—car accident, bad back, or nervous disorder.

When deciding on the right disability coverage, the questions we need to answer are how much, and how long. Disability insurance covers a specified percentage of your income. Typically insurers will cover a maximum of two-thirds of your income. That's not as bad as it sounds, because in most cases the benefits are not taxed. The result is that your disability benefits are likely to be almost what your take-home pay was when you earned a paycheque.

For example, let's say you earn $50,000 per year. After taxes you actually take home about $35,000. If your disability insurance covers two-thirds of your income, then your benefit would be $33,000 per year—pretty much what you were taking home before. If the insurance companies started offering more than two-thirds of income as a benefit, people would be making more money on disability than when they were working—and some folks wouldn't be motivated to get back to work even if they were able.

The length of time you will be covered is called duration of benefits, and it is commonly two years, five years, or to age 65. This timeframe is the most overlooked aspect of disability insurance. Let's say you purchase a policy that pays two years of benefits and that you then become permanently disabled. Who's buying your groceries after two years? Once your benefits run out, there's no more money coming in. That's why the only timeframe you should be considering is benefits to age 65.

Disability insurance also has an elimination period. This is the amount of time after your disability during which no benefits are payable. It's intended to reduce short-term claims, which helps lower costs. Common elimination periods are 30 days, 60 days and 90 days. There's no best answer here, but I normally recommend 90 days. Any shorter than that and premiums get expensive. Any longer than 90 days and there's not a big savings in the premiums. Purchase the elimination period you feel most comfortable with in terms of paying premiums, then ensure that you have enough of an emergency fund to pay for your needs during the elimination period.

Most disability policies have an option centred around your occupation: they will either cover you if you can't do what you're doing now ("own occupation") or only if you can't work at all ("any occupation"). While having "own occupation" coverage is important to many people, I'm less certain. I suggest you consider the higher cost of this option in relation to how strongly you feel about going back to work doing something else if you become disabled.

Different policies also feature different options over what happens if you're disabled for a period, then go back to work, then become disabled again. Or there are provisions around what happens if you're able to work 50% of the time. These get complex fast, and they vary by company, so I'll simply recommend that you have your broker investigate

> Disability insurance coverage generally has a duration of benefits lasting two years, five years, or to age 65. This timeframe is important, yet it's frequently overlooked

the options. Remember though, you'll need to balance premiums for these options with the realization that if you become disabled, you're going to wish you had purchased the Cadillac of policies.

The coverage we've discussed up to now is long-term disability insurance. Short-term disability insurance would cover you during the elimination period—for the first 30 to 90 days or so. Let's recall the insurance principles we discussed at the beginning of this chapter. We said that insurance should protect you from catastrophic financial loss. Is the loss of your income for 30 days catastrophic? If it is, it shouldn't be—you can take steps to make sure that you have this level of savings in an emergency fund. The need for insurance only becomes catastrophic when a disability is expected to last for the long term.

Short-term disability isn't readily available through individual policies. It is sometimes available through group insurance plans, but it will be expensive. If you're looking at short-term disability protection, consider self-insuring by saving.

Individual disability policies are expensive—no two ways about it. Group insurance through work, however, is often much more affordable. In fact, it's generally so much cheaper that if you have coverage at work there is little point shopping for individual coverage.

However, if you have coverage at work, you should confirm that you are covered for two-thirds of your income, and that you have benefits to age 65. If not, consider asking your employer to increase these benefits. Unlike health and dental insurance costs, disability premiums are typically borne by the employee. So if you're asking for a better disability policy at work, your employer likely won't care because you're paying the increased costs.

If you have coverage at work that only provides benefits for two years, you could purchase an individual policy with a two-year elimination period. Then if you're disabled, your work policy would pay for the first two years, after which your individual policy would kick in and start paying benefits.

The last point to note about group insurance is that it's tied to your employment, so it may not be portable. If you lose your job, you may lose your coverage as well.

CRITICAL ILLNESS INSURANCE

Critical Illness insurance pays a one-time benefit amount if you contract one of about two dozen conditions deemed to be "critical illnesses." If you get cancer, wouldn't it be nice if you got a cheque for $250,000? You could take the family on a trip to Disney World. You could afford treatment at the Mayo Clinic. It would make things a lot better, wouldn't it?

But wait a second—did you forget that insurance is supposed to protect you against catastrophic financial loss? Let's say you develop cancer or have a heart attack. While this is certain to be an emotional time, will you lose $250,000? You may want to take a trip to Disney World, but using insurance to pay for something you didn't have before directly contradicts the idea of protecting against a loss.

And those treatments at the Mayo Clinic? Again, this is creation of wealth, not protection from loss. In Canada, cancer treatment is free. Open heart surgery is free. We don't rack up hundreds of thousands of dollars in medical costs.

What about lost wages? Well, if you have a proper disability policy and are permanently disabled by your illness, then that policy will provide benefits. Most critical illness plans actually require that you survive the condition—you have to remain alive for a specified period in order to qualify for benefits. As such, it is not an appropriate replacement for life insurance.

So why is critical illness insurance so popular? Because it's an emotional sale in most cases. Be aware of what you're purchasing, and test it against the three principles of insurance: catastrophic financial loss. Treat critical illness insurance with a healthy dose of scepticism. And make sure you have adequate life insurance and disability insurance before considering critical illness insurance. (There's one exception: because disability insurance is tied to income, people without any income can't purchase coverage. In that case, critical illness insurance can help fill that void.)

Critical illness insurance premiums are structured similar to life insurance premiums and are available in various term and permanent formats. (With a term structure, some companies will also offer a conversion clause similar to that found in life policies.) The structure to choose again depends on how long you're looking to keep the coverage. If you're treating this as income protection, then a term policy would be appropriate. If you're looking at keeping the coverage forever, then one of the permanent premium structures would be better.

Insurance companies in Canada use a fairly standard set of definitions when determining what health conditions are covered. Still, their exact policy provisions can vary in the fine print. One of Canada's foremost experts on critical illness has kindly allowed me to use their spreadsheet that compares in detail the coverage available for many of the more well known products. That spreadsheet is available at savingandinvestingbook.ca if you'd like to look at it in detail.

Glenn Cooke started his life insurance career in 1986 and has worked independently since the late 1990s. He has consulted and provided marketing services to thousands of insurance companies, banks and brokers across Canada and the U.S. However, his focus remains on educating Canadians on the types of life insurance available, as well as how to get the best rates. He has become a pioneer in the online life insurance business in Canada, and today he works with his clients over the internet and by phone, entirely skipping the kitchen-table sales process. At his website, lifeinsurancecanada.com, you can find calculators, technical studies, online quotes and plenty more on life insurance.

SUMMARY

You now have the essential tools and information to save for your financial future at any age.

Remember that financial planning is a journey and not a destination. Remember that saving and investing requires lifelong learning, commitment and monitoring.

If you need more information or support, you have now been introduced to some of Canada's premier personal finance bloggers and their websites. We encourage you to expand and grow through the growing community of Canadians who are taking control of their financial lives.