Snapshots™

STARTING OUT:
SAVING AND INVESTING

NOW THAT YOU ARE STARTING OUT IN LIFE THERE ARE MANY THINGS TO CONSIDER. SOME, SUCH AS DECIDING ON YOUR LIVING ARRANGEMENTS AND DEALING WITH STUDENT DEBTS, WILL BE MORE URGENT. HOWEVER, SETTING UP A SAVINGS PLAN SHOULD ALSO BE SOMETHING YOU CONSIDER A PRIORITY.

Retirement is probably 40 or more years away, but getting started now will have a dramatic effect on how much money you have later on in life and whether you can achieve all of your financial goals. Establishing a budget is a crucial step in taking control of your finances. (Speak with me about the Budgeting tools available through Snapshots). It's probably safe to say that with your other financial obligations you will not have a lot of money left over at the end of the month. However, it is never too early to get started, and even making a regular small contribution to a savings plan can reap substantial long-term rewards.

Ways to Save

Short-Term Savings

Everyone should have some short-term savings or 'emergency fund' that can be accessed quickly when needed. This could be for things such as unforeseen car repairs or to help manage expenses in case you lose your job. Most people agree that you should set aside at least three months' worth of living expenses. Short-term savings should be readily accessible and, ideally, earning some interest in the meantime. However, by definition, safe, liquid investments such as a chequing or savings account pay little or no interest. A reasonable alternative may be Money Market funds, which are generally highly liquid (easy to buy and sell) and offer more competitive yields. I can provide more details about these types of investments. You will need to consider the costs of getting money from other sources (such as your credit cards or other credit), as well as Employment Insurance and Short-Term Disability insurance, to determine how much of a financial cushion you need in your short-term savings. At the end of the day, you do not want to be tying up too much money in low interest-paying investments.

Long-Term Savings

Registered Retirement Savings Plans (RRSPs)

RRSPs are the most popular way for Canadians to set aside money for retirement. These are plans created and administered under the Income Tax Act. There are many specific features of RRSPs, and I can provide you with details. The most important to keep in mind, though, is that money you put into an RRSP will give you a tax deduction in the year that you make your investment and, while inside the plan, will grow tax sheltered—which means you won't pay tax on the money in your RRSP until you withdraw it in the future (presumably, when you retire). The amount you can contribute to an RRSP is directly related to your income in the previous year. For example, if your income last year was $30,000, you would be allowed to contribute 18% of that—or $5,400—to an RRSP this year. Be aware that an RRSP in itself is a legal structure, not an investment. To contribute to your RRSP, you must buy an investment that is RRSP-eligible; there is a very broad variety to choose from. In addition, there are two basic categories of RRSP:

Individual RRSP

These are RRSPs that you can set up directly with your investment dealer or bank. You are responsible for making your own contributions.

Group RRSPs
These are plans that are set up by your employer for the benefit of you and your fellow employees. Under this plan, your employer makes contributions to an RRSP in your name, on your behalf. Your contributions are deducted at source (directly from your paycheque) and in many cases your employer will match your contributions, which means you'll be setting aside more money than you would on your own.

Lump Sum versus Periodic RRSP Contributions
When you have an individual RRSP, you will be responsible for making the contributions. Although you can make a lump sum contribution at any time, there are definite advantages to establishing a regular contribution plan that automatically directs money from your bank account to your RRSP savings on a regular basis. These are usually referred to as Pre-Authorized Chequing—or PAC—plans and most financial institutions will allow regular contributions of as little as $25. By using a PAC plan, you become used to the regular withdrawals from your account, which is probably easier in the long run than a lump sum contribution.

Tax-Free Savings Account (TFSA)
In 2009, the federal government introduced a new tax-efficient way for Canadians to save money: the Tax-Free Savings Account (TFSA) allowing you to contribute up to your accumulated maximum, which is increased by $5,500 per year as of 2016. Although there is no tax deduction allowed on the contributions (as in the case of an RRSP), the income earned in the account is tax-free and any withdrawals are tax-free. You can use the money in your TFSA to pay for such big ticket items as a car, home or travel. Money in it can be withdrawn tax-free at any time—and you can replace the money you take out of the TFSA the following year. As long as you are a Canadian resident 18 years of age or older with a SIN, you can open a TFSA.

I can provide you with more information about the TFSA as well as assist you in establishing an account.

The Lifelong Learning Plan (LLP)
If you have left school but are considering going back, the LLP is a way to use your RRSP savings to pay for a full-time return to school. As with the Home Buyers' Plan (ask me for more information), the LLP lets you or your spouse essentially borrow from yourself by withdrawing money from your RRSP(s) and paying it back at a later date. Here is more information about the LLP. I can certainly provide you with more information.

The Long-Term Effects of Starting a Savings Plan
You've likely already heard of the power of compound interest or investment, and it is very true. Here are some simple examples demonstrating the results you can achieve with a long-term savings plan. Please note that the following hypothetical calculations assume that the issuer of the investment doesn't default and all cash flows are re-invested at the expected rate of return.

Example 1 – Assumptions:
Investor age 21, investment term = 40 years
Amount to be invested = $25 per week
Expected rate of return = 3% annually
Type of investment = RRSP (tax-free growth)
Amount saved in 40 years = $100,500

In this example, our investor begins making $25 weekly contributions at age 21. After 40 years, she has saved $100,500, assuming a 3% annual rate of return. If she waits until age 35 to begin her savings plan, she will have to invest $50 per week to save the same amount of money by the same age.

Example 2 – Assumptions:
Investor age 21, investment term = 40 years
Amount to be invested = $25 per week ($1,300 per year)
Increase in amount invested per year = 5%
Expected rate of return = 3% annually

Type of investment = RRSP (tax-free growth)
Amount saved in 40 years = $250,000

In this case, our investor also begins making $25 weekly ($1,300 per year) contributions at age 21, but increases the amount she invests every year by 5%. Forty years later, assuming her money grows at a 3% annual rate, she will have an investment worth $250,000. If she waits until age 35 to begin saving, she will have to invest $125 per week to save the same amount of money by the same age.

Which Investments are Right for You?

The proper answer to this question is 'it depends'. There are literally thousands of investments available for you to choose from, and it can be very confusing and intimidating when you are starting out in the investment world to decide where to begin. One rule in finance is that risk and return are directly related; in other words, if you want higher potential returns, you must accept a higher degree of risk, and if you want security and safety in your investment, then you must accept lower potential returns. Roughly speaking, there are three broad types of investments or "asset classes": money market instruments or cash (which may be considered "safe" investments), fixed income (bonds), and equities (stocks). In general, cash and cash equivalents have the lowest volatility (fluctuation in prices) but also the lowest potential returns over the long term, while equities historically have the greatest long-term potential returns but also tend to experience the highest volatility. Investment grade fixed income falls somewhere in between.

For many investors, mutual funds are a convenient way to access these various types of investments. Your money is pooled with other like-minded investors and is invested on your behalf by qualified investment professionals. Mutual funds help take the guesswork out of investing and allow you to hold a wider range of investments than you could realistically buy on your own. Buying mutual funds is easy as most fund companies either have a low or no minimum initial purchase and many offer the option of pre-authorized monthly payments so you can keep investing automatically.

Many mutual funds are structured to invest, in varying proportions, in a combination of the three asset classes discussed above. It's important to note that the amount of money allocated to these asset classes will have a direct and ongoing effect on your long-term investment returns. You are strongly advised to have a discussion with a qualified Financial Advisor. Advisors are highly trained, as well as legally and ethically required, to treat you as a unique individual and determine enough about your circumstances, objectives and personality to make informed and appropriate suggestions for your investment portfolio.

For more detailed information on investing in mutual funds, take a look through this Mutual Funds 101 brochure or speak with me.

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