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Couple urged to pay off debts, forget real estate

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FROM SATURDAY'S GLOBE AND MAIL

In Vancouver, a couple we'll call Chuck and Ruth are in the early stages of their careers. Chuck, 31, is a marketing director for a high-tech company. Ruth, 28, is finishing a post-graduate degree in science and working on a contract with a government unit. They are thinking of having children some day, though not necessarily in the near future.

With \$142,500 annual gross income and promising careers, they seem to have their lives in order. Yet \$160,000 of debts to be paid off and the challenge of coming up with cash for a conventional mortgage down payment in the expensive Vancouver market make their wish to move from a rented apartment to a home of their own more a dream than anything they can realize soon.

"The dilemma is that, as a renter, we are paying somebody else's mortgage," Chuck explains. "We have a risk that Ruth's job, which is not secure, could end. Then I would be stuck with the whole mortgage payment. I feel uncomfortable with all this risk. Yet we want to start building up our nest egg. Our friends, after all, have begun to buy their own homes."

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Facelift asked Derek Moran, a certified financial planner who heads Smarter Financial Planning Ltd. in Kelowna, B.C., to work with Chuck and Ruth to determine how solid their plans are and how they can buy a house.

"The couple's goals are like many others," he explains. "A house in a decent neighbourhood, kids and a solid retirement. In fact, there has never been a worse time in history to buy a house in Vancouver. It now takes 64 per cent of average pretax income to fund housing costs in Vancouver. House prices in Vancouver cannot rise forever."

Chuck and Ruth can build up a conventional down payment on a \$500,000 starter home. First step — pay down their nearly \$160,000 of loans as aggressively as possible, Mr. Moran suggests. If they use every dollar of their \$864 monthly unspent and theoretically saved income, they could be out of debt completely in 10½ years, assuming that interest costs average 6.5 per cent over the period.

Chuck and Ruth can take several steps to increase their savings rate. First, pay less rent. They are now paying \$1,500 a month. They might find something cheaper and bank the difference. They allocated \$600 a month to personal travel. That could be cut back as well. There is \$620 a month for entertainment, another category that could be reduced. The savings could go to debt reduction, reducing the time it will take to get out from under their anchor of debt.

Many people wonder if they should pay down debt or add to registered retirement savings plans. In Chuck's case, it makes sense to contribute to his RRSP. His marginal tax rate after various employment benefits are deducted is 37.7 per cent. He should contribute to the maximum each year through his corporate savings plan. He purchases \$650 of company stock each month at 85 per cent of the applicable market value at time of purchase. He instantly gains a 17.7-per-cent return on the investment and is permitted to invest up to 10 per cent of his annual salary, which he does maximize. He should continue adding \$650 a month to the plan, the planner adds.

Ruth, on the other hand, is in a low tax bracket. Only \$40,000 of her income is taxable; the rest — \$17,000, is a tax-exempt scholarship. Her low tax rate of about 21 per cent makes RRSP savings less attractive, Mr. Moran says.

There are several ways that Chuck and Ruth can buy a house. Canada Mortgage and Housing Corp. allows buyers to use high-ratio mortgages with as little as 5 per cent down. A recent change to high-ratio borrowing allows buyers to enter the market with zero per cent down. In each case, mortgage insurance charges are added to the principal. High-ratio mortgages are nevertheless a risky way to buy a house, and add to final costs, the planner notes.

The couple could use the Home Buyers Plan to buy a house. They have never owned a home before, so they qualify for the plan. Each can use up to \$20,000 of RRSPs provided that funds have been in the RRSP for at least 90 days. That's just the potential, however. For now, Mr. Moran says, they have to deal with their debts.

Pay off those debts first, the planner urges, and forget about real estate for a while. House prices in Vancouver could decline within a few years. Waiting may be better than spending a great deal today when there are bargains tomorrow, he says.

Chuck's RRSP will grow to \$292,000 in 2006 dollars by the time he is 55, assuming 6-per-cent annual growth plus a \$4,800 annual contribution enhanced with a 25-per-cent boost from his employer. If he continues contributing to age 60, with the same assumptions, his RRSP will be worth \$370,300. By age 65, it would grow to \$461,000, the planner says.

The capital Chuck accumulates to his age 55 could support an annual taxable, inflation-adjusted income for the couple of \$13,590 until Ruth reaches age 82, her life expectancy, plus five more years just to be safe. If they work until Chuck is 60, the capital would provide \$18,900 a year. If he were to work to age 65, the capital would support income of \$26,500, Mr. Moran estimates.

The corporate savings program, financed at a rate of \$650 a month plus 17.7 per cent added by the employer as a stock discount, would add \$323,700 by Chuck's age 55, \$423,750 by his age 60 and \$539,700 by his age 65, Mr. Moran says.

At 60 each could receive as much as \$7,095 from the Canada Pension Plan. Together they could receive \$18,892 from their registered plans and \$21,619 from the

stock purchase program. Much of the final number would be a tax-free return of capital. At 65 they could each receive \$5,903 of Old Age Security a month. Each would then have total annual income of \$54,701 to age 65 and \$66,507 thereafter, the planner notes.

At 65 each could receive as much as \$10,135 a year from CPP. Together they could receive \$26,481 from the registered plans and \$30,993 from the stock purchase program and \$5,903 each year of Old Age Security. The total is \$89,550 to her age 87 in 2006 dollars. The numbers are split evenly so the OAS clawback, which begins at about \$62,000 of annual income, should not trouble them, Mr. Moran says.

There is a great deal that is uncertain in the as yet unformed parental lives of Chuck and Ruth. Children will add complexity, but for now, the couple should decide on a path to a house, the planner says. Debt reduction is the conservative thing to do. Aggressive debt reduction could leave the couple with manageable debt half of the present level in five years, just when they think they might want to begin having children. Buying a house when the market is high and carrying even more debt is precarious, Mr. Moran says. The goal should be to take risk out of life rather than add to it, he insists.

"This couple can't have everything right now," Mr. Moran says. "They have a lot of student loan debt, a relatively small amount of assets, and a long life ahead. They should pace themselves, pay down their debts and then consider going into the kind of deep debt that buying a house in Vancouver will entail."

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