

Paying Down Your Mortgage vs. RRSP Investing

We all know that our own homes are an extremely important investment. We also know that making annual contributions to our RRSPs is very important. If you have surplus cash for investing, which is the more important to work on first? Indeed, one can find experts to support either argument. Let's examine the alternatives in detail and look at some examples.

Your mortgage is probably the largest financial obligation you will ever have and because payments are made with after-tax dollars, it is very expensive debt. Furthermore, every extra dollar you pay on your mortgage comes directly off the principal (assuming your mortgage has a prepayment option), lessening the length of time it will take you to pay off the mortgage and lowering your total interest cost by a significant amount. For example, on a \$100,000 mortgage at 8.5%, by making a \$5,000 prepayment each year, you would reduce the amortization period of the mortgage to just over 10 years from the traditional 25 years and reduce your interest cost by \$83,705. In investment terms, a prepayment on an 8.5% mortgage is like getting a tax-free return on an investment of 8.5% each year. Paying down a mortgage also gives a great deal of psychological comfort which should also be taken into account.

We also know that our RRSPs are a very important investment and that starting an RRSP and making contributions in the early years is critical if we are to amass sufficient funds for a comfortable retirement. Most Canadians are becoming only too aware that by the time they retire, there may not be any assistance forthcoming from the Government.. Employees are also discovering that their company pension plans may not be sufficient to maintain their pre-retirement standard of living.

Neither can you plan to have your paid-off home finance your retirement. Even if you were to sell your home, purchase a less expensive one and invest the difference, it would not likely be sufficient to finance a 20 or 30 year retirement. It's becoming more and more important to make contributions to an RRSP each and every year and to invest them wisely so that you can have a financially worry-free retirement. After all, why spend most of your life working and then have to suffer a lower standard of living during what should be some of the most enjoyable and carefree years of your life?

Keep in mind that your RRSP contributions are tax-deductible. In investment terms, if you are in a 50% tax bracket, a \$1,000 RRSP contribution is equal to \$500 in after-tax money to pay down your mortgage. You must also take into account the fact that your contribution compounds tax-free within the RRSP. For a taxpayer in a 50% tax bracket, earning 10% in an RRSP is like earning a 20% return outside the plan.

Many investors, however, find it is very difficult, if not impossible, to both reduce your mortgage and add to your RRSP at the same time. Is it best, therefore, to concentrate on just the mortgage or to just make regular mortgage payments and make RRSP contributions at the same time or to do a little of both?

One solution is to compromise by making your maximum RRSP contribution (or whatever you can manage) and using the resulting tax refund to pay down your mortgage.

Although you may now carry forward unused RRSP contribution room from 1991 onwards, allowing you to pay down your mortgage for several years and then make one large catch-up contribution, you must weigh the benefits of this strategy against the loss of the tax-free growth of those unused contributions over the period. When trying to determine what's best for you, you must take your own circumstances into consideration.

Here are a few factors to consider and which might help you decide on the best course of action. These are your marginal tax rate, your age and where you are in your mortgage amortization schedule. Your marginal tax rate is important because the higher your tax rate, the greater the upfront deduction for the RRSP contribution and the more attractive this option is. Your age should be taken into account because the further you are from retirement, the more valuable your RRSP contribution is as it has more time to grow. And finally, where you stand in the amortization schedule on your mortgage makes a difference because paying down the principal in the early years of your mortgage means that you will save a substantial amount in interest payments in the long run. Conversely, paydowns in the last few years save you relatively little in interest.

Each household's circumstances differ, so it's important to consider all the variables, do some number crunching and ask advice from your financial advisors.