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Are Lucas and Penelope saving enough to retire at age 65?

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Lucas and Penelope are in their early 40s with two children, ages 9 and 5. Their family income is about $195,000 a year. Both have company sponsored registered retirement savings plans at work to which they and their employers contribute.

"We've never really sat down with a financial adviser to plan for retirement," Lucas writes in an e-mail. "Most of the decisions we make are based on online articles and/or resources provided through our company's RRSP provider," Lucas adds. "Financial planning was something that both our parents never discussed, and we are hoping to change this with our kids."

Penelope and Lucas have a house in the Greater Toronto Area with a small mortgage, which they hope to pay off in a few years. As well, they have a condo in Ontario, rented to a relative, and another in Alberta – "this was our first home as a married couple" – that they are renting out at a loss. "We tried to sell this a few times, but with the economic downturn, we couldn't get what we paid for it so we decided to rent it," Lucas writes.

They wonder whether they can afford to retire at age 65 with a budget of $80,000 a year after tax. "Until what age do we have to work?" Lucas asks. "Should we sell the rental condo?"

We asked Ian Calvert, a vice-president and principal at HighView Financial Group in Toronto, to look at Lucas and Penelope's situation.

WHAT THE EXPERT SAYS

Real estate represents 78 per cent of the family's assets, Mr. Calvert says. "As Penelope and Lucas start to plan for their retirement, they will need to make a shift to more liquid assets on their balance sheet." Given their ages (she is 42, he is 44), they have enough time to focus on their savings and building up more liquid assets, the planner says.

"Because they still have two decades to retirement, they need to take advantage of the power of compounding in a tax deferred environment to capitalize on this time and build up their retirement accounts."

Together, they are saving $17,000 a year to their employer-based RRSPs. Including contributions from their employers, they are saving a total of $26,000 a year. Their current registered savings total $375,000. "If they continue with this rate of savings, their combined retirement savings would be $1.9-million by 2042, when Lucas will be 65," the planner says. This assumes they can earn an annual rate of return on their portfolio of 5 per cent. "As an average, this is a realistic and achievable return target," Mr. Calvert says.

With a 4-per-cent rate of return, their combined savings would be $1,678,000 by 2042, he says, still enough for them to retire comfortably.

To achieve this target over time, they will require both the dividend income and growth in value provided by equities, he says. Most of

their savings are in group-sponsored RRSPs, which can have limited investments options, the planner says. Within their options, Lucas and Penelope have chosen to invest their retirement savings in target date mutual funds. "In this type of investment vehicle, there is an asset allocation formula that gradually gets more bond-heavy over time," Mr. Calvert says. "In other words, they aim to be more conservative as you approach retirement by reducing their stock exposure."

These funds simplify investment decisions, but they may not have an asset mix that is aligned with the target return clients need to achieve their goals, the planner says. In some fund-of-funds products, there is a fee for the underlying mutual funds and another cost for managing the fund itself, rather than a single all-inclusive fee. Exacerbating this challenge is that employer-based savings plans don't always show total costs, he adds.

An alternative to the fund of funds would be selecting from the options within the group plan. By doing this, they would have more control of their asset allocation and could tailor this to their own specific retirement target. An example would be selecting the individual funds within the group plan lineup. Not only would this allow them to control the amount of equities in their portfolio, it would also give them flexibility on the mix between Canadian, U.S. and global stocks.

Lucas and Penelope's level of retirement savings, combined with their future Canada Pension Plan and Old Age Security benefits, should give them enough liquid assets to meet their spending target without having to sell any of their properties, Mr. Calvert says.

"However, one important aspect to consider in their retirement forecast is inflation," the planner says. With an estimated inflation rate of 2 per cent a year, their $80,000 spending target will rise to $121,000 after taxes by retirement. With estimated combined CPP benefits of $35,000 a year and OAS benefits of $20,000, they will need about $85,000 a year from the RRSPs/registered retirement income funds, the planner says. (Income taxes are estimated at $19,000.)

"At this rate of withdrawal, their retirement assets will last comfortably to the end of their lives if they keep their expenses under control," Mr. Calvert says.

One concern with the couple's plan is the lack of future flexibility. "Building up their group RRSPs should be the cornerstone of their retirement plan, but they should not neglect their tax-free savings accounts," he says. This is because all funds being withdrawn from their RRSPs will be considered taxable income in retirement.

Currently, they have a combined $15,000 in TFSAs, leaving a substantial amount of unused contribution room. "Even if the contributions are small, they should start an automated monthly contribution to their TFSAs and use them as investment accounts, not simply as high interest savings accounts," Mr. Calvert says. "Having access to tax-free withdrawals from their TFSAs later in life will be a major enhancement to their retirement plan because of the resulting flexibility."

As to the Alberta condo, Lucas and Penelope have to weigh the potential for capital gains against the current negative cash flow of $200 a month. "If they expect consistent appreciation on the property, it can still make sense to carry it," the planner says. "However, if the price of the property has been relatively flat and producing negative cash flow, the capital could be earning a better return elsewhere."

CLIENT SITUATION

The people: Lucas, 44, Penelope, 42, and their two children, ages 5 and 9

The problem: Are they saving enough to retire at age 65 with a budget of $80,000 a year? Should they sell the money-losing condo?

The plan: Continue with their company-sponsored RRSPs. Target a return of 5 per cent. Contribute as much as possible to their TFSAs to give them more flexibility after they have retired. Weigh the potential for capital gain when deciding whether to sell the Alberta condo.

The payoff: A comfortable retirement

Monthly net income: $12,215

Assets: Residence $1-million; rental condos $700,000; bank accounts $35,000; his TFSA $10,000; her TFSA $5,000; his work RRSP $230,000; her work RRSP $130,000; registered education savings plan $50,000. Total: $2.16-million

Monthly outlays: Mortgage $3,000; property tax $310; home insurance $75; utilities $260; maintenance, garden $75; transportation $810; groceries $800; child care $600; clothing $40; line of credit, car loan $625; gifts, charity $300; vacation, travel $100; dining, drinks, entertainment $255; personal care $20; club memberships $60; pets $20; sports, hobbies $20; subscriptions $10; drugstore $50; life insurance $140; communications $250; RRSPs $1,475; RESP $420. Total: $9,715. Surplus of $2,500 goes to unallocated spending or saving.

Liabilities: Mortgages $320,000; line of credit $9,340; car loan $8,625 Total: $337,965

Ian Calvert is a Vice President & Principal at HighView Financial Group.