



Developing a financial plan for the next generation

Like their parents, Bill and Carroll Cole, whose situation we discussed in the September issue, Jennifer and Andrew have specific financial and life goals that will be easier to achieve with a good investment strategy. Their financial plans must take into account their short- and long term dreams, tax situation, and present and future sources of income.

Because Jennifer and Andrew are at a different life stage than Bill and Carroll, recommendations for them must also be geared towards their longer time horizons, higher earning potential and greater tolerance for risk. Let's look at Jennifer's situation first.

THE YOUNG FAMILY

Jennifer, 35, and her husband Scott Young, 42, live in Vancouver with three young children. Both work outside the home in well-paying jobs, so their annual household

income amounts to \$110,000. Yet on a recent visit to see Bill and Carroll in Brandon, Manitoba, Jennifer told her parents she was worried that they weren't doing everything they could to manage their money and their taxes effectively. Bill and Carroll, fresh from their positive experience with their financial advisor, suggested that Jennifer and Scott speak with a financial professional.

When the Young family returned to Vancouver, Jennifer asked around and one of her colleagues at work recommended that she approach her financial advisor, Meena. Before they met in person, Meena suggested that Jennifer and Scott work together to make a list of their short-term and long-term financial goals. Following are the priorities they came up with:

- Reduce their overall debt,
- Ensure they have enough invested to retire comfortably and maintain their standard of living,
- Achieve financial peace of mind,
- Be in a position to pay for their children's education.



Jennifer and Scott sat down with Meena the following week to review their list and together prepared a “financial snapshot” of their situation (please see chart).

Meena started by identifying the positive features of Jennifer and Scott’s current circumstances. Most obviously, they have a \$12,590 annual surplus to put towards their goals. They also have nearly three decades to go before they reach retirement age, and in that time their incomes will likely rise as they receive salary increases and promotions.

Before tackling their stated objectives, Meena suggested a few additional considerations they will want to add to their overall plan:

- Develop a tax plan to maximize deductions and minimize taxes due,
- With a young and growing family, it is critical for them to ensure that their Will and estate plan is complete and up to date so their children are provided for if anything happens to either parent.

THE CHALLENGES

Jennifer and Scott have been reluctant to invest in their RRSPs over the past couple of years because of volatility in the financial markets. This year, they are considering skipping their RRSP contributions altogether and using

Financial Snapshot - Jennifer & Scott

Net Worth

Assets

Home	\$ 450,000
Scott’s RRSP	\$ 40,000
Employee Share Program	\$ 15,000
Bank Accounts	\$ 2,000
Jennifer’s Car	\$ 24,000
Scott’s Car	\$ 15,000

TOTAL \$ 546,000

Liabilities

Car Loan	\$ 14,400
Mortgage	\$ 275,000

TOTAL \$ 289,400

Net Worth \$ 256,600

Cash Flow

Annual Income (after tax) *

Jennifer (\$50,000 before tax)	\$ 44,680
Scott (\$60,000 before tax)	\$ 45,960

TOTAL (\$110,000 before tax) \$ 90,640

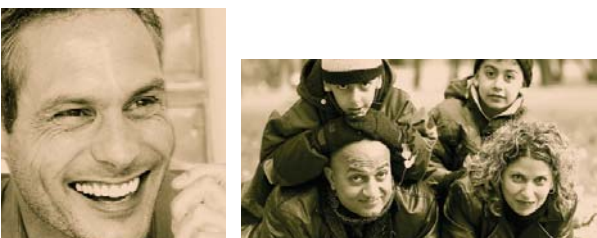
Annual Expenses

Mortgage	\$ 22,250
Basic Living Expenses (Groceries, clothing, property taxes, utilities, house & car insurance, etc.)	\$ 20,500
Medical & Drug Costs	\$ 500
Car Loan	\$ 4,800
Dining Out & Entertainment	\$ 6,000
Childcare and Children’s Lifestyle Costs	\$ 24,000

TOTAL \$ 78,050

Net Balance \$ 12,590
(Annual Income - Annual Expenses)

* Effective tax rate: Jennifer 10.6% (Marginal: 25.15%) (because of the \$18,000 deduction for childcare), Scott 23.4% (Marginal: 31.2%)





the money to pay down their mortgage instead. Meena advises against this because RRSP contributions offer an attractive tax deduction and their tax refund can then be used towards their mortgage. She understands their concerns about market volatility, however, and promises to look into investment options that they will be comfortable with. She asks the couple to complete a risk profile questionnaire, a series of questions about their financial situation, time to retirement and tolerance for volatility, so she can analyze their risk tolerance and put together investment recommendations after the meeting.

Another concern they have is Scott's employee share program. Because the money – a significant \$15,000 – is concentrated in a single stock, they worry that this lack of diversification exposes them to unnecessary risk.

MEENA'S RECOMMENDATIONS

In their second meeting, Meena presents Jennifer and Scott with her proposal. She starts with recommendations related to their retirement savings. Since Scott has significant RRSP room available from previous years, she suggests that they contribute \$10,000 of their surplus as well as the \$15,000 from Scott's employee share program into his RRSP. Although Jennifer and Scott considered this money to be their "emergency fund," Meena explains that it makes more sense for them to lower their risk by diversifying this asset within an RRSP. In order to continue with their RRSP contributions for the coming years, Meena

suggests the couple make a combined monthly contribution of about \$850.00 to avoid saving for a lump-sum at the end of the year.

With the new contributions, Scott's total RRSP savings will rise to \$65,000. At Scott's marginal tax rate of 31.2%, he will receive a tax refund of \$7,800, based on his \$25,000 contribution, which they can use towards their debt. To reduce the amount of interest they pay on borrowed money and speed up the process of eliminating their debt completely, Meena suggests that they open a Manulife One account and deposit their tax refund there. Manulife One is a combined borrowing and chequing account that lends people up to 75% of the value of their home and pays competitive money market interest rates on their savings. Meena suggests that Jennifer and Scott use the money they have available from Manulife One – in their case up to \$337,500 – to pay off both their existing mortgage and car loan. In the new account, the moment they deposit their salary cheques the money is applied against their outstanding debt, and they can make additional lump-sum payments at any time. The Manulife One approach could save the couple thousands of dollars in interest costs each year and see them debt-free about eight years earlier than if they continue on their current path.

Since their mortgage is coming up for renewal next month, this is the perfect time for them to open a Manulife One account. It also provides them with an

immediate source of money should an emergency situation arise.

Based on Jennifer and Scott's answers to the risk profile questionnaire, Meena sees that they're not as risk-averse as they think they are. However, their anxiety about the markets is an important factor, so to give them peace of mind, she recommends putting all of their RRSP savings, amounting to \$65,000, into a Manulife Investments Power of Two® strategy.

The Power of Two is a strategy that offers the return potential of investment funds and the security of a Guaranteed Interest Contract (GIC). Essentially, it combines the benefits of a segregated fund (a Guaranteed Investment Fund or GIF) and a GIC. A segregated fund is similar to a mutual fund but is only offered through an insurance company. Segregated funds have additional protection features not offered by mutual funds, such as providing a principal guarantee at maturity or upon death.

With the Power of Two, Jennifer and Scott can have guaranteed growth – they choose the rate of return, then a portfolio of segregated funds and a GIC is constructed to deliver the guaranteed result – with the potential for even higher results if the portfolio of investment funds perform strongly. It is also a valuable building block in the couple's estate plan because, as

investment products purchased through an insurance company, the proceeds are paid out quickly to named beneficiaries bypassing probate and other estate fees in the event of their death.

Meena recommends that Jennifer and Scott choose a 2% guaranteed minimum compound return on their investments to ensure their total RRSP value is always growing to help combat the effects of inflation. To achieve this, of their \$65,000 in RRSP holdings:

- 40% will be used to purchase a 10-year GIC with a 4.5% rate of return to provide them with guaranteed growth of 2% and security. This investment is cashable at any time (subject to potential charges.)
- 60% will be invested in segregated funds with a 100% principal guarantee after 10 years. This will provide exposure to the equity markets with some capital protection, provided that Jennifer and Scott hold their investment to maturity.

One of Jennifer and Scott's goals was to set aside money for their children's education, but when Meena does a quick calculation she discovers that Jennifer's parents, Bill and Carroll, are already investing enough money annually in their grandchildren's RESP that should cover most, if not all of the three children's post-secondary education costs.





Jennifer and Scott are happy to see that after all of these additional financial planning strategies have been implemented, they will still have some surplus left over. The budgets of young families tend to fluctuate from time to time. This surplus will give them breathing room beyond their fixed monthly expenses.

THE NEW GRADUATE

Jennifer's younger brother Andrew, 25, has just finished his Master's Degree, and has landed an attractive job in downtown Toronto. Studying business has given Andrew a healthy objectivity about his money and some of the analytical skills he needs to manage it sensibly. Although he has specific goals in mind, he's unsure about the most efficient way to meet them. As soon as regular pay cheques start coming in, he wants to:

- Begin saving to buy his first home,
- Pay down his student loan, and
- Purchase a car for more independence.

Andrew knows there are tax-saving strategies he should probably have in place and he'd like to have money set aside for emergency expenses. Also, ever since Jennifer's meeting with Meena, she's been urging him to put together a will and he'd like to arrange that, too. He approaches Toronto-based financial advisor, Julian.

THE CHALLENGES

Although Andrew has always been a good saver, and put aside as much money as possible from the part-time jobs he held through school, most of that money was used to pay for his education. When his godfather passed away a few months back, Andrew received a \$40,000 inheritance that also went straight into his bank account. Now that Andrew is poised to start earning a considerable salary thanks to his new degree, Julian sees right away that the first step will be to explain to his new client why it's important to accept some degree of risk (and the higher potential returns that go with that) in order to meet his longer-term goals.

When he meets with Julian, Andrew explains that he's much more concerned about his short-term goals than about retirement, which seems like an eternity away. Julian tells him that while putting off retirement savings is a common impulse among young investors, the power of compounding means that if he starts now he won't have to struggle later to make up for lost time. Besides, an RRSP is actually an excellent saving vehicle for Andrew to use as he sets aside money for a new home because the First Time Home Buyers' Plan will allow him to withdraw up to \$20,000 from his RRSP when he's ready to make a down payment without any immediate tax consequences. He'll have to either pay the money back into his RRSP over a maximum 15-year period, or pay taxes on the annual required payments.

Financial Snapshot - Andrew	
Net Worth	
Assets	
RRSP	\$ 5,000
Bank Accounts/Savings (inheritance)	\$ 40,000
	\$ 45,000
Liabilities	
Student Loan	\$ 10,000
Net Worth	\$ 35,000
Cash Flow	
Annual Income	After tax*
Andrew (before tax \$70,000)	\$ 52,150
Annual Expenses	
Basic Living Expenses (rent, food, clothes, utilities, etc.)	\$ 13,200
Medical & Drug Costs	\$ 200
Dining Out & Entertainment	\$ 12,000
TOTAL	\$ 25,400
Net Balance (Annual Income - Annual Expenses)	\$ 26,750

* Effective tax rate 25.5% (marginal tax rate 43.4%)

As for the car he wants to buy, Andrew isn't sure whether to borrow, or to buy it outright with cash from his savings. Similarly, he doesn't know whether he should pay off the student loan outright or gradually reduce it over time. And he tells Julian that he doesn't want to lock in his money because he has so many purchases coming up, including buying a whole new wardrobe for his new job. He has also thought about opening an account that will enable him to invest in mutual funds, but wants some guidance about which funds would be appropriate for his situation.

JULIAN'S RECOMMENDATIONS

Julian suggests that Andrew's first move should be to contribute as much as his contribution room allows to his RRSP. Not only is this a good strategy as Andrew saves for his first home, but it will ease his tax burden during a year when Andrew's income will rise significantly as he joins the corporate world. Andrew immediately sees the logic behind this advice and deposits \$10,000 of his savings into his RRSP to use the contribution room available from this year and past years. This will generate a tax refund of \$3,750 for Andrew.





Andrew's risk profile questionnaire shows that he is considerably more comfortable with risk than his sister. This makes sense since at his stage of life, he has no dependants or major responsibilities such as a mortgage. As a business graduate, he knows a lot about the financial markets and is willing to accept the volatility associated with them. Julian suggests that Andrew invest his RRSP savings – which combined with his previous \$5,000 RRSP savings amounts to a total of \$15,000 – in a properly diversified asset allocation portfolio, offering expert management and significant long-term growth potential.

Since the interest paid on his student loan is eligible for a tax credit, Julian suggests that Andrew pay off his student loan monthly, rather than use his inheritance.

To round out his investment plan, Julian suggests that Andrew use \$10,000 to invest in properly allocated MIX mutual funds from Manulife Investments. MIX funds are a good investment choice for non-registered plans since they help to minimize taxes.

That leaves \$20,000 to work with. Julian suggests that he put all of that money towards his new car, which should allow him to pay cash and avoid a car loan. Once he's purchased a car, Julian reminds Andrew that he will need to include car insurance in his monthly budget.

This strategy will start Andrew on the path towards investing inside and outside his RRSP. To get into the habit of "paying yourself first," Julian recommends that Andrew start making regular monthly contributions into a registered investment account of \$1,050 to minimize taxes and maximize his RRSP, while still contributing annually to a non-registered account once he starts receiving a salary. He can cash out the money at any time to pay for upcoming expenses, or use it with up to \$20,000 of his RRSP savings to make a down payment when he finds the house he wants to purchase.

Finally, Julian referred Andrew to an estate lawyer to draft his Will, which he can easily update whenever his situation changes.

CONCLUSION

Over the winter holidays the following year, Bill and Carroll host a big family dinner in Brandon for their grandchildren, Jennifer, Scott, Andrew and his girlfriend, Rachel. Over dessert, they start talking about how much closer to their goals they are this year than last. Bill and Carroll are thoroughly enjoying their renovated kitchen and looking forward to summer barbeques on their new deck. They feel more at peace about their retirement income as well, since they know



exactly how much they have to work with. Jennifer says that, thanks to Meena, she and Scott have developed estate plans, including choosing guardians for their children should anything happen to them – and that this, together with a reduced debt load and diversified investment portfolio, is helping her sleep better at night. Andrew's Honda Civic is parked outside, and, having been steadily contributing to his investment plan, he says he feels almost ready to start looking for a house.

A well-designed financial plan goes beyond investment choices to help you meet your short- and long-term financial and life goals in a way that suits your risk tolerance, tax situation and lifestyle. It is a road map that shows you where you're going and how to get there with a minimum of detours. And, as long as you make sure it is regularly re-evaluated to keep it current, a financial plan can help you, like the Cole family, achieve your dreams.

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