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A newbie's guide to RRSP investing

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Special to The Globe and Mail
Published Thursday, Feb. 20 2014, 5:00 AM EST
Last updated Monday, Feb. 24 2014, 11:58 AM EST

As the March 3 deadline approaches and the pro-RRSP message is trumpeted by TV ads, billboards and media stories, Canadians across the country are saying to themselves: I think I need one of those.

More often than not though, people land in front of a financial adviser with little knowledge of the investment vehicles they plan to buy.

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Many people who are looking to invest in a registered retirement savings plan often don't even know what an RRSP is, says Carl Spiess, director of wealth management for ScotiaMcLeod.

"There are way too many people who think an RRSP is an investment, and it's just an account," Mr. Spiess says. "People walk in and have this idea, 'I need to buy an RRSP,' and it's no, you need to put money into an RRSP to shelter it from tax and then decide on your investment."

When it comes to RRSPs, the investment options are plentiful, from exchange-traded funds to mutual funds to stocks and beyond. The first step is talking to a financial adviser about whether an RRSP is the right choice for you and your financial plan, says Richa Hingorani, senior manager of financial planning support at Royal Bank of Canada Financial Planning.

"Don't make temperamental decisions at this time of year just because of wanting an income tax break or because you've been hearing about ETFs or a particular stock," Ms. Hingorani warns. "Average Canadians spend more time planning their vacations than managing their investments."

To give you a head start before you make that RRSP appointment, here's a primer explaining some of the most popular investment options, and why you might want to consider them – or not:

1. Guaranteed income certificates

With a GIC, you are agreeing to lend a financial institution a sum of money for a period of time (a term). These investments appeal to risk-averse investors, because they are guaranteed to get that same amount of money back at the end of the term, plus a fixed rate of interest (Note: Some market-linked GICs offer a variable interest rate.)

GICs are considered a "safe" choice for investors, but the trade-off is that the interest rate is low – typically 2 or 3 per cent. In general, the longer the term, the better the interest rate.

Mr. Spiess says a short-term GIC can be a good choice for someone planning to utilize the funds within a year or two. Or for a very risk-averse investor, a "ladder" of GICs could be an option worth considering. To create a ladder, you divide your money equally into GICs with terms of one to five years. Each year a GICs comes due, you roll it into a new five-year certificate, so you can take advantage of rising interest rates, while limiting your exposure if rates fall.

"Ladder GICs seem to be very popular because you are not leaving it up to one rate of return," Ms. Hingorani says. "You are taking care of a lot of reinvestment risk, and you are never at the mercy of the markets."

2. Bonds

With bonds, you are acting as a creditor, lending money to a company or government. Bonds have a set term (which can be as short as six months and as long as 20 or 30 years) and a set interest rate. When the bond matures, you get your money back plus the interest you are owed. Some bonds have floating interest rates that go up or down over time.

Bonds have traditionally been seen as a lower-risk, lower-return choice (in comparison to a stock, for example), but there are still risks. Credit ratings, inflation and interest rates can affect bonds. If, for example, you buy a bond at 3 per cent and then interest rates go to 1 per cent, your bond becomes valuable. However, if interest rates go up to 10 per cent, your bond is no longer appealing to buyers. If you need to sell a bond before its maturity date and it's worth less than you bought it for, or if the issuer goes bankrupt, you can end up losing money.

"Going into a straight bond, like a 10-year bond, if interest rates go up over the next year, the market value of that bond can decline, and that can be unnerving for a novice investor," Mr. Spiess says.

3. Mutual funds

Canadians like their mutual funds. As of December, mutual fund assets under management in this country totalled $999.2-billion, according to the Investment Funds Institute of Canada.

A mutual fund is a portfolio of bonds, stocks and other assets owned by many investors and managed by an investment company. Because the investments of many are pooled, it allows individuals to be diversified in a way they couldn't be on their own. The idea is that your risk is minimized because your money is in an array of investments, and your returns can be higher than GICs or bonds.

Despite their popularity, mutual funds have their detractors, because of the high fees charged by some mutual fund managers.

"Because there are 5,000 funds in Canada, it makes sense to talk to an adviser, and there's lots of information you can research online as well," Mr. Spiess says. "The fund investor has traditionally gone into what was hot last year, so that might be something to discuss with your adviser – trying not to just chase last year's hot product."

4. Target date funds

Mr. Spiess says target date funds have become a popular choice with RRSP investors. Like mutual funds, the investments of many are pooled to allow for a diversified portfolio, but in this case, investments are managed and structured according to some date in the future (retirement, for example). So a younger person might choose a 2045 target date fund because that's when she sees herself retiring, whereas an older person might choose a 2025 target date fund. Managers change the asset mix according to how close someone is to the target.

"While the client is younger, the [portfolio] would be a more aggressive, stock-based fund, and then as the client gets closer to that target retirement date, then it becomes more of a bond or income-oriented fund," Mr. Spiess says.

Target date funds can be appealing because they make long-term investing easier, though they have also been criticized for being too "one size fits all" without taking the individual investor's specific needs into consideration.

5. Segregated funds

This is a type of investment fund available through a life insurance company. Proceeds received by the insurance company are used to purchase assets (such as mutual funds, for example), then shares are sold to investors. Like mutual funds, segregated funds offer a diverse portfolio of investments that are managed by a professional money manager, but they also offer guaranteed protection of your principal – 75 per cent to 100 per cent of the initial investment, upon death or contract maturity.

The downside? You need to hold those funds for a certain time period to take advantage of this guarantee, and you can also pay higher fees for this kind of protection.

Another reason segregated funds are popular is that it can be a way of leaving money to your family without it going through a will, as these funds are designated to a particular beneficiary, says Lea Koiv, national director of retail tax and estate planning at Standard Life.

"You can have a lengthy time span involved in validating wills, plus you have fees. But if I have a plan with a designation on it, that money could be paid out in as little as 10 business days."

6. Exchange-traded funds

ETFs are passively managed investment funds, a collection of bonds, stocks and other assets. Like mutual funds, ETFs allow investors to pool their money with other investors, but ETFs track or "shadow" an index or benchmark (for example, in a particular sector or commodity, such as infrastructure or oil). The idea is that investors can get the diversified portfolio and the higher returns they crave, while paying management fees lower than mutual funds.

“As a general comment, mutual funds tend to be actively managed and are generally provided through advisers, and ETFs are generally passive, used by self-directed investors or people with advisers who have a fee-based account where they can invest in stocks and bonds and ETFs directly,” Mr. Spiess says.

Although ETFs are often considered to be the more cost-efficient choice, Mr. Spiess says that isn’t always the case.

“To say ETFs are the low-cost choice always and mutual funds are the expensive ones isn’t necessarily true,” he says. “There are some actively managed ETFs that are now expensive ones, because you’re paying for a level of management rather than just buying an index.”

7. Stocks

Simply put, a stock is a type of security that represents a share in ownership of a company. Some stocks pay dividends, and you can make money when the stock’s value goes up, or lose money if it goes down. Mr. Spiess warns against jumping on the latest hot stock.

“There’s been a lot of research to show that when self-directed investors advise on their own portfolio, the percentage of stock that they have that is in brand-name companies is very high,” he says. “And they are therefore missing out on companies that might not be name-brand – industrial companies or financial companies that aren’t recognizable but are profitable or in industries where they are making good money.”

Ms. Koiv adds, “I think it’s inadvisable to jump on the latest fad. People have a bad habit of buying at the top and selling at the bottom.”

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