Determining how much money you'll need

When you’re planning your retirement, perhaps the most important question you have to deal with is how much money you’re going to need. Unfortunately, one of the most common mistakes people make is to underestimate their requirements. This section will help you avoid that mistake.

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The first thing you need to do

Before you can determine how much money you'll need, you have to think about what kind of lifestyle you want to enjoy. You have to have some idea of the kinds of things you want to do with your newfound free time.

For some, retirement means having the time to spend in the garden. For others, retirement means having the time to travel. Gardening costs very little. Travel costs a lot.

The point is, what you do with your time determines how much money you'll need. So you've got to sit down, gaze into your future and ask yourself some questions like:

-When do you want to retire?
-Do you plan on downsizing your home?
-Will you sell your expensive city home and move to the country?
-Will you be moving to a retirement community?
-Will you rent or own a vacation home?
-Will you spend time in warmer climates? How long?
-Do you plan on any major purchases or renovations to your home?
-Will you travel? How often? How far?
-Will you stay in costly hotels or will a B&B do?
-Will you work part-time while retired?
-Will you become more active in your community?
-Will you get involved in volunteer work?
-Will you be supporting or helping to support any family members?
-What hobbies will you pursue? What will they cost?
-Will you join a golf club? Or buy a boat?
-Will there be much dining out? Theatre? Movies?
-Do you want to spend your capital over your lifetime or do you want to leave an estate?

Each one of these questions relates to money. How you answer determines whether you'll need more or whether you'll need less.

The real threat

Inflation is one of those words that we've heard so often, its true dangers may begin to diminish. Kind of like someone crying wolf. When you hear the cries so often, you eventually start to ignore them. But we can't afford to ignore inflation.

Given today's volatile markets, many people are choosing ultra-safe investments like GICs. But that safe return you're earning today can yield a financial disaster for you in the future. Here's a simple example what inflation does to your money.

First, let's assume a moderate 3% rate of inflation. Now, imagine putting a ten-dollar bill under your mattress and leaving it there for 20 years. When you take it out, you'll find that your ten has turned into a five-dollar bill. That's what inflation does to your savings.

That means for you to get the purchasing power of the ten-dollar bill back, you have to earn at least 3% on your money. That's just break-even.

If your investments are earning anything less than 3%, you're losing money.

And this example assumes 3% inflation, a typical average rate over the last 50 years. It's not unusual for inflation to run 5% or 6% or higher and at those rates, the purchasing power of your ten dollars would be turned into pocket change.

Conclusion: Although your investments should be based on your objectives and risk tolerance, you need growth investments in your portfolio to make up for inflation. And yes, there will be more volatility and higher risk. But if you don't have some higher earning investments, the little example above shows what can happen.

If you'd like to get some help in growing your savings and investments sufficiently, click here to find the CPA financial planning professional closest to you.

While on the subject of threats to your security, there is one other that should be mentioned. And that is the threat of a medical or long-term health emergency. Inflation is a certainty and to some extent, you know what to expect. For more on how to protect your financial security from health disasters, click here to learn more about Critical Illness Insurance.

Sources of retirement income

If you're like most Canadians, your income will be a mix of pension income and income from investments. These can be divided into 4 main categories:

1. Government Pension Plans
If you've ever contributed, you're eligible for government pensions. But you won't get them automatically. You have to apply and be approved. It's your responsibility to do your homework and make sure you get every government benefit you're entitled to.

The two major plans are the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP). This pension is designed to replace about 25% of the earnings on which you paid into the Plan.

The size of the payment you will receive depends on the number of years you've contributed and how much you contributed during that time.

When you can start collecting
The normal age to begin receiving payments is 65. You can also begin as early as age 60 but the government will reduce your benefit by ½ % per month (6% a year) for each month prior to your 65th birthday. This reduction is permanent.

If you start your pension at age 60, your monthly payment will be 30% lower (6% a year for 5 years) than if you wait to age 65, but by starting it sooner, you are likely to get the pension for a longer period of time.

On the other hand, if you turn 65 and delay taking payments, the government will increase your benefit by ½ % per month for each month you delay your claim. Again, this increase is permanent.

If you start your pension at age 70, your monthly payment will be 30% higher than if you took it at age 65. If you apply after age 70, retroactive benefits are only payable for a maximum of 12 months.

One good thing to know is that your government pensions are indexed for inflation – they rise each year to cover the cost of inflation – plus they are guaranteed for as long as you live.

In 2003, the maximum CPP/QPP retirement pension is $801.25 per month or $9,615 a year.

Old Age Security
Old Age Security (OAS) is a basic benefit paid to all Canadians who are 65 and older and meet certain Canadian residency requirements. But depending on your other income, you may have to give some or even all of it back.

Maximum monthly benefits in 2003 is $456.08 or 5472.96 per year. If you've been an adult Canadian resident for 40 years or more, you qualify for the maximum.

If your income is $57,879 or higher, your OAS could be subject to "clawback" of 15% tax on the amount your income exceeds this amount. Once your earnings are approximately $94,311, you would receive nothing.

Other government pensions
For those with lower incomes, assistance is available through Guaranteed Income Supplements, Spouse's Allowance, Widowed Spouse's Allowance, Disability Pension and other topping-off benefits. You can find more information on these and other government pension plans, at the government web site:
http://www.hrdc-drhc.gc.ca/isp/common/cpptoc_e.shtml

2. Company Pension Plans
We all know people who worked at the same career or for the same company for 25 or 30 years. And when they retired, they received around 70% of their pre-retirement income.

To receive 70% of income is about as good as it gets for a company pension. And it's becoming rare. Changing workplace, increasing mobility, early retirement and more self-employment are some of the reasons.

Company pension plans are as varied as the companies that offer them. And having one does not guarantee lifetime financial security. You should become familiar with your company's plan, see what it offers and see how it meshes with the rest of your retirement income sources.

Some company pensions are integrated with CPP/QPP, which means the employer-paid pension is reduced when you become eligible for government pension. Some of the most common types of company plans are:

Defined Benefit Plan – This is the most popular of all company pension plans. It guarantees a specific level of pension income, typically a percentage of your income at a certain age or after a certain number of years of employment.
These plans are sometimes criticized because they are guaranteed and must therefore sacrifice some performance for security. Another drawback is that they are not portable from one employer to another. Although a commuted lump sum may be transferred to a new employer.

Defined Contribution Plans – Also known as "money purchase plans", these plans do not guarantee the level of pension income to be paid. They simply define the amount of the contribution that is made by the employee and the employer. Although the employee bears this risk of uncertainty, they can also enjoy the higher rewards of good economic times.

One advantage is that you can transfer your plan from one company to another if the new employer accepts the transfer, or you can roll your money into a Locked-In Retirement Account (LIRA) or an RRP if you leave your job. At retirement, you must use the accumulated value of your plan to purchase either a life annuity or, in some pension plans, a Life Income Fund (LIF).

Group RRSPs - These are loose pension programs sponsored by employers and designed to encourage employees to save through easy payroll deductions.

Employers usually match the employee contribution. The employee has responsibility for choosing and managing the investments within their RRSP and for selecting their retirement income plan when they retire.

Deferred Profit Sharing Plans - Although not formal pension plans, these plans are often used by employers to build retirement funds for their employees. The contributions of the employer and any investment income earned remain tax - sheltered until retirement.

At retirement or termination from employment, the employee can either transfer the employer's portion of the funds to his or her RRSP or select an eligible retirement income option.

3. Income from Registered Investments

At some point, and certainly by the time you turn 69, you will convert your RRSPs to a RIF (Registered Retirement Income Fund) or possibly some type of annuity.

If you have a registered pension plan through an employer, when you leave you can transfer your pension credits to a Locked-in Retirement Account (LIRA) or a locked-in RRSP. At some point, you can convert this money to a Life Income Fund (LIF) or in some provinces, a Locked-in Retirement Income Fund (LRIF) or an annuity.

You can learn more about RRIFs and LIRAs in the section: turning 69, some things to know.

And you can learn more about annuities in another section: one form of income you can count on.

4. Income from Non-Registered Investments

There are many ways in which you can receive income from non-registered investments. Here is a listing of a few.

-Interest on personal savings
-Interest from GICs
-Dividends from or sale of stocks
-Interest from bonds
-Dividends or redemption of mutual funds
-Conversion of home equity
-Income from business assets
-Income from real estate
-Liquidation of personal assets

For more information on non-registered investments, please see the section on Investment Planning.

905.780.0908 T | 905.780.3815 F | INFO@CPA-FINANCE.COM

Income you can count on

Every retirement plan should have some security, some income that can be relied on every month. That's what an annuity can provide.
An annuity is a financial contract between you and an insurance company. You give them an amount of money in one lump sum and they agree to give it back to you in set small amounts over a planned length of time.

The attractiveness of annuities depends largely on interest rates. The higher the rates, the more an annuity offers. Someone who had purchased an annuity years ago when rates were 12% would be looking at today's low rates with great satisfaction.

An annuity is perfect for you if you want to receive a reliable income from your assets but you don't want to be involved in managing them. You'd rather rely on the expertise of the insurance company.

The insurance company invests your money into the types of assets that you select. And like a RIF, the money is able to grow tax-free. And like a RIF, you pay tax only on the payments you receive.

Annuities offer three main benefits – security, convenience and tax-deferred growth. Plus they may help avoid probate.

There are many types of annuities
One thing to keep in mind is that once you purchase an annuity, generally, its terms can never be changed. So be sure to give careful thought to the type you choose and the options it offers.

Annuities can vary by their duration
-Defined term - Such as 5, 10, or 20 years. At the end of the term, the annuity is depleted and payments end.
-Life annuity – An annuity can last for life, making guaranteed payments to you for the rest of your life.
-Joint-life annuity – Or they can continue payments as long as you or your spouse is still alive

And they can vary by their risk and reward
-Fixed–rate annuities guarantee a stream of payments.
-Variable annuities offer flexibility with stock, bond, and other investment portfolios. You can choose based on your long–term goals, risk tolerance, and your unique situation.
-Indexed annuities guarantee a stream of payments that is indexed for inflation

Three factors determine the size of payments you'll receive
Regardless of the type of annuity, payments will be based on three key criteria:
-the amount of capital used to purchase the annuity
-interest rates at the time of purchase
-your life expectancy (and your spouse's if using a joint-life annuity) at the time of purchase

You can receive payments monthly, quarterly, annually or any other interval agreed upon at the time of purchase.

If you'd like the peace-of-mind of knowing exactly how much income you're going to receive without the responsibility for investing your money, an annuity might be right for you. If you'd like to know more, click here to find the CPA financial planning specialist closest to you.

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