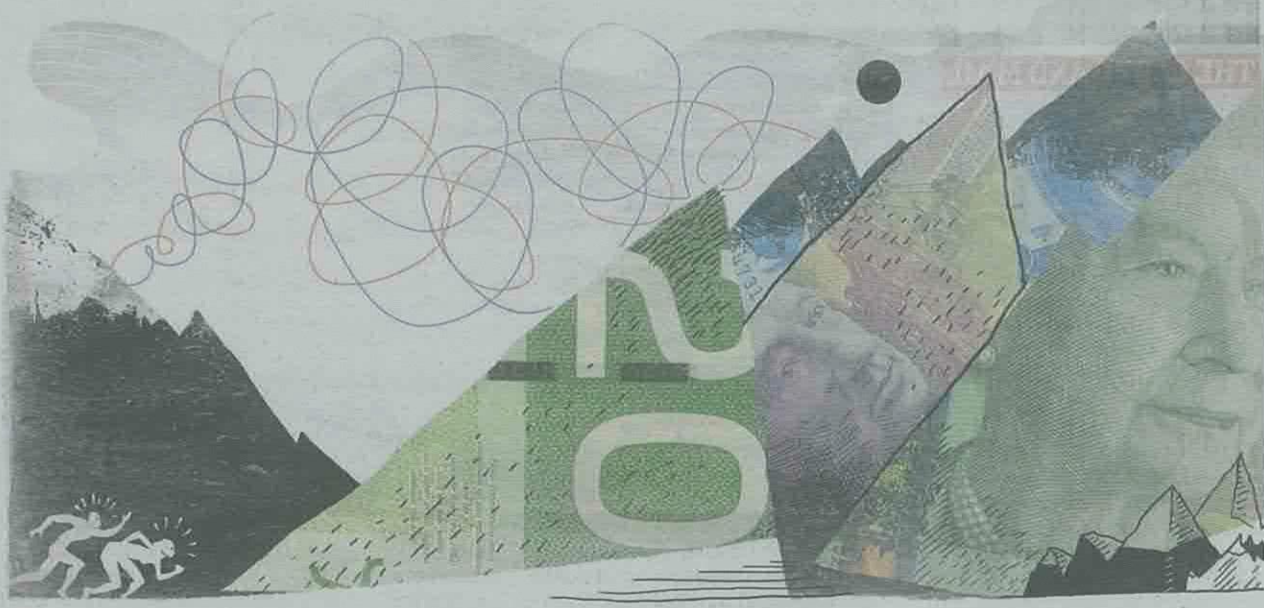
PORTFOLIO MAKEOVER

Pay down debt or save? Couple faces uphill battle

Even with big student loans, these recent immigrants still need a rainy day fund



DUSHAN MILIC

KEITH NORBURY

After six years of marriage, Sara and Mike are ready to start a family. They would also like to buy a home and put aside money for the education of their future children, and for their own retirement. Yet they face many of the familiar obstacles that stand between young couples and those objectives: student loans, modest incomes and some debt.

"We've had some debt issues here and there with all the moving and everything," says Mike. "Right now, we're stable."

Complicating their situation is the fact that Mike, 30, and Sara, 25, are landed immigrants from New Hampshire. Their only investment is a Roth IRA (Individual Retirement Account) that Mike established while working at a credit union back home.

They came to Canada in 2005 when Sara enrolled in Mount Allison University in New Brunswick shortly before they got married. Their plan was for Sara to complete her degree, which she did, and return home. But they liked Canada so much they decided to stay. In June, they became permanent residents.

Mike's Roth IRA is worth $3,100. The money is in a higher-risk mutual fund. Mike is pleased with its performance, noting that he put only about $1,500 of his own money into it. Its value has reached as high as $4,000. But he hasn't touched it since 2005, and he's wondering whether he shouldn't at least rebalance it.

The couple have a combined take-home income of about $4,200 a month; their combined gross is $50,000 to $60,000 a year. Mike works part-time as an administrative assistant for a small accounting firm, and has a second part-time job as a transcriptionist at a university. Sara works as an office manager.

They each have student loans. The combined balance is $35,000, and they are making payments of $325 a month. They owe about $3,500 on credit cards and have a few other small debts, which they expect to pay off by next summer. They own a car, but it is paid for.

In January, Mike will begin accounting classes at a local college with the aim of becoming a certified general accountant. The course will cost up to $2,000 a year.

They rent a basement suite for $997 a month. They have no life insurance and no wills.

"I don't really know where to start and I don't know what to focus on," Mike said of his investment strategy.

We spoke with Dale Collins, a certified financial planner with Adamek & Associates in Victoria, and Paul Gleeson, a financial adviser with Nicola Wealth Management in Vancouver.

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THE BASICS

$3,100
in a Roth IRA account in the U.S.

$50,000 to $60,000
annual combined income

$35,000
in student loans, with monthly payments of $325

$3,500
in credit card and other debts

2,000
annual schooling costs for Mike

DALE COLLINS'S TIPS

Dale Collins
Financial planner, Adamke & Associates

1 Mike and Sara should buy life insurance while they are young and healthy, Ms. Collins advises. (She offers that from experience: Her sister was diagnosed with cancer when she was 21.) Similarly, the couple should write up wills and powers of attorney. Next, they should pay off their credit card debt promptly. Ms. Collins usually makes clear to her clients how much interest they're paying, "which motivates them to get rid of it."

2 As long as their incomes are modest, they should avoid setting up an RRSP. Instead, they should open a Tax Free Savings Account (TFSA). "I would suggest having the TFSA in a conservative position so they have the option to move to an RRSP and use it for their home purchase if they want," Ms. Collins says. She recommends a front-end zero or no-load fund in order to avoid penalties, should they want to use the money.

3 More specifically, Ms. Collins recommends a front-end zero Fidelity Canada balanced fund or a no-load Phillips, Hager & North income fund as a place for the couple to sock away $250 every two weeks into a TFSA. "In my experience, it's nice to have options, especially when clients are young and starting out." Once they move into a higher tax bracket, they can start putting money into RRSPs and then use up to $25,000 through a tax-sheltered Home Buyers' Plan for a down payment on a home.

PAUL GLEESON'S TIPS

Paul Gleeson
Adviser with Nicola Wealth Management

1 First, Mike and Sara should set financial goals. Do they want to buy a house or save for retirement? Then they should decide how "best to use their residual free cash flow each month," Mr. Gleeson says. To those ends, their top two priorities should be clearing up debts and setting up a rainy day savings fund. They should apply 70 per cent of their residual cash toward debt reduction and put the rest into a TFSA.

2 "It is important to establish some savings in the case of any emergency, such as if Mike or Sara lost one of their jobs. These savings should probably be relatively safe and liquid." He recommends fixed-income assets, such as bonds or first mortgages, or preferred shares of stock, which produce good dividends and are less volatile than common shares. Another option is high-yield bonds, which are riskier than mortgages but less volatile historically than equities. Such investments could yield 4 per cent to 5 per cent more than current interest rates, he says.

3 They might also consider cashing in the Roth IRA and moving that money to a TFSA to make it easier to manage. However, they might face restrictions and penalties in doing so. The IRA has lost about 22.5 per cent of its value in recent years, and these funds might better be invested in "a wider asset mix" that may yield better risk-adjusted returns. Mike and Sara should be aware that as U.S. citizens, they must file taxes in their home country. He suggests contacting a cross-border tax specialist. The good news is that given their modest incomes, and treaties against double taxation, it is likely that they won't owe any U.S. taxes. "Mike and Sara's situation is quite straightforward," he says. "Clearing debt and the associated high interest costs, along with establishing some savings, should be their top priorities."