Life Cycle of an RRSP

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It happens all the time: The phone rings. After some chitchat, the caller asks the "$64,000" question: "Advisor "X" said he can make 15% per year for me. How much return can *you* make?"

Let's step back and look at the life cycle of an RRSP.

I categorize the life cycle of an RRSP into three distinct stages:

- Incubation,
- Youth, and
- Adulthood

The "incubation stage" covers the period from the time you start your RRSP until it exceeds your annual earned income.

The "youth stage" starts when your RRSP holdings exceed your annual earnings and it ends when it is larger than ten times your annual earnings.

The "adult stage" starts when your RRSP value is larger than ten times your annual earnings.

Incubation Stage:

This is your most important, yet most vulnerable stage. Because your RRSP is small, you may easily be swayed from your long-term objectives. You may think that you'll never be able to save what you need at this rate. Or, you may be discouraged by the market ups and downs.

If you contribute the maximum dollar amount to your RRSP regularly, it will take about four years and ten months (at 6% per year growth) until your RRSP equals your annual earnings. Alternately, if you had a more aggressive portfolio growing at 12% per year, it will take about four years and four months until the same amount is accumulated. The difference is only six months. And the additional risk. In other words, 90% of your portfolio growth is as the result of your disciplined investing and only 10% is attributable to the higher growth rate. Don't expect any miracles from the growth side.

So at this stage, don't worry about hot tips, hot funds, hot managers, MER's, DSC's, market ups and market downs, or market timing. They have *no significant* effect on your portfolio. The most important thing is that you keep investing with discipline, month after month, year after year.

If you are just starting and are nervous about investing, and someone tells you: "Oh, you are young, you should put everything into the equities!". Tell them you feel more comfortable with a balanced portfolio. It may take a few months longer until your RRSP reaches its youth stage, but you'll have the much-needed staying power along the way.

Youth Stage:

If you have been contributing to your RRSP regularly and fully, your RRSP may reach the youth stage sometime during its fifth year.

During the youth stage, the growth gradually becomes as important as your contributions. After the third year of the youth stage, your annual portfolio growth is probably larger than your contribution limit. Towards the end of this stage, your annual portfolio growth approximately equals your annual earnings.

Here, it is important to include top-performing, high-efficiency investments in your portfolio. You may want to hold bonds rather than

If you contribute to your RRSP fully (18% of your earnings each year, equal monthly deposits, assuming earnings grow at the same pace as inflation, and that you make less than $75,000 per year), the following table shows how long it takes to accumulate different multiples of your annual earnings.

RRSP Life Cycle Stage:	Multiple of your annual earned income:	The time it takes to accumulate (y: years, m: months) 6% Growth	9% Growth	12% Growth	Investments:
Incubation	1 x Annual Earnings	4y 10m	4y 6m	4y 4m	Mutual Funds
Youth	2 x Annual Earnings	8y 6m	7y 8m	7y 1m	Mutual Funds, Bonds
	5 x Annual Earnings	16y 5m	14y	12y 4m	Mutual Funds, Bonds, Stocks
	10 x Annual Earnings	24y 6m	20y	17y 1m	Mutual Funds, Bonds, Stocks
Adult	15 x Annual Earnings	30y	23y 1m	20y 1m	Mutual Funds, Bonds, Stocks
	20 x Annual Earnings	34y	26y 8m	22y 4m	Mutual Funds, Bonds, Stocks

bond funds as your fixed income investments. When your portfolio reaches about four times your annual earnings, you may want to start buying individual stocks (blue chip, of course).

It is usually at this stage investors become over-confident, aggressive and reckless with their investments. Just because you made it so far, it is not an automatic ticket to successful investing. Stick with high quality. Continue investing regularly. Don't get sidetracked. There are no short cuts.

Adult Stage:

At the adult stage, preservation is the key. Increase your bond holdings. Rebalance your portfolio twice a year, in March and in July[1]. Seek only top-performing funds with the lowest fees. Review each investment periodically and get rid of non-performers quickly. Include a good selection of stocks in your portfolio.

At this point, if you are still contributing to your RRSP, it is probably only for tax benefits. The daily fluctuations of your portfolio are probably larger than your annual RRSP contribution limit.

Within a few years after you reach this stage, you are financially ready for retirement.

What about the $64,000 question the caller asked?

The key question during the first two stages of your RRSP[2] life cycle is: "How much of a fluctuation are you *comfortable* with?" If you don't mind losing a chunk of your wealth occasionally, then take the risk, make the 15% a year. But if you find out after the fact that you should have taken only a smaller risk, it will take a longer time to recover.

On the other hand, the key question during the adult stage is not the "comfort", but the "need". "How much of a risk do you *need* to take?"

Don't take any more risk than is absolutely necessary. Be traditional. Don't fall for fads. I remember a few years ago at a mutual fund luncheon, the portfolio manager saying, "With these new income trusts paying such high dividends, why would anyone buy bonds?" When we look at some of these income trusts now, we know why companies were downloading their cash flow to investors: they noticed that commodity prices were falling. Their investors didn't. Everyday I see such investments in portfolios of retired individuals. Some of them are now worth only half of their original cost.

Know what you are investing in. That is probably your best risk avoidance.

As usual, the thoughts expressed in this article are of a general nature, only. You should consult with a professional to discuss any aspects of investing or financial planning specific to your personal situation.

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With balanced investing, you may end up reaching your RRSP's "youth" stage faster than with an aggressive portfolio.

For example: Both Chuck and Sue save 18% of their earned income each year, both earn less than $75,000 per year, both started with nothing in their RRSP.

Chuck invested everything in aggressive equity funds with 15% per year growth.

Sue has a balanced portfolio of 60% equity funds and 40% bonds, yielding 10% per year growth.

A market crash of 30% occurs.

A market crash of 30% occurs at the end of year:	The time it takes to accumulate within the RRSP one year's earnings y: years m: months	
	Chuck	Sue
1	4y 7m	4y 10m
2	4y 11m	5y
3	5y 1m	5y 1m
4	5y 4m	5y 3m

[1] See my previous article "Seasonality and Rebalancing", November 1997.

[2] The examples given in this article are applicable to those without a pension plan.