AND BABY MAKES THREE

Now that Mia's here, the Barretts' priorities have suddenly changed. Can they get by on one income? Which comes first, their mortgage or their RRSP? What insurance do they need? We find the answers every young family needs to know **BY JULIE CAZZIN** ILLUSTRATION BY AMEDEO DE PALMA

Karl and Claudia Barrett are ecstatic. Earlier this year, the couple welcomed their newborn daughter, Mia, to the family. They love having a baby around the house but it has also made their life more complicated—and not just because of night feedings, diaper changes and endless loads of laundry. Their financial life has suddenly become more complicated as well. "I never realized that when you had a baby, so many pieces of your financial puzzle have to be re-examined," says Karl, 34, a mechanical engineer with an oil and gas firm in Regina.

Like many young families, Karl and Claudia are finding that their new addition is forcing them to take stock and come up with a whole new list of financial priorities. Never have there been so many demands on their income, and right when they need it most, that income is going to be significantly reduced. Claudia, who's now 31, was just laid off from her job at a landscape company. She's decided to give up working full time for a while. "Spending as much time as possible with my daughter is a once-in-a-lifetime opportunity," Claudia says. "And we're considering having a second child in two or three years, so I won't be working full time for years."

The Barretts (we've changed both of ➤

their names to protect their privacy) are diligent savers and they're starting their new family from a strong position. Despite their young ages, they have already managed to tuck away over $160,000 in RRSPs and other investments, and the couple's only debt is their $147,700 mortgage. Until now their financial strategy has been simple: they focused on paying down their mortgage as quickly as possible. But lately a slew of financial advisers have come out of the woodwork with lots of conflicting advice, and now they're confused about what's important and what isn't. "We've had insurance agents trying to sell us whole and universal life insurance policies as well as insurance for our daughter," says Karl. "We've also had salespeople call us several times to get us started on saving for Mia's post-secondary education. It's made us really question our financial strategy."

The four questions that most worry the Barretts are typical for young couples. The first is whether they should focus on paying down their mortgage or building up their retirement savings. Their second concern is how they can put the savings they have now to best use. Their third is what kind of life insurance they should get, now that they have a dependent. Finally, they feel they should start saving up for Mia's education, but they're not sure how much to save or what kind of investments they should use to save that money. "We have to take a fresh look at all of our financial goals," says Karl. "There's only so much money to go around and we'll have to reorganize our lives and our finances to make it all work."

Karl and Claudia are confident that they'll eventually figure out their priorities, as both come from families that knew the value of a buck. Karl grew up in a small town in northern Saskatchewan. His dad was a carpenter and his mom stayed home to care for him and his sister, Marie. "My parents were good with finances," says Karl. "They had to be. Dad was always on contract so they were always saving for a rainy day." Claudia's parents, who were cattle and grain farmers, were fiscally conservative too. "My parents got paid twice a year—when they sold their calves and when they sold their grain," remembers Claudia. "They were forced to be good with their money."

When he was 19, Karl went to college in Saskatoon to study engineering. He worked in a lumber mill during the summer months and graduated with no student debt. Claudia went to the University of Saskatchewan in Regina to study agricultural sciences. In 1998, Karl moved to Regina as well, after getting a job designing equipment for oil fields. He slowly moved up the ranks of the company and today he's a department supervisor making $90,000 a year.

HOW THE MONEY IS SPENT

YEARLY DISPOSABLE INCOME	
Karl's income	$90,000
Claudia's income	$17,000
Minus: taxes and other deductions (includes income tax, CPP, EI)	– $22,800
NET DISPOSABLE INCOME	**$84,200**
YEARLY EXPENSES	
Shelter	
Mortgage on home (includes prop. taxes)	$15,500
Home insurance	$700
Hydro/gas/water	$3,400
Cell phone/internet/TV	$2,100
Total shelter	**$21,700**
Transportation	
Car insurance	$2,000
Gas	$4,000
Maintenance	$2,500
Total transportation	**$8,500**
Personal	
Groceries	$4,800
Clothes, haircuts, etc.	$500
Furniture	$500
Vacation	$3,500
Charity	$300
Gifts for holidays and birthdays	$1,200
Restaurants	$1,600
Miscellaneous	$3,600
Total personal	**$16,000**
TOTAL EXPENSES	**$46,200**
Annual income available for investment (total income minus total expenses)	**$38,000**

Five years ago, the couple met at a birthday party given by a mutual friend. Karl liked Claudia right away. "She was smart and easy to talk to," says Karl. "She was also down-to-earth and not too girlie." The couple moved in together after dating for a month and have lived together ever since. "We'd like to get married next year," says Claudia. "When Mia is a year old, we plan on spending $10,000 for a nice wedding. It's something we're looking forward to."

In the meantime the Barretts want to get their financial plan in order. They're especially confused about whether they should be focusing on their mortgage or maxing out their RRSPs. They've already paid the mortgage down to $147,000. (They bought a two-storey home in Regina for $210,000 in December 2005, with $15,000 down and a 30-year mortgage with a five-year fixed rate of 5.5%.) It comes up for renewal next year, and they're not convinced it should remain their top priority. "Just when we've convinced ourselves that paying off the mortgage quickly is the right thing to do, we're beginning to question that strategy because of the low mortgage rates," says Claudia.

On the other hand, right now the mortgage seems more important than saving for retirement, as they're both young and both of them hate debt. Lately, Karl has being paying heavily into his RRSP because his defined benefit pension plan at work is not that great. He contributed $14,000 last year, but they wonder if they should be reducing that amount. "Maybe I should reduce my RRSP contributions and use the money to pay down the mortgage instead," says Karl.

Claudia also wonders whether they should be giving more thought to using tax-free savings accounts as an investment vehicle instead of RRSPs. She feels that TFSAs may be a more effective tax strategy for them. "I've done some reading on TFSAs and am starting to think that maybe they are a better investment option for us than RRSPs," says Claudia.

Complicating that decision further is the question of whether they should cash in some of their savings and put that money towards the mortgage. Right now, the couple has $21,700 sitting in an investment account and $12,000 in a real estate investment trust (REIT). "I'm tempted to hold on to the REIT. It's managed by League Assets but I don't know much about it," says Claudia, who bought the IGW REIT on a recommendation from a friend two years ago.

The Barretts are also looking at getting life insurance. Right now, Karl only has $100,000 of coverage through his employer, but now that they have a baby, they've begun looking at both whole and universal life policies. The life insurance agent they talked to is strongly encouraging the universal option. "We are thinking of getting a 10-year term to cover our mortgage, a $150,000 20-year term for both of us—when Mia is growing up—and $100,000 life for both of us," says Claudia. "But at a cost of $2,000 a year, it's expensive. The agent is also encouraging a life insurance policy on our daughter Mia."

Finally, there's the question of getting a Registered Education Savings Plan (RESP) to save up for Mia's education. They are considering a Canadian Scholarship Trust Fund—but they aren't sure it's right for them.

WHAT THE EXPERTS SAY

By keeping their goals simple, say our experts, the couple can achieve a lot, even on a reduced income. With Claudia on maternity leave she is entitled to $17,000 in benefits this year. If she works part-time over the next couple of years, she can bring in another $15,000 annually. Coupled with Karl's $90,000, after paying their expenses, the couple will have $38,000 left over each year to plan for the future. "That's the key to their financial success," says Marc Lamontagne, a fee-only planner at Ryan Lamontagne Inc. in Ottawa. "They don't need a magic formula to success. All they need is a little common sense and discipline." Here's what they need to do:

Pay off their mortgage. At this stage in their lives, the Barretts' top goal should be to pay off their mortgage debt. It will save them tens of thousands of dollars in interest payments over the years and give them great peace of mind. They can start by cashing in the $21,700 they have in their investment account and putting it towards their mortgage. That will bring it down to about $126,000.

They should also speak to their banker and mortgage broker about renewing their mortgage today instead of waiting until it matures next year. Interest rates are low right now but they are likely to increase throughout the year. "To avoid paying an early renewal penalty on their mortgage, they should ask for a blended rate. That way they continue to pay the current rate for the remainder of their term, and then switch to the new rate after that," says Lamontagne.

WHERE THEY STAND

ASSETS	
Home	$240,000
Karl's RRSP	$46,600
Claudia's RRSP	$71,200
Karl's TFSA	$3,100
Claudia's TFSA	$3,500
Investment account	$21,700
REIT investment	$12,000
Savings account	$3,500
Cars	$16,000
Total assets	**$417,600**
LIABILITIES	
Mortgage on home	$147,700
TOTAL LIABILITIES	**$147,700**
NET WORTH (total assets minus total liabilities)	**$269,900**

When they renew, the Barretts are in a good position to look at how they can pay off their mortgage faster. They should get the best five-year fixed rate they can, and reduce their remaining amortization to 10 years. That will increase their mortgage payments, but only by about $3,500 a year. "They have the excess income to do it," says Lamontagne.

IF CLAUDIA STAYS HOME WITH BABY, THEIR INCOME DROPS. WHICH IS THE TOP PRIORITY: THE MORTGAGE OR THE RRSP?

Cash in their REIT. The Barretts need to ask themselves, "If I had this money again, would I buy this REIT?" If the answer if 'no' then they should cash it in and put that sum towards their mortgage. Claudia says she was promised a return of about 10% annually, so she'd like to hang on to it. But the experts are skeptical. "If the Barretts have an asset they don't completely understand, and if the returns seem too good to be true, then they are likely taking on more risk than they need to," says Alfred Feth, a fee-for-service planner in Waterloo, Ont. Lamontagne agrees. "But if they decide to sell, they must check on penalties and liquidity issues associated with the REIT," he says. "There will probably be taxes to pay so they should get a tax accountant's opinion on the timing of the sale."

Continue making RRSP contributions. Even though their main focus should be the mortgage, Karl should keep contributing to RRSPs as their budget allows. This year, he should try to make a $14,000 contribution, but to a spousal RRSP for Claudia. They should do the same next year if they can. However if Claudia doesn't return to work, then the couple could forego RRSP contributions completely for a while. Either way, the Barretts should stick with RRSPs rather than switching to TFSAs. "Karl is in a fairly high tax bracket so it makes sense to choose the RRSP savings over the TFSA," says Feth.

Buy term life insurance. Yes, their agent was pushing whole and universal life insurance, but the Barretts should keep in mind that the commissions on universal life policies are often three times what they are on term policies. "Life insurance agents can't make a living selling term insurance," says Lamontagne. "They need to sell universal life policies to survive, but it's not the best option for the Barretts." Instead, Lamontagne advises the Barretts to purchase a $500,000 term life policy for Karl. If Karl dies, this will allow Claudia to pay off the mortgage, stay home for a few years with her child, put money aside for retirement, and pay for Mia's education. Claudia, on the other hand, should only have enough term insurance to pay off the mortgage, about $150,000. The cost for a 20-year-term for the above two policies is just under $60 a month, or $720 a year. And forget about life insurance for Mia, says Lamontagne. "Life insurance is designed to replace income. So it just doesn't make sense to buy it for a child."

Build their own RESP. Lamontagne says there are some drawbacks to pre-packaged RESPs. You can be locked in to a monthly savings amount, the fees are not always transparent, and the investments are often held in bonds and GICs. Interest rates are low now, so there might not be a lot of growth after the fees are paid. Instead, he thinks the couple should opt for a self-directed RESP at their local bank, and hold a mix of low-fee equity and bond mutual funds. "If they save $2,500 a year in an RESP, they will maximize the grant matched by the government," says Lamontagne. "By the time Mia is 18, she will have enough to pay for a four-year post-secondary degree."

Get a will and power of attorney. This wasn't one of the Barretts' concerns, but it should be. That's because they aren't married yet, and common-law couples don't share the same property rights as married couples. For instance, in a common-law couple, furniture and other property belongs to the person who bought it, unless otherwise specified in a will. The Barretts should draw up a will that specifies property rights as well as power of attorney. They should also assign a guardian for Mia in case both of them die prematurely.

Keep $10,000 to get hitched. The Barretts know they want to get married next year, so they should set aside cash for the wedding. "The money is there and they should use it when they're ready to tie the knot," says Lamontagne. After all, getting married is probably the most important financial decision the Barretts will make—it's worth spending a little to make sure it gets off to a great start. | M

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