RRSP's And Tax Shelters. Which Investments Should You Shelter?

The most common position on this seems to be that if you have investments in a RRSP (or other similar shelter like a RRIF) you should have your fixed income securities in the RRSP's and your equity investments outside. The reason for this is to take advantage of the special tax treatments on Canadian dividends and on capital gains. This seems logical enough, but it is an approach that we have never been comfortable with. It seemed to us that it made more sense to shelter the higher income investments, which should be the equities.

This presents an interesting dilemma, shelter the higher income, but lose their tax advantages, or shelter the lower income to keep the tax benefits. So as usual, we set out to do some analysis.

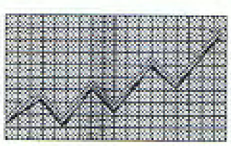
We ran a number of scenarios where an investor had 50% of their investments in equities and 50% in fixed income investments. The first group assumed that equities would have a long term average annual return of 10%, the historic rate, and that fixed income investments would return 5%, which is what we expect over the long term, even though historically fixed income investments have only returned about 4%.

Then we ran our analysis for the two options for an investor in the 50% tax bracket, and one in the 25% bracket.

In the short run, there was little difference, but in the long term, in both cases there was a distinct advantage to having the equities inside the RRSP. For the investor in the 50% tax bracket; after 20 years they had 28% more money, after 30 years 64% more and after 40 years more than two times as much. For the investor in the 25% tax bracket, the effect was less pronounced, but still significant. After 20 years this investor had 14% more money, after 30 years 29% more and after 40 years 50% more.

The above analysis reflects the long term returns that we expect based on the last seventy years and our knowledge of the present. However, if equities do not outperform fixed income investments, then it would be better to have your fixed income investments inside the RRSP. On the other hand, if you do not expect equities to significantly outperform fixed income investments, then why would you hold them, given their inherent risk?

IFC Investment Principles



1 Balance your investments according to your personal circumstances.
2 Always diversify your investments.
3 Invest in Quality.
4 Invest regularly & gradually.

Still, we wondered how much equities had to outperform fixed income vehicles in order for it to be better to have the equities inside the RRSP. So we ran another group of scenarios. In this group we assumed that equities would return 10% and that fixed income's would return 7%.

We actually doubted that there would be an advantage to putting the equities in the RRSP when the returns were this close. But we were surprised to find that again, while in the short run there was little difference, in the long run there was still a significant advantage to putting the equities inside the RRSP.

We found that for an investor in the 50% tax bracket, if the equities were inside the RRSP, after 20 years they had 13% more money, after 30 years 33% and after 40 years they had 64% more. For the investor in the 25% tax bracket after 20 years they had 6% more, after 30 years 15% and after 40 years they had 29% more.

Conclusion

This leads us to the following conclusion: If you are expecting equities to outperform fixed income investments, by enough to justify holding them, you should shelter them in your RRSP first, then if they do not make up the full amount that is inside your RRSP's, shelter some of your other investments. Again, starting with those with the highest expected returns. Of course, the above assumes that liquidity is not an issue.