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Pay down debt, or feather your nest egg?

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By DALE JACKSON

If you really want to go your own way this RRSP season, consider diverting your contribution instead to paying down your debt.

That's the message from Toronto chartered accountant and author David Trahair, who makes a compelling argument that a dollar contributed to an RRSP is a dollar better spent paying down debt.

"The banks and the people selling financial products are in business to make a profit so there's an inherent conflict of interest in the advice they give," he argues. "If they loan you the money to make an RRSP contribution, they're making money off your loan, but when you give the money back to them they're making fees from the management expenses of the mutual fund".

The RRSP-versus-debt debate has been raging for years, but rarely have the stakes been higher. According to the Ottawa-based Vanier Institute for the Family, average Canadian household debt is equal to 131 per cent of household income compared with 90 per cent in 1990. Statistics Canada says 40 per cent of Canadian credit card holders regularly pay interest on their monthly balances. A recent Investors Group survey found that 35 per cent of Canadians plan to carry up to $100,000 in debt into retirement.

Added to the fact that the stock and bond markets are currently flat-lining, and Mr. Trahair contends no one should contribute to an RRSP until all debts - including mortgages - are paid off.

If long-term equity market returns are any indication, however, Mr. Trahair has a tough sell. Over the past 20 years, the S&P/TSX Composite Total Return Index has grown in value at an annual average rate of about 10 per cent, while statistics from the Canadian Real Estate Association show an average annual return of just over 5 per cent for residential real estate over the same period.

But Mr. Trahair says the raw numbers are misleading. "For the vast majority of people, it's nowhere near 10 per cent because they made investing mistakes, they've picked the wrong stock or mutual fund, and there's a constant drag on fees. To make that elusive 10 per cent you have to be 100 per cent in equities," he says.

Paying down debt, however, is risk free. Every dollar invested is a dollar you don't owe, the amount of interest that would have been charged over time is saved, and it's tax free. Thus, paying down an 8-per-cent consumer loan results in a guaranteed after-tax return of 8 per cent. There are no fees associated with paying down debt, but in some cases (such as mortgages) there are limits with penalties.

But Moshe Milesvsky, a professor of finance at Toronto's Schulich School of Business, says a dollar is better spent contributing to an RRSP than to paying off debt - especially if you compare it with a variable rate mortgage. "I think when you adjust for risk it still makes sense," he says.

Prof. Milevsky has studied the correlation between house prices and equity-market returns over several periods and says RRSP contributions always come out the winner.

"It really comes down to a cold, hard calculus of rates of return," he says. "It might be one of the easiest decisions out there: What rate are you earning on your RRSP? What rate are you paying on your mortgage? Go with the higher one," he advises.

While Mr. Trahair says a debt-free home should be the first priority for any financial plan, Prof. Milevsky suggests an approach where an RRSP contribution comes first and the tax rebate is applied to the mortgage.

One area where they both agree on is high-interest credit card debt, which Prof. Milevsky says should always be dealt with before an RRSP contribution. "I am stung by people who pay a 25-per-cent interest rate on their credit card debt."

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