The Best Way to Use TFSAs

Description

Tax-free savings accounts (TFSAs) can be used for saving for retirement, but they also can be used for so much more. For example, you can use TFSAs as an emergency fund or to save for a big purchase such as a down payment or a vacation.

Canadians can only contribute a set amount to their TFSAs every year. Any contribution room that you haven't used from previous years will accumulate. Any TFSA withdrawals made in earlier years will add to the contribution room in the next calendar year.

Let's clarify with an example. Ben became eligible to start contributing to TFSAs in 2016. The TFSA contribution room was $5,500 for both 2016 and 2017. If Ben contributed a total of $5,500 to TFSAs in 2016 and withdrew $2,000 before the end of that year, he would have $7,500 of contribution room this year.

Given that TFSA earnings are tax free, investors can save some serious money with TFSA accounts.

Set a financial goal

Before you create a TFSA account, have a goal in mind. For example, if you're saving for a vacation in a year's time, you probably don't want to invest that money in the stock market. You might want to invest in a guaranteed investment certificate instead.

If the goal for the account is an emergency fund, then it needs to be accessible at any time and the money needs to be 100% secure. In that case, you might save it in a high-interest savings account.

If your goal is to save for a down payment for a mortgage in three years or longer, then you might want to invest in some safe dividend-growth stocks, which are priced at a reasonable or better valuation.

Enbridge Inc. (TSX:ENB)(NYSE:ENB) comes to mind. Despite the recovery from its recent low, the leading North American energy infrastructure company is still reasonably valued and even looks to be trading at a discount on a forward basis assuming its earnings and cash flow per share recover. The company starts you off with a ~5.4% yield today. Management shows confidence in the company by increasing the dividend by 10% per year through 2020.

Maximize total returns

Withdrawals made from TFSAs are tax free. So if you have a long-term investment horizon, it makes sense to aim to maximize your total returns in TFSAs. Enbridge is a good candidate for decent total returns in the long run.

We're talking about an investment horizon of decades. A 12% rate of return and 8% rate of return, for example, makes a huge difference depending on how much you ultimately invest over the long run.

For instance, if you invest $5,500 every year in a TFSA for 8% per year for 30 years, you'll accumulate ~$683,076. If you get 12% per year on the invest, you'll accumulate over $1,601,846 — a difference of +$900,000!

Investor takeaway

Investing in TFSAs is a great way to save, especially for big purchases such as a down payment or a vacation. It helps if you have a financial goal before investing in one so that you'll have something to work towards. It also makes sense to maximize returns (but be aware of the risk you're taking) when investing in TFSAs because what's earned inside is tax free.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing

TICKERS GLOBAL

1. NYSE:ENB (Enbridge Inc.)
2. TSX:ENB (Enbridge Inc.)

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