Investors: This 1 RRSP Tip Could Help You Retire Early

Description

Do you want to retire early with a big RRSP that can carry you through your golden years?

If so, you've got your work cut out for you.

Although RRSPs let you grow your investments tax-free, they become taxable when you start making withdrawals. If you cash out before age 71, your funds are withdrawn as defined by the formula 1/(90 – age). If you cash out at the maximum age of 71, they're withdrawn at an increasing fixed percentage each year.

As RRSP holdings become taxable on withdrawal, you need to make sure that you have a large enough balance to sustain you through your retirement–net of taxes. The following is one strategy that can help you get there in good shape.

Reinvest dividends when you're young but allow them to flow out as you approach retirement age

Generally, RRSP investors tend to invest in dividend stocks. Retirement is all about income, after all, and when you're 80, you can't wait out the next downturn before your payday. So it's almost a truism that RRSP holdings should be in income-producing investments.

However, that creates a conundrum:

Should you reinvest your dividends, or let them be paid out?

Theoretically, dividend reinvestment boosts total returns. And over a long enough time frame with good enough stocks, it works out in practice as well. However, dividend reinvestment *temporarily* reduces returns during bear markets: cash holds its value better than a falling stock.

So, what you want to do is reinvest your dividends while you're young enough to wait out bear markets. When you approach retirement age, you can allow them to be paid out, which lets you maximize your returns when you're young, and build up a "safety cash horde" as you approach retirement and start needing the money more.

If you start letting your dividends flow out at age 61, you can watch them accumulate until age 71, at which point you'll have a large pile of cash that you can withdraw without selling stock.

The rule that incentivizes this strategy

The strategy of letting dividends flow out as you approach retirement is incentivized by RRSPs' mandatory withdrawal policy. At age 71, you have to start withdrawing your funds, and if you don't have enough to cash to cover them, you'll have to sell stock.

When you come to that point, it helps to have a nice percentage of your holdings in cash, so you don't need to sell out of too large a percentage of your portfolio.

A solid stock for this strategy

One solid stock for dividend reinvestment is **Fortis Inc** (TSX:FTS)(NYSE:FTS). As a utility company with an ultra-stable revenue stream, it's likely to grow its dividends for the foreseeable future. This prediction is borne out by history: FTS has increased its payout every year for 46 consecutive years.

At current prices, the stock already yields 3.35%, which is pretty good, but with management aiming to increase the payout by 6% every year going forward, the 'yield on cost' could go much higher.

Utilities are great for dividend growth because they're protected by high barriers to entry and extensive government regulations. In Fortis' case, these advantages (among other factors) have resulted in a dividend growth rate of 7.3% annualized over the past five years.

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