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How to Beat a 2% GIC

The last two years have seen some of the most gut wrenching stock market returns in history, causing some investors to swear off stocks or funds forever. Droves of investors have turned to the world of fixed income – bonds, GICs, money market funds and other low risk, stable return investments as a means to achieve their financial goals.

But parts of the fixed income market have been equally as cruel – term deposits purchased five years ago offered 5% annual returns. Today many fixed income investments offer less than a 1% annual return. Earning 80% less money, while guaranteed, is hard to swallow for any investor.

For a young investor saving for retirement, a bond paying 1% may be peace of mind, but this investor may be stretched to save five times as much capital to achieve the same retirement goal which is effectively what you would need to do. And, with an annual inflation rate of 2% or more, an investor earning less than 2% on a fixed income investment has a negative real return – in plain English, the cost of living is rising faster than your portfolio return is, reducing your standard of living for each year this occurs.

So a GIC, bond or other term deposit may be a smoother ride to retirement, but you better save up a lot more dough, or have a big, fat inflation indexed pension, or both to ensure a retirement quality of life that suits your goals. Either way, we should sit down with you and calculate exactly what you need to be saving – call anytime to set a meeting to do this important goal-based planning work.

And what about people already retired? At this stage of life, capital preservation trumps juicy returns – a retiree cannot afford to have a big stock market loss as there is no time to recover the lost capital. This means retirees definitely need a stable base of investments that throw off a regular income flow – monthly ideally, so they can take this income and live off it as a supplement to CPP, OAS and pension income. Here, fixed income investments, traditionally GICs, have filled this need. But an investor with $500,000 in GICs paying 5% five years ago, earned $25,000 of annual interest income to live off. That same investor renewing that GIC at 1% today gets $5,000 of annual interest – 80% less!!! That's a shocking drop but a sign of the times – and worse, if low interest rates are here to stay, does that mean more retirees will be getting part time jobs to replace the lost income?

One often thinks that the greatest investment risk to retirees is stock market volatility. This is true, but perhaps an even greater risk is longevity risk – the risk that you will outlive your money. With Canadians living longer, medical costs rising, and our general cost of living doubling every 25 years (source: inflation rates, Bank of Canada), Canadians not only need a sizeable asset base before they retire, but they need to be assured of a permanent and consistent income stream from this asset base for po-

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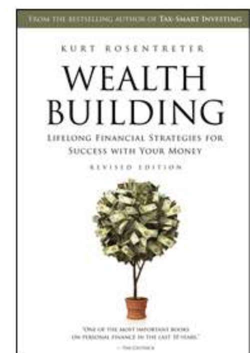

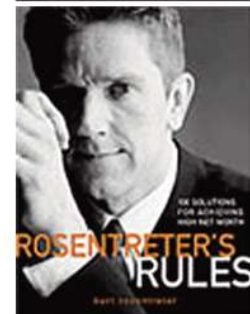

tentially 50 years if you retire at age 55. The key word is consistent – 50 years is half a century – a long time to forecast your cost of living from a single point of view today.

Fixed Income as Your Core

This article is not designed to talk anyone out of buying bonds or GICs – these investments should always be a pillar to your investment plan, offering stability, regular cash flow and consistent income over time.

Fixed income investments should be “laddered”. This is an established term that refers to having maturities staggered over time – a bond maturing in each of one, two, three, four, five years – out to ten years. This laddered sequencing ensures there is always a bond maturing to provide income to the owner or to revisit and reinvest at the current interest rate of the day.

While GICs can only be laddered out five years, government or corporate bonds can be purchased for up to 35 years out – and in doing so, providing access to much higher interest rates than GICs can offer.

Fixed income investments suitable to this core category are:

- Federal government bonds – have maturities from 1 day to 35 years away
- Provincial government bonds
- Municipal bonds
- Treasury bills
- Banker’s acceptances
- High quality corporate bonds
- Guaranteed Investment Certificates (GICs) – have maturities from 30 days to 5 years away
- Savings accounts
- Money market funds
- Short term bond funds

Because the categories above are considered lower risk, they have the best credit ratings and the lowest returns. These are the kinds of fixed income investments that are paying less than 2% right now (May 2010) for a short term return. Some rates are up to 4% if you are prepared to lock in for a few years.

So How Can You Do Better Than a 2% Return?

In order to get a higher return, you must take on more risk, more cost, sometimes both, or buy a product that is a bit different.

Risky Fixed Income Investments

For investors prepared to take some extra risk on their bond investments in order to chase higher returns, there are a variety of products to consider. Let’s be clear here however – these bond products do not guarantee a good rate of return, and you can in fact, lose money with them. If you want the assurance of never seeing a negative return associated with your bond portfolio, the choices above are your only choices in the bond world.

- Lower quality corporate bonds
  Bonds issued by smaller companies, weaker companies, companies in trouble may have a lower credit rating (A, BBB, BB or so) resulting in annual returns that may be 4%, 5%,6% or even 7% in 2010. But beware – if these companies go bankrupt you could lose it all.

- Bond mutual funds
  A managed portfolio of government and/or corporate bonds, actively managed by a professional manager for an annual MER fee of up to 1.5%, has generated cash flow to investors of approximately 4% a year for the last few years, and a total return in 2009 that exceeded 10% for some products. Yes, these are huge returns from a relatively safe pool of bonds – the downside is that a bond fund does poorly in a rising interest rate environment, meaning higher interest rates in the next few years could get you the same 4% cash flow each month but a total return of a negative 10% for a few years as the value of the pool itself adjusts to the new interest rate levels. If you just want the cash flow however, it should be better than any GIC. And if you don’t need the money for a few years, you can likely weather through the interest rate volatility on the bond fund itself.

- Corporate bond funds
  If owning one corporate bond sounds too risky, owning 200 of them combined in a pool and professionally managed for a fee may be the way to go for you. Corporate bond funds or high yield corporate bond funds can pay 5% or 6% cash flow per year – often distributed monthly which is ideal for a retiree. But, like regular bond funds, the value of the pool itself (called the net asset value or NAV) faces decline if market interest rates rise. Your 6% cash flow will continue month after month, but it is possible that the value of the bond fund itself will decline for a few years as market interest rates rise – if they rise. If you can stomach this "paper loss" for a few years, the cash flow paid out monthly should more than beat a government bond or GIC.

Some Bonds and Some Equity
High income Funds and Monthly Income Funds - If you can stomach some greater risk than bonds alone, there are many high income vehicles that combine the best of bonds, income trusts, preferred shares, REITs and dividend paying stocks in a blended portfolio that can pay upwards of 8% cash flow a year. Now that is cash flow – not total return. Total return can be higher or lower depending on whether the value of these securities rise or fall in market conditions. A "high income" fund could have a year where the cash flow to you is 8% and the total return is 20% in a good stock market year. Another year this same fund may still pay you 8% cash flow, but may have a -15% total return in a deep stock market correction. If this goes below your pain threshold, then rule these products out. But if you can roll with the stock market and not react, then you'll get up to 8% cash flow either way. By buying a fund of these products you also get better diversification than you could create on your own, a steadier, monthly income stream than you could easily build on your own, a lower tax rate on the income than you will on bond investments. Yes, these products include a dimension of tax savings, leaving you with a greater after-tax income if you buy these outside of registered accounts.

A Lot of Equity
If you are ready to take a portion of your portfolio fully into the stock market, there are two high cash flow types of products to consider:

- High dividend paying stocks – companies like Canadian banks, oil companies, phone companies and utility companies often pay dividends exceeding 4% a year. Dividend income in Canada is also taxed at approximately half the tax rate of interest income. And while the value of the stocks themselves can rise and fall creating a lot of stress for an investor, the dividend payments from many of these companies have been paid for decades – better still, they have raised the dividends again and again over time. This serves as an amazing inflation hedge that you cannot get from interest paid by a bond.
- Real estate investment trusts or REITs - a reit is a company that owns commercial office towers, shopping malls, nursing homes, strip malls, health care complexes or apartment buildings, manages these properties and passes cash flow after expenses to shareholders in the form of annual distributions. If you are a believer in Canadian real estate, this approach to real estate investing offers you a 5% to 9% tax smart cash flow yield each year without the hassle of dealing with tenants, cleaning toilets or the location risk of owning one rental property. Better still buy a basket of these reits by purchasing a real estate exchange traded fund (ETF).
- Energy Income trust mutual funds – a basket of oil and gas company stocks, this package of investments is likely the highest risk product described in this document. With price swings that may exceed 30% up or down in the stock market, this fund of 30 or more energy trusts offers cash flows of 8% or more a year. If you are a believer that the world is running out of oil and that oil companies will benefit long term, getting paid up to 8% while you wait for the long term growth is a pretty fine return.

These funds also offer a tax advantaged income due to the nature of what you are investing in.

Hybrid Products
For investors not ready to go into the stock market but who cannot also accept a low bond return a hybrid group of products called "principal protected notes (PPN)" and "index linked GICs" has developed.

Basically these are GICs on steroids – you invest a lump sum of money for a fixed period of time (e.g. $5000 for 3 years) and the return is based on a stock market product. You are guaranteed to get your principal back no matter what – eliminating all downside risk for you. If the stock market product rises, you will get some portion of the return

that is designed to exceed what a GIC offers. So you may get stock market like returns on the upside, and a downside that can be no worse than getting your own money back.

Interestingly, certain version of these products even offer CDIC insurance of $100,000. This is the same insurance you get with GICs.

These linked GIC products have been very popular with investors afraid of the volatility of the stock market but who still want stock market like returns.

The World of Insurance Products
Many insurance products are also designed to provide high income, and then come with unique advantages because of how insurance is structured in Canada.

Insurance company GICs – these look and smell like regular GICs, but have some additional advantages:

- For some retirees, they qualify for the pension tax credit, providing a $2000 a year tax writeoff that regular GICs don't offer.
- Insurance company GICs allow you to specify a beneficiary, such that on death you will avoid probate fees as the GIC money flows directly to the beneficiary. This is not possible with regular GICs.

Insurance company segregated fund or "seg" funds – often called insurance company mutual funds, these funds offer the same stock and bond management as a regular mutual fund, along with several additional characteristics:

- Your original capital is guaranteed over ten years – this means you can never lose your original investment and provides a lot of peace of mind to investors wanting to invest in the stock market for big returns but not wanting the big losses!
- Better still, some seg funds offer resets when the seg fund rises in value the new base price that is guaranteed can be locked in to this higher value. Even if the value of the stock market then declines and your product value decreases, you have guaranteed the higher amount forever.
- Seg funds allow you to designate a beneficiary so that on death the money will bypass the cost of probate and go directly to beneficiaries.
- Seg funds are creditor proofed and cannot be taken if you go bankrupt.
- The cost of all these benefits is an additional 1% or so of MER inside the fund. Some say that the potential savings from not losing 30% in the stock market is easily worth this small incremental fee.

Guaranteed Withdrawal Products – one of the most popular products in recent years has been the guaranteed withdrawal product. It combines features of a seg fund with features of an annuity. You can invest as little as $25,000 today. Every year that you do not draw an income from this capital you will be credited with an automatic 5% bonus (a guaranteed 5% return in effect). Once you start to draw an income, the income will be guaranteed for 5% for life – no matter what you will get this 5%. In the meantime the assets are invested in a seg fund and if they rise in value, you can receive the potential of a reset of the base amount to a higher level (which will stay permanent) and then your 5% withdrawal will be based on this higher amount. So you get a guaranteed income for life with upside for more income. There's more: the income you get is taxed at lower rates than interest income is taxed. And when you die the assets can be passed to your heirs without probate costs. This type of product is ideal for Canadians seeking to provide a guaranteed income alongside their CPP or OAS. Think of this product like a pension plan – a guaranteed pension plan for life.

Joint and Last to Die Annuity with Inflation Indexing – Annuities have been around for decades. You provide a lump sum to an insurance company in exchange for a lifelong pension – a pension that will also pay to the death of your spouse, who ever lives longer.

The pension payments will be paid monthly and they will rise with inflation over time so your income keeps up with the cost of living. Additionally, the payments can be taxed at lower rates than regular interest income, providing you with greater cash flow than a bond or GIC might. Lastly, if you fear that you will lose all the money if you and your spouse die prematurely at the same time, relax – you can add a guarantee feature that sees the annuity pay to your

estate for up to 20 years from the date of purchase. In my opinion, everybody who doesn't have a big, fat defined benefit pension to cover their core costs in retirement should be buying a life annuity to supplement their CPP and OAS to cover off all essential costs for life. Investment income from stocks, bonds and funds should only be relied upon for variable costs in retirement. This is the only way to have a worry free retirement – ensuring that you have enough income each year for all the fun stuff you want to do, and ensuring you have income for life overall.

How We Can Help as your Professional Financial Planner

- Before you buy a product you need a plan – we will continue to guide you before retirement by telling you what you need to save per year. After retirement, we will perform calculations to provide parameters on how much to spend per year. Our biggest concern is making sure you don't stop working in your career until you have enough saved, and when you do retire, that you don't run out of money!

- When it comes time to buy the products, we have some of the broadest, more independent and objective product selection in Canada than any bank or dealer:
  - GICs from more than ten different banks and trust companies with rates updated daily
  - Hundreds of government bonds to choose from daily
  - Hundreds of corporate bonds to choose from daily
  - The best dividend paying stocks worldwide as measured by Dividend Aristocrats
  - Dozens of the best high income mutual funds as measured by Morningstar
  - The latest index linked GICs weekly
  - Seg funds, guaranteed withdrawal products and annuities from Canada's insurance companies.

Unlike other financial advisors and dealers that may offer you a narrow or very limited product choice, we are free to select from the broadest array of product choices to ensure the best value for you.

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