Fixed Income Alternatives for the "Safe" Money in your Investment Portfolio

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It's not the stock market you need to worry about…

The 80s, 90s and 00s

As recently as 20 years ago, investors had enjoyed GIC and bond interest rates of 6% to 12% and fixed income products were considered a secure, simple, low-cost cash flow source for retirement income for seniors.

2008 to 2019

In 2008, the financial mortgage crisis in the U.S. almost brought down the entire global financial system. Central banks around the world decreased interest rates rapidly during that time as a form of stimulus to encourage borrowing by making debt cheap to hold. It worked, but low interest rates were maintained until 2019. This translated into shockingly low GIC and bond interest rate returns of 2% to 3% per year. Investors, mostly seniors, were now forced to consider buying term deposits paying the lowest rates in their lifetime. Not wanting to deviate from a conservative risk profile, seniors gritted their teeth and accepted 2.5% one-year GIC rates for the first time ever, knowing that after income tax and after inflation the real return on the GIC was negative. But for the peace of mind of knowing the money is guaranteed and safe, investors bought GICs and bonds anyway.

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March 2020

The virus pandemic created a whole new worry wall and central banks once again lowered interest rates a further 1.50% in Canada to hopefully stimulate markets. Unfortunately, past interest rates never returned to their higher levels in the 90s ("normalized") and these further rate cuts took bond and GIC interest rates down to 0.30% to 1.30% for a one year GIC by the summer of 2020.

While governments gorged on debt, millennials with big mortgages and businesses that use debt to grow are happy with these low interest rates. One group has been sacrificed for the economic good of the country: fixed income investors, often seniors, looking for safety and cash flow to live off in retirement.

2021

As I write this summary in January 2021, interest rates on GICs and bonds are the lowest in Canadian history**.** A one year fixed income investment now pays approximately 1% return or less for a one year maturity. Before tax. Before inflation (inflation, or the rising cost of buying goods and services, is often 1% to 2%/year).

Worse, I don't see these low interest rates changing for many years – perhaps decades. So low interest rates are here to stay. It's a new era of investing and the comfort levels we and our parents had buying GICs and Canada Savings Bonds over the last 50 years is gone. So, what do you do?

The Rules

When you opened your investment account (anywhere) you identified facts about your investor profile and signed and dated these facts. The facts were about your time horizon for investing, your investing knowledge, risk preference, objectives, stomach for losing money, net worth and other factors. As part of this profiling

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that you approved, you may have concluded that a certain percentage of your portfolio should go into fixed income (bonds, GICs, bond funds) because that is what is suitable for your objectives and investing needs. One huge conclusion needs to be drawn from the paperwork you signed:

1. You cannot change your risk tolerance and sign new forms because you dislike the new low interest rates on bonds and GICs.

Basically, if your profile hasn't changed, you cannot change the products that were suitable before. Bonds and GICs were relevant to your profile before because they offer a high degree of safety and a source of liquidity – that has not changed. What has changed is that bonds and GICs no longer offer much interest income for return or cash flow. But basically, unless you can justify why your investor profile is suddenly changing to higher risk you may be forced to buy the same bonds and GICs paying 1% now because frankly, they still suit you as an investor in the eyes of the provincial securities commissions.

Is Buying a 1% GIC so Bad?

Buying a 1% bond or GIC is awful. But the more important consideration is to assess what role fixed income plays in your overall portfolio:

- If you need money for spending over a year or two it is still essential you avoid the stock market and accept these low paying securities as the appropriate means of investing for short term cash. Period.
- If the bonds and GICs are a portion of a balanced portfolio that includes equities, annuities, real estate, or other growth-based investments then relax – holding a few low paying bonds or GICs at 1% rates will have minimal impact on the average portfolio return over time. You have more than enough fire power on the growth side of the portfolio to reach your goals based on your financial plan we have built together. You don't need to sacrifice stability, common sense and comfort if a 1% bond still lets you achieve your financial goals.

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- In my opinion, the real risk of low rates lies mostly with investors who are mostly or entirely in bonds and GICs and have no equities to counter-weight the portfolio. Having a million dollars in GICs and nothing else may truly lead to an economic step backwards in purchasing power as your returns are surpassed by inflation and taxes and your value for money shrinks. No one should be 100% in fixed income unless there is a special reason to do so.

Options

Of course, if we can do better than a 1% and stay within your true risk tolerance, then let's explore the list of options together. In our practice, our broad licensing permits us to offer a broad world of product choice free from bias. It's one of the reasons our practice is positioned at an independent firm. Count on us in 2021 and beyond to review the following list of product options with you as your GICs and bonds mature throughout the year. We will come prepared to talk to you about these options and why they may be a fit for you as a substitute for GICs and bonds you previously owned and found comfortable.

Options for Similar Investments to Replace Low-Paying GICs

1. Stay with low paying GICs and bonds – yes 1% is low, but GICs are still very stable and easy to understand. Accept the low returns and adjust other variables in your investment plan like savings rates or spending rates. As I said before, your risk profile that you previously approved may only allow you to buy products like this. You cannot just flip to the stock market because you want to.
2. Buy longer maturity bonds and GICs. Interest rates are a bit better with maturities on GICs and bonds between five years and twenty years out. If interest rates stay low for a long time then there is nothing wrong with bond longer term maturities. If you die the products can be sold off.
3. Explore annuities for guaranteed pension income to cover essential costs in retirement. This is a consideration for investors over age 65 and the older

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the better. Cash yields can be over 6%/year for life and frankly I don't think enough retired Canadians are considering annuities as a great guaranteed income option alongside CPP and OAS.

4. Buy corporate bonds instead of government guaranteed bonds or GICs. You can buy bonds from big and small companies with a wide variety of interest rates. They often pay more than GICs but come with no guarantees. Stay out of the small, risky companies.
5. Buy bond mutual funds or bond ETFs. Both are baskets of dozens of corporate or government bonds from around the world that are traded daily by professional managers for a fee. You don't hold to maturity – this is like owning a stock portfolio except that it is bonds. We tell investors in bond funds that one year you may earn 5% and another year you may lose 5%. You have to decide if this risk/return trade off is ok for you compared to a guaranteed GIC at 1%.
6. Buy products from the real estate world. Private mortgage products, rental property ownership, distributions from REITs and more are all sources of cash flow from what was a super-charged Canadian real estate market over the last 15 years. That all changed in 2020 as people were unable to pay business or personal rent, condo fees went through the roof, office towers sit empty a year later and nursing home real estate will be facing COVID-19 lawsuits for years to come. Real estate investors may someday return to their feeling of "easy money" but for now COVID-19 showed us how vulnerable real estate is to a large-scale economic event.
7. Buy high dividend yielding stocks. Danger, danger. If a security is paying a high dividend it may be "fake" and include a return of capital. Or it may be unsustainable and will crash down in months ahead. Be very wary about dividend yields over 5% /year and the nature of the business behind the payment.
8. Take on more general stock market exposure. This is the easy answer couched in a massive risk shift. Here's the pitch: why buy a 1% GIC when you can buy shares Royal Bank of Canada that have paid a 5% /year dividend

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for decades? I hear you. Very tempting. And perhaps we will guide you to do this. But a few considerations first;

a. All stocks and equity products are high risk. Your GICs and bonds were low risk. If we try to change your risk profile at our investment dealer for this account, our dealer will question why there is a sudden change. It is not acceptable to say that the client doesn't want to buy a 1% bond. That is not an allowable answer. You need to comment on what qualitative factors in your investor profile have changed that permit us to re-code the profile from low risk to high risk on this portion of your portfolio.
b. In March of 2020 Royal Bank stock dropped -30%. It dropped more than that in 2008. And it was down in 2018 as well. People react negatively during sharp downturns. Investment dealers do not want to get sued because we let you invest more than your comfort level in the deep end of the pool. There is no such thing as a blue-chip stock anymore. Enron, Bear Stearns, Nortel, Manulife Financial, BMO, SNC Lavalin, GE, Blackberry and the list goes on of high flying, dividend payers that hit the ditch and people lost a lot of money. GICs and bonds do not hit the ditch – ever.

Final Words

1% GICs and bonds are paying a lower rate of return for a lot of investors who found shelter in the safety of guaranteed products for decades. That safety is still there and should not be abandoned.

Many investors are better off adjusting their overall financial plan (raising savings levels, working later into their 60s, downsizing real estate to increase savings) than they are putting every maturing GICs in the stock market in 2021 because they dislike the new 1% rates.

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Count on me and the team to guide you through these decisions. We have your back and we know all the product options for you. We look forward to these conversations through the year and welcome all questions. Your goals are well in hand as we explore the realities of what you need to consider to reach your financial future.

Warm regards,

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