

INVESTING



Quest for Income

At a paltry three per cent, Canada's prime lending rate is hovering near all-time lows, and remains well below historical averages. While most agree that the eventual direction will be up, it's anyone's guess as to when interest rates will begin to rise. Until then we must continue to operate within the realities of today. As **Melissa Lee** explains, generating an income in our current ultra-low interest rate environment poses significant challenges for advisors and clients alike

Generating a meaningful income, while simultaneously managing risk, has become a growing concern for many Canadians — not only for those entering retirement, but also for those already retired. These clients need to generate an income from their savings, and yet desperately want to protect what they've accumulated throughout their working years. Nowadays that's easier said than done.

Of course, this situation isn't unique to Canada; our neighbours to the south are facing the same reality. In fact, last year, and for the first time ever, Duke University's undergraduate economics department set out to determine the optimal portfolio construction for an income investor given today's rock-bottom interest rates. The department ran a competition in asset allocation where students had to decide what percentage of assets to allocate to equities, and what percentage to invest in fixed income.

"This lower nominal rate environment has driven the financial industry," says Jeffery Keill, an investment advi-

sor with IPC Investment Corporation in Carleton Place, Ontario. "First, it was a search for growth with high retained earnings type of growth stocks. Then, after growth stocks fell out of fashion, people started to look for anything with yield. Cash was king again. Dividend-producing assets and the advent of income trusts played right into the hands of retirees desperately searching for cash flow payout and reduced risk. This has continued, and today we are seeing herds of retirees searching for the golden goose that will continue to pay out high rates of cash flow with as little financial risk as possible."

As Keill points out, this is at odds with conventional investment wisdom. It's unrealistic for investors to expect strong investment returns without accepting some form of risk. This is where the rubber meets the road: How can advisors generate income for their clients while minimizing risk and preserving assets throughout retirement? While there is no magic bullet, no one-size-fits-all solution, there are many strategies that can be devised from any number and combination of financial products. Let's explore some of the more common means of generating income through investing.

INVESTING

GIC LADDER

Perhaps the most basic strategy for generating income — a guaranteed investment certificate (GIC) ladder — is achieved simply by purchasing a number of GICs with staggered maturity dates. For example, an investor would purchase five different GICs, with one-, two-, three-, four-, and five-year maturities. From this point forward, whenever a GIC matured it would be re-invested in a new five-year GIC, thereby avoiding the lower returns associated with a GIC of shorter maturities.

“Although current interest rates make it hard to justify securing any part of the portfolio in short-term GICs, using a laddered approach to deposits will accomplish a similar benefit to shortening duration on a bond,” adds Keill. “You are able to re-invest at higher rates if rates do rise. This keeps liquidity risk down while keeping the average yield a little higher.”

The advantages to a strategy such as this are twofold: investment returns are guaranteed, and the principal is protected. That sounds promising, but there’s just one problem: at current rates, most GICs offer nothing in the way of *real* return. Why would an investor buy something that offered no real return? While this approach may seem absurd, GIC sales are alive and well in Canada. This is perhaps because after losing significant amounts of capital during the 2008 global recession, many investors are more concerned with security than the potential for higher returns.

In any case, while it’s true the investor’s rate of return and original capital are guaranteed, investing in GICs leaves clients greatly exposed to another type of risk: inflation risk. After accounting for taxes and inflation, many GICs will actually cause the investor to incur a loss of purchasing power. The investor’s *number* of dollars may have slightly increased, but his purchasing power has likely decreased.

REAL ESTATE

Given the abysmal stock market returns in recent years, in particular the “lost decade” from 2000 to 2010, it’s no wonder so many clients have become disillusioned and discouraged with stock market investments, and have sought alternatives like real estate.

Real estate investing comes in many forms, but perhaps the most obvious way to invest in real estate is to buy property directly. For many Canadians, purchasing a house is the largest single investment they’ll ever make. And even within the realm of direct purchase, there are many options available. Some may choose to simply buy a house and live in it, and patiently wait for an increase in value. Others may be interested in buying a property, such as a duplex or triplex, as a means of generating rental income. While all of these strategies are valid options, some of the biggest disadvantages of owning real estate directly are the additional costs (such as property taxes and utilities), responsibilities and expenses of upkeep and maintenance associated with ownership.

There are other options for those who wish to invest in real estate without actually purchasing property. Over the last few years, investors have poured money into real estate funds in search of higher-yielding investment vehicles. Mutual funds, such as the Great West Life GWL Real Estate Fund with a whopping \$3.5 billion under

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management, are clearly a popular choice for many investors. For more fee-conscious investors, real estate ETFs such as the iShares XRE - S&P/TSX Capped REIT Index Fund may be a desirable alternative to mutual funds. At 0.6 per cent, the MER of the iShares XRE ETF is significantly lower than the MERs of most actively managed real estate mutual funds. (In contrast, the GWL Real Estate fund has an MER of 3.2 per cent for the no-load option.)

BONDS

As we know, interest rates and bond prices are inversely related. This has played out quite nicely for fixed income investors over the last 30 years. As interest rates plummeted from a high of 22.75 per cent in 1981, bonds soared. Of course the converse is also true: when interest rates rise, bond prices decline. Considering interest rates have nowhere to go but up, the current negative outlook for bonds has many investors questioning the wisdom of a traditional 60/40 split between equities and fixed income. As Warren Buffet recently stated, “Right now, bonds should come with a warning label.” Does it still make sense for clients to hold 40 per cent of a portfolio in an asset class with such a negative outlook?

“Interest rates have been hovering around their 50-year lows for almost five years now,” says Yanic Chagnon, vice-president,

WORDS OF WISDOM

Jeffrey Keill, an investment advisor with IPC Investment Corporation in Carleton Place, Ontario, offers a few points on the investment philosophy he shares with his clients:

- Maintain a solid portfolio framework and don’t go chasing rainbows. “The thirst for returns tends to create behaviors that are emotional rather than logical,” he says.
- Ensure your strategic mix between asset classes is right for you, and maintain a dynamic re-balancing process. “This will help reduce [a client’s] emotionally-charged decisions and increase their overall risk-adjusted return.”
- Understand and accept the fact that interest rates are low, and that we must adjust our expectations accordingly.

INVESTING

retail solutions, Standard Life. “Not only has this hurt investors’ ability to generate yield, but this has also effectively squeezed out a lot of the safety they’re used to seeing in traditional fixed income products. Prices of bonds have been bid up so much that even the smallest increase in rates could lead us into negative bond returns. Just look at what happened in the second quarter of this year when the DEX lost 2.4 per cent in response to an increase in rates. The income cushion just isn’t large enough anymore. This puts investors in the very difficult position of having to choose between sticking with traditional lower-yielding bonds and taking on more risk in an effort to capture more yield.

Moving up the risk ladder is in vogue these days. The more popular high-yield bonds offer better yields than traditional bonds, but at a cost that comes in the form of credit risk. High-yield bonds, also known as “junk bonds,” are by definition below investment grade.

“Investors looking for higher yields in the fixed income space could consider corporate bonds. Currently, corporate bonds are offering about 60 basis points more than government bonds,” adds Chagnon. “However, an interesting subset of corporate bonds is high-yield bonds. For investors prepared to accept more risk, these bonds are offering about 370 basis points more than government bonds. Now that’s quite a bit more cushion against rising rates, but it comes at the cost of greater risk.”

It’s not that the decision to buy high-yield bonds is inherently good or bad. The point is that it’s important for clients to proper-

LAnnuities can include guarantee periods that can be constructed to fit most any income objective, and can often provide the highest guaranteed after-tax income of all retirement products.

ly understand the risks associated with their investments. Bonds are typically thought of as the “safer” portion of a balanced portfolio, helping to smooth out the higher volatility of equities. But high-yield bonds often perform more like equities than bonds, potentially leaving the investor exposed to much higher volatility than anticipated. Ensuring your clients understand these differences, and the risk and reward trade-off with high-yield bonds, can help them make better investment choices.

DIVIDEND-PAYING STOCKS

Shares of dividend-paying companies are often considered great investments. After all, dividends are paid out of surplus cash from corporate earnings, and a consistent history of timely dividend payments should be a sign of a healthy and profitable company. As

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such, investors often use *dividend yield* as a guide for seeking out high dividend-paying stocks.

That sounds straightforward, but making one-dimensional investment decisions, such as those based solely on dividend yield, can be disastrous. If a company's share price drops, and its dividend remains the same, the dividend yield will rise. While a company may have a high dividend yield, its share price may be headed to \$0.

This brings us to an important point: What matters more — yield or total return? Portfolios of dividend-paying stocks can be an excellent means of generating income for clients. And companies with high-dividend yields may be great investments. However, when searching for great dividend-paying stocks, it's important to consider other parameters in addition to the current dividend yield. Does the company have a good track record of earnings and growth? How about other fundamentals such as earnings per share, price-to-book, and return-on-equity? Considering other metrics such as these will lead to more informed decisions when it comes to purchasing quality dividend-paying stocks.

ANNUITIES

Offering investors guaranteed income, annuities can be a great tool for securing a reliable income stream. In particular, annuities offer a solution for many unique situations, including investors who: want some assurance that their income will last throughout their lifetime; have neither the time nor resources to recover from negative market performance; want to protect their income against inflation with an automatically increasing income stream; and/or require a predictable tax bill related to their investment income.

While those features are great, annuities remain one of the least popular of all financial instruments. Study after study shows that only a very small percentage of retirement savings goes towards the purchase of annuities. Why? Some of the most common objections from clients include a reluctance to relinquish control of capital and a concern that the insurer will retain a large portion of the original investment in the event of premature death. Much of this stems from a lack of understanding as annuities can include guarantee periods that can be constructed to fit most any income objective, and can often provide the highest guaranteed after-tax income of all retirement products.

In today's environment, another roadblock is that many clients are simply hesitant to lock their funds at such low interest rates. However, in order to understand whether annuities are right for your clients, it's important to understand the different types and the role they can play in retirement and estate planning.

Ultimately, the goal is to generate a healthy, lifestyle-sustaining retirement income with a portfolio that's properly aligned with a client's risk tolerance, goals, and time horizon.

Keill raises a great point: that a client's risk tolerance or goals should not change with interest rates. Whether it's stocks, bonds, annuities, GICs or real estate, there is no "correct" or universally "best" solution when it comes to generating income for our clients. As we can see, each strategy has potential advantages and disadvantages, and the best strategy for any particular client will be the one that best suits his or her own unique circumstances. 

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