

Stocks Down, Bonds Down - Where to turn?

Generally, the investment world can be split into two main-stream terms:

- 1) Stocks
- 2) Bonds

Investors typically split their money between these two based on their goals, knowledge, and comfort. Some of our clients are 100% in bonds (or guaranteed equivalents) while others are 100% in stocks; however, most investors fall somewhere in the middle which we commonly refer to as a Balanced Investor.

Over the last 12 months, the Bank of Canada (BoC) has raised interest rates five times. There are several types of bonds. The least risky and often used as a benchmark are AAA rated Government of Canada's. According to Thompson Reuters, their values at the time of writing were:

1 year	2.10%
5 year	2.38%
10 year	2.45%

Two quick observations: despite rates rising...Bond rates are still incredibly low making it a challenge to create a sustainable retirement income. Second, when rates go up, the price of a bond falls. In a simplistic illustration, if the 10-year Government bond was 2% and rises to 3% that results in an extra 1% interest each of the 10 years. Theoretically, existing bonds issued at 2% would drop roughly 10% in price to make up for this shortfall.

I have always been a fan of James **Bond** movies and over

the years there have been many actors that have played the role of 007. As an investor, there are a few substitutes for **Bonds** as well. Among our favourites are preferred shares and mortgages.

Preferred Shares (prefs) are similar to bonds because they are guaranteed by the company and pay a fixed rate of return; however, they pay dividends in lieu of interest making them incredibly tax efficient – as per table:

TAXABLE INCOME:		Earnings Pension or Interest	Eligible Canadian Dividends
11,635 to 39,676		20.06%	-6.8%
39,677 to 46,605		22.70%	-3.2%
46,606 to 79,353		28.20%	4.4%
79,354 to 91,107		31.00%	8.3%
91,108 to 93,208		32.79%	10.7%
93,209 to 110,630		38.29%	18.3%
110,631 to 144,489		40.70%	21.6%

Source: Natixis Global Asset Management (2017/01/04)

In addition, preferred shares typically pay a higher rate of return. Currently, many investment grade prefs pay close to 5%. For example:

Enbridge 5-year Bond (06/30/23) pays 3.57%
Enbridge 5-year Pref (ENB.i) pays 5.1%

Bank of Nova Scotia 5-year Bond (04/17/23) pays 3.15%
Bank of Nova Scotia Pref (BNS.i) 4.85%

Not only do investors get 40%-50% more yield with preferred shares, they also get a major tax break. For example, a **retiree earning \$45,000 a year before tax in dividends will actually get money back from the dividends**. This is due to the Canadian dividend tax credit. Looked at another way, an investor would have to earn about 1.3x more from a bond to end up with the same after tax result. In the above example, a 5% preferred would be equivalent to a 6.5% bond. It is worth noting that preferred shares tend to carry slightly more risk because bonds rank ahead of them in the event of a default. In addition, prefs trade on the stock exchange which is subject to investor emotion and liquidity events.

When we think of mortgages, we often think of buying a home with the help of a mortgage that takes most of our working years to payback. As an investor, we can flip this around so we are the ones being paid (ie: mortgage holder). Essentially, investors pool their monies together and hire a manager to invest into several mortgages. There are several types of mortgages: residential, commercial, development, etc. All carrying different levels of risk and return. Currently, yields to investors range between 4-7% depending on the risk and terms accepted.

If an investor decided to use prefs and mortgages, they should be placed in the most appropriate account. Prefs are best located in non-registered and corporate accounts to take advantage of the Canadian tax credit. Whereas mortgages are best located in tax sheltered plans like RSP, RIF, RESPs & TFSA's.

As always, please consult a professional before making any investments.

Until next time...Invest Well.
Live Well.



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