Stocks Down, Bonds Down - Where to turn?

Generally, the investment world can be split into two mainstream 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 Canadas. 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 & TFSAs.

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

Until next time…Invest Well.
Live Well.

Eric Davis
Vice President & Portfolio Manager
eric.davis@td.com
250-314-5120

Keith Davis
Investment Advisor
keith.davis@td.com
250-314-5124

TD Wealth Private Investment Advice **daviswealth.ca**

This document was prepared by Eric Davis, Vice President, Portfolio Manager and Investment Advisor, and Keith Davis, Investment Advisor, for informational purposes only and is subject to change. The contents of this document are not endorsed by TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank. For more information: 250-314-5124 or Keith.davis@td.com. Published November 14, 2018.