Which is Best Now? GICs or Bonds?

2022 was a tough year for many investors. Not just stock markets, but bond markets had their worst year in over 40 years. In an effort to combat high inflation, the U.S. Federal Reserve (Fed) aggressively raised their policy rate from 0.0% to 4.25% which caused bond prices to drop. This has been one of the fastest interest rate increases we have seen. According to Morningstar, the FTSE Canada Universe Bond Index, which tracks investment grade government and corporate bonds, was down -11.7% in 2022.

On a positive note, higher interest rates have made Guaranteed Investment Certificates (GICs) more enticing. This has left some investors questioning if they should dump their bonds for GICs.

Bonds are publicly traded instruments that can easily be bought and sold, whereas non-redeemable GICs must be held until maturity. An argument can be made that GICs are more secure since they include Canada Deposit Insurance Corporation (CDIC) coverage, which provides additional protection in the event of a bankruptcy, but is limited to $100,000 per financial institution. When considering bonds or GICs, investors should pay attention to yields, creditworthiness, taxation, and liquidity.

Bonds are Looking Cheap

Typically, bonds are issued at "par" which is $100 and promise to pay a "coupon" until they mature. As interest rates increase, an existing bond issued at a lower rate will trade at a discount to compensate a prospective buyer. Currently, several bonds are trading at a discount around $90-$95. Once these bonds mature, investors will earn a capital gain of $5-$10 because the bond pays out at par. In addition, they will also clip the coupons.

Bonds Offer Tax Advantages

Tax is a key consideration in evaluating your actual returns. In non-registered accounts, GIC returns are categorized as interest and taxed at an individual's marginal rate - in B.C. it is typically between 20%-54 %. On the other hand, yields or total returns for bonds include the coupon (interest payments) plus bond price appreciation, and it's this price appreciation that's categorized as a capital gain (or loss). Only half of the capital gains are taxed. To illustrate hypothetically, we've compared a 1-Year GIC with a 1-year corporate bond trading at a discount:

	1 Year GIC	Bond due Jan 2024
Investment	$1,000,000	$1,000,000
Yield to Maturity	5.0%	5.0%
Bond Price		$97.31
Interest	$50,000	$23,370
Capital Gain		$26,630
Tax (54% Interest + 27% Gains)	$27,000	$12,620+7,190= $19,810
After Tax Return	**$23,000**	**$30,190**
After Tax Yield	**2.3%**	**3.02%**

The overall 5.00% yield to maturity for this bond is comprised of 2.3% from coupon payments and 2.7% from the bond appreciating from $97.31 to par of $100. Price increases are taxed as capital gains and lead to a higher after-tax return relative to a GIC with a similar yield and term.

Rates are nearing their peak

In December 2022, both the Bank of Canada and US Fed mentioned they are near peak interest rates. Currently, the "yield curve" is inverted which means short-term rates exceed longer-term. This suggests that governments may need to lower interest rates to help spur economic growth. As rates drop, the value of bonds tend to rise and could quickly surpass GIC returns.

We believe that an allocation to bonds presents an opportunity we have not seen in over a decade. Furthermore, fixed income can help to provide diversification benefits, reduce overall portfolio volatility and preserve capital over the long term. While it has been a tough ride for bond investors, we feel that brighter skies are on the horizon and patience will be rewarded.

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