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Bonds

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GICs

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Market Insights

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Wealth Investment Office

Bonds vs. GICs

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No doubt, 2022 will go down as one of the most memorable and difficult for fixed income investors. Inflation jumped to levels not seen in a generation (reaching a high of 9.1% in July 2022 in the U.S.), and central banks responded with a decisiveness also not seen in a long, long time, with the U.S. Federal Reserve (the Fed) increasing its policy rate by 450 basis points (bps), from 0.25% in February 2022 to 4.75% as of February 2023.

Both these occurrences reminded everyone of the first rule of bond investing: When interest rates go up, the value of bonds goes down. U.S. government bonds fell 12.5% in 2022, investment-grade corporate bonds fell 15.8% and high-yield bonds fell 11.3%. This is what the end of a 40-year bull market in bonds looks like.

A year ago, the 10-year U.S. Treasury yielded 1.55%, a five-year GIC was 1.75% and the average yield on a one-year investment-grade bond backed by a chartered Canadian bank was 1.2%. Today, those numbers are 3.5%, 4.1% and 5.1%.

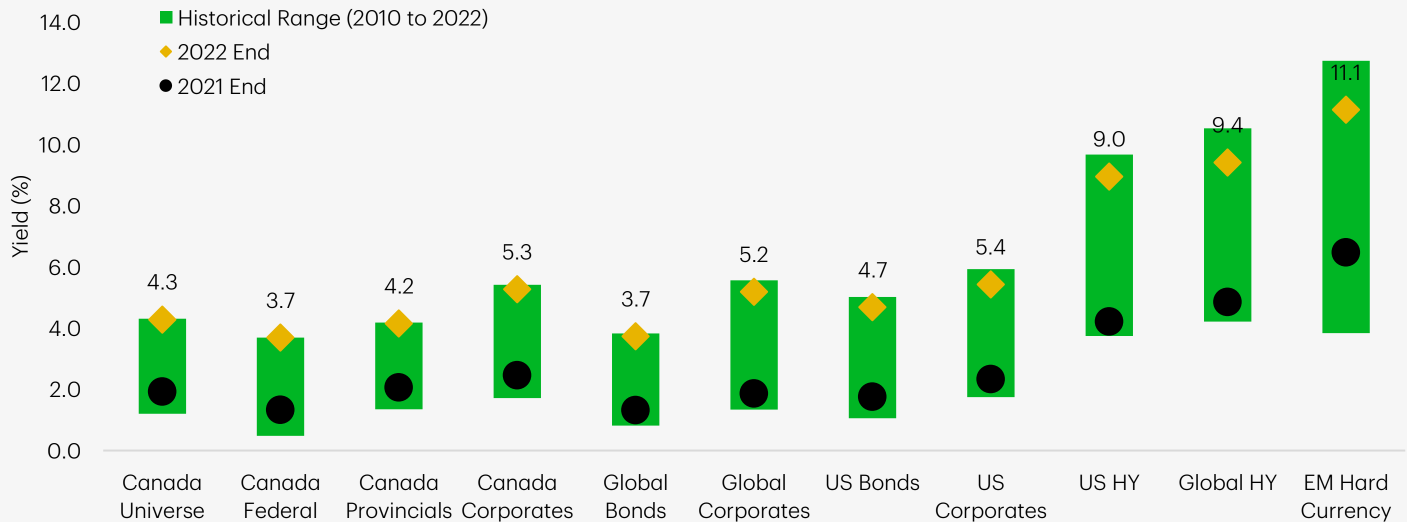
The fear of inflation and the unexpected pain of losing money in fixed income have led many investors to flee for the safe and predictable returns of guaranteed investment certificates (GICs). At first blush, this makes a lot of sense. GIC yields are attractive, providing a return we haven't seen in a long time. That being said, there are much better options, and in many cases, investors are making an emotional decision that has the potential, over the long term, to undermine portfolio returns. Simply put, investors who opt for GICs in this market are ignoring the second rule of bond investing: *When interest rates go down, the value of bonds go up.*

Key Takeaways

- Bonds and guaranteed investment certificates (GICs) offer attractive opportunities right now, but when you take into consideration yields, taxation, liquidity and potential for capital gain, bonds are clearly more appealing.
- When bonds trade at a discount, part of their return is taxed as a capital gain, meaning more money ends up in the investor's pocket.
- Fixed income can provide diversification, reduce overall portfolio volatility and preserve capital over the long term.
- TD Wealth's Asset Allocation Committee is maximum overweight fixed income. Yields across the asset class are well above the lows of the past decade and now offer higher potential returns.
- We still see compelling investment opportunities for lower duration (5-years and shorter) corporate bonds given that all-in yields remain elevated relative to historical levels.

The move in bond yields means that bond investments — across the asset-class spectrum — are trading at yields and prices not seen since 2010 (Figure 1). Historical data suggest that higher yield levels today will very likely translate into higher total returns in the future. This means that investors could benefit from holding a variety of bonds — including government, investment-grade credit and high-yield — because increased income tends to bolster total returns over time.

Figure 1: Highest yields and best prices since 2010



Source: Bloomberg Finance L.P. and TD Wealth as of February 6, 2023

Why Bonds?

There are many reasons. Most investors only buy a GIC because they want the posted interest rate and the certainty that they will be able to recoup the principal on their investment. Bonds provide this and more.

Reason 1: Certainty.

The rise in interest rates over the past year has sent most high-quality bonds and bond indices into a plunge. Keep in mind, however, that changes in bond price don't matter to investors holding the bond to maturity. Unless the underlying issuer goes bankrupt — a virtual impossibility for Western governments, and highly unlikely for investment-grade corporates — the bond will mature at par.

Reason 2: Tax advantage.

When we calculate total return for any investment, tax treatment is a key consideration. Returns for GICs — generated by coupon payments alone and categorized as interest income in non-registered accounts — are taxed at the full marginal rate. Yields or total returns for bonds, however, 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 50% of capital gains are taxed at the individual's marginal rate. An added bonus is that capital losses can be used to offset gains.

This report is not intended to provide tax advice and is for informational purposes only. Consultation with a professional tax advisor is recommended.

To illustrate, we've compared a one-year GIC with a one-year IG corporate bond trading at a discount (Figure 2). The overall 5.1% yield to maturity for this specific bond is split, so approximately 2.85% a year is from coupon payments and the remaining 2.25% comes from the appreciating bond price (to par value of $100 as it draws closer to the maturity date).

The yield that an investor collects from the increase in bond price (as it moves from a purchase price of $97.66 to the repayment amount of $100) is taxed as a capital gain and leads to a higher after-tax return relative to a GIC with a similar yield and term, which has no price movement and therefore no potential for capital gain.

Figure 2: Return Components of GIC vs. Corporate Bond

	1- Year Non-Cashable GIC	TD Bond (March 2024 Maturity)
Term (Years)	1.0	1.0
Yield-to Maturity	5.00%	5.10%
Par Value	$1,000,000	$1,000,000
Price Today (2/6/2023)	$100	$97.66
Coupon Rate	5.00%	2.85%
Total Taxable Interest Income	$50,000	$28,500
Total Capital Gains	$0	$22,460
Tax on Interest Income (53.53%)	$26,765	$15,256
Tax on Capital Gains (26.76%)	$0	$6,010
Total Tax Paid	$26,765	$21,266
Total After Tax Income	**$23,235**	**$29,694**
Total After Tax Returns	**2.32%**	**2.97%**

Source: FactSet, as of February 6, 2023

Reason 3: Liquidity.

Bonds are liquid. They are publicly traded instruments that are easily bought and sold on the market. Non-cashable/non-redeemable GICs must be held until maturity, unless the individual can demonstrate significant financial hardship. Even then, there is no guarantee that the issuing financial institution would comply. If the issuer does agree to break the GIC contract, there are usually substantial penalties, which include the loss of some or all of the accrued interest. Bond positions can be exited as needed or desired, if for example the bond price appreciates.

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Reason 4: Potential for capital gain.

Figure 3 compares a one-year non-cashable GIC to the same one-year corporate bond we used earlier. Remember: When interest rates go up, bond values go down. What we are showing here is the after-tax return of a one-year corporate bond and a one-year non-cashable GIC in differing scenarios:

> **Scenario 1: Interest rates go down a 0.5% and 1%.** When this happens, a bond outperforms because some of its return is a capital gain.
>
> **Scenario 2: Interest rates stay the same.** When this happens, the bond outperforms after taxes again because of the capital-gain component.

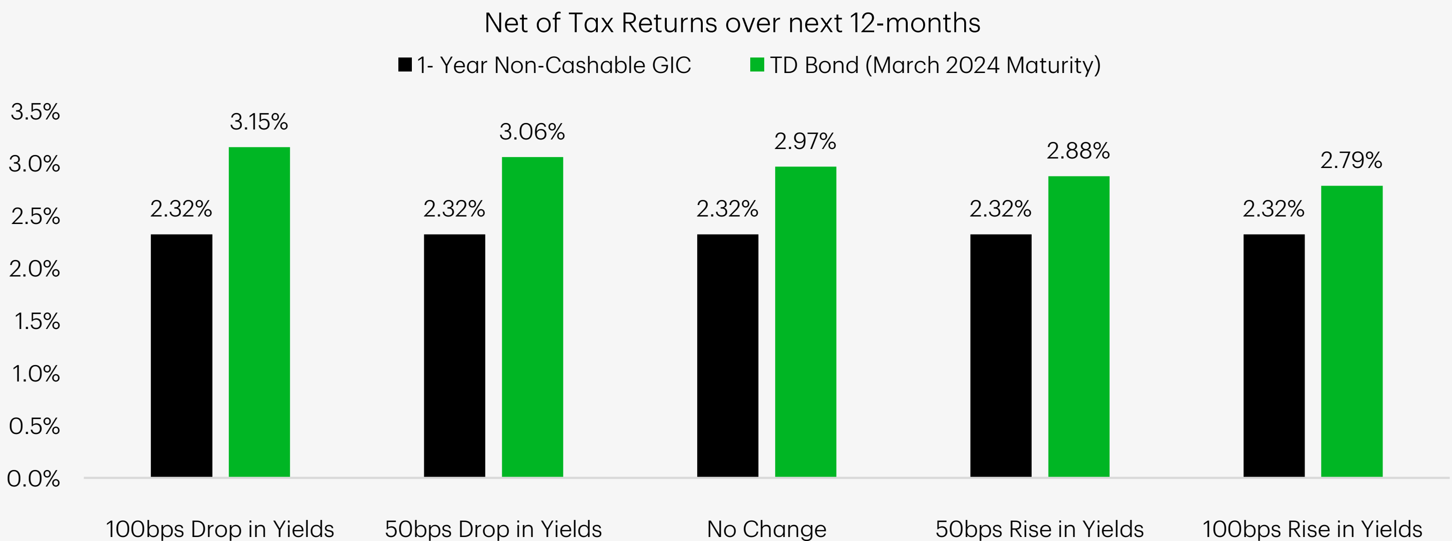
Now, keep in mind, things don't always happen the way you expect and interest rates could potentially go up. Again, we must always remember the second rule of bond investment: When interest rates go up, the value of bonds go down.

> **Scenario 3: Interest rates go up a 0.5% and 1%.** Even in this instance, the bond provides a better rate of return because of the impact of favourable taxation and liquidity.

Furthermore, we must remember that, whether interest rates go up or down, if you hold to maturity, the bond will, absent issuer bankruptcy, mature at par. Not only does this work over the maturity of the bond, but also over longer periods by "laddering" a number of corporate bonds to mature over time (i.e., over 1 to 5 years). This is what active fixed income management is all about.

Bond Ladders can help create predictable streams of income, diversify exposure across bond sectors, and manage some potential risks from changing interest rates.

Figure 3: Return Components of GIC vs. Corporate Bond



Source: Bloomberg Finance L.P. and TD Wealth as of February 3, 2023

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Consider the Investment Environment

At time of writing (February 2023), TD Wealth's Asset Allocation Committee (WAAC) is maximum overweight fixed income. Figure 4 shows the current strategic and dynamic asset-class weights from the Wealth Investment Policy Committee, whose mandate it is to interpret WAAC views and set general asset-class weights by investor profile. We highlight our current position in cash, fixed income and corporate allocations to emphasize our thinking in this current environment.

Figure 4: WIPC strategic and dynamic asset-class weights by investor profile

Asset Class	Balanced Income		Balanced		Balanced Growth		Growth		Aggressive Growth	
	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.	Strat.	Dyn.
Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Fixed Income	56.0%	59.0%	41.0%	44.0%	26.0%	29.0%	16.0%	19.0%	0.0%	2.0%
Domestic Gov't Bonds	20.0%	24.0%	14.0%	18.0%	9.0%	13.0%	5.0%	9.0%	0.0%	2.0%
Invest. Grade Corp Bonds	19.0%	20.0%	14.0%	15.0%	9.0%	9.0%	6.0%	6.0%	0.0%	0.0%
Inflation Linked Bonds	4.0%	4.0%	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	0.0%	0.0%
High Yield Bonds	4.0%	2.0%	3.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Global Bonds - Developed	6.0%	6.0%	5.0%	5.0%	3.0%	3.0%	2.0%	2.0%	0.0%	0.0%
Global Bonds - Emerging	3.0%	3.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	0.0%	0.0%
Real Assets	10.0%	10.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	13.0%	13.0%
Mortgages/Private Debt	7.0%	8.0%	7.0%	8.0%	7.0%	8.0%	7.0%	8.0%	0.0%	0.0%
Real Estate/Infrastrucutre	3.0%	2.0%	8.0%	7.0%	8.0%	7.0%	8.0%	7.0%	13.0%	13.0%
Equity	32.0%	29.0%	42.0%	39.0%	57.0%	54.0%	67.0%	64.0%	85.0%	83.0%
Canadian	10.0%	8.0%	12.0%	10.0%	17.0%	15.0%	20.0%	18.0%	25.0%	23.0%
U.S.	13.0%	11.0%	17.0%	15.0%	23.0%	21.0%	27.0%	25.0%	35.0%	33.0%
International	6.0%	6.0%	8.0%	8.0%	11.0%	11.0%	13.0%	13.0%	15.0%	15.0%
Emerging Markets	3.0%	4.0%	5.0%	6.0%	6.0%	7.0%	7.0%	8.0%	10.0%	12.0%
Fixed Income	65.0%	69.0%	50.0%	54.0%	35.0%	39.0%	25.0%	29.0%	2.0%	4.0%
Equity	35.0%	31.0%	50.0%	46.0%	65.0%	61.0%	75.0%	71.0%	98.0%	96.0%

Strat: Strategic, Dyn: Dynamic. Source: Wealth Investment Policy Committee, as of February 10, 2023.

We think that over the next 12 to 18 months interest rates will likely come down. Why? Consider: (1) Consumer demand is slowing, with credit-card debt rising and home prices down; (2) With mortgages rates up, housing is less affordable, driving prices and activity lower; (3) Leading indicators are pointing to higher unemployment; (4) Capital spending usually slows ahead of recessions; and (5) Recession or not, we are in a late-stage economy.

The combination of higher debt, lower house prices and (eventually) a weaker labour market will lead to lower consumer spending and a slowing economy — it's just the timing that is unclear. In any event, we are confident that we have already seen the bulk of rate hikes. Rates are likely to remain stable through 2023, or we may even begin to see some cuts, if the economic slowdown becomes severe. Either scenario would represent a positive backdrop for fixed income.

Food for Thought

Bonds tend to perform well during recessionary periods. If the Fed succeeds in bringing inflation lower, it could create an even stronger backdrop for fixed income investment.

Figure 5: Fixed-income returns during past recessions

Past Recession Periods		U.S. Treasury Returns for the Period
Start	End	
July 1981	November 1982	36.59%
July 1990	March 1991	8.58%
March 2001	November 2001	5.65%
December 2007	June 2009	8.93%
February 2020	April 2020	6.29%

Source: TD Wealth, NBER, Bloomberg Finance L.P. as of February 6, 2023.

All of which helps to explain why TD Wealth maintains such high conviction in its actively managed fixed income portfolios. There are five reasons we are maximum overweight in the asset class:

1. **Yield:** Bonds currently offer attractive yields and better tax implications in non-registered accounts.
2. **Certainty:** Bonds offer safety in a rising-yield environment because they can be held until maturity at par.
3. **Liquidity:** Bonds offer ample liquidity with no locked-in investment period.
4. **Capital Gains:** Bonds may offer a tax-efficient capital gain in a falling-yield environment and are currently mostly priced at discount.
5. **Returns:** Absent a highly unlikely bankruptcy scenario, government and investment-grade bonds will likely provide better returns along with preservation of capital over the long term.

Conclusion: Over the long-term, bonds easily beat GICs

We are nearing the end of the business cycle. Against this backdrop, we've positioned our portfolios defensively. What matters most in an environment like this is to stick to one's wealth plan and portfolio approach to investing.

The GIC vs. bond question demonstrates how important it is to focus on these two aspects of your investment strategy. There's always going to be something that has the potential to distract you from your goals and bump you off a process-oriented way of thinking. Ultimately, over the long term, asset allocation and good process is the greatest contributor of return.

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