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A new direction for fixed-income investing

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In a low interest rate environment, try corporate bonds, preferred shares, annuities or even dividend stocks

It wasn't that long ago that fixed-income allocations of retirees' portfolios could be dominated by GICs and Canada Savings Bonds – safe instruments that provided decent returns.

But in these days of low interest rates and yields, experts say those fixed-income alternatives don't provide an income at all when you factor in inflation. It's time, they say, to consider less traditional ways of bringing in income.

"When savings bonds were paying 6, 7, 8 per cent – the good old days – and inflation was running 2, 2½ or even 4 per cent – you could retire off that, you could live off it. It was a reasonable return," said Moshe Milevsky, a finance professor at York University and the author of a slew of books on personal finance.

But, he said, those returns don't exist any more. "It's necessity that's forcing us to think in other directions."

Some of those directions: corporate bonds, preferred shares, annuities and, though they aren't considered fixed income, dividend stocks.

Take investment-grade corporate bonds. Robert Gorman, the chief portfolio strategist for TD Waterhouse, said investors should consider them "one step further on the risk curve" from government bonds, "but by and large, if it's investment grade in Canada, your chances of credit issues are very, very slim."

Investment grade means a credit rating of BBB or better and yields tend to be about 3.5 per cent-plus, a lot better than about 1.7 per cent for a 10-year Government of Canada bond, Mr. Gorman said. Corporate bonds also have the benefit of shorter durations.

Next up on the risk curve: preferred shares. They often have yields similar to corporate bonds, Mr. Gorman said, with risk associated with the underlying company.

The huge benefit to investing in preferred shares is their tax advantage, according to James Hymas, president of Toronto-based Hymas Investment Management Inc. and a preferred-shares expert.

"The great distinction between preferred shares and long-term corporate bonds is that preferred shares give you entitlement to the dividend tax credit – which for most people has the effect of multiplying your return by a factor of about 1.3."

Investors who want to take advantage of the dividend tax credit need to hold their preferred shares in a taxable account, not an RRSP.

Preferred shares provide holders with a dividend and a stated dollar value per share when it is redeemed by the company. The prices of the shares trade up and down.

Often, Mr. Hymas said, investors are attracted by a high yield and buy preferred shares, and a short time later the issue is called for redemption at a far lower price than they paid for it – "and they end up with a very poor return or even losing money."

Nancy Woods, an investment adviser at RBC Dominion Securities Inc., said preferred shares used to be much more straightforward – one was told yield and maturity date and that's all. Now they're more complicated, and "all of the options and the benefits and choices seem to be in the hands of the issuer." Investors need to do their homework before buying in, she said.

The same can be said for annuities, Mr. Gorman said, which are available in many different forms – fixed term, for life, with or without survivorship. "But for individuals who attach very high importance to certainty, annuities can certainly play a role," he said.

Essentially, annuities are contracts that guarantee an income to the beneficiary.

Prof. Milevsky, an annuity expert, said one of the benefits of annuities for Canadians – if you buy it outside of an RRSP – is how the money is taxed. The payment is not taxed just as income, but as return of your principal and part of the interest, which tends to be generous to the beneficiary. People considering annuities can also look into ones that are combined with insurance, so that the principal or part of it can go to survivors.

Prof. Milevsky said the important thing about annuities is that they provide a source of income – "and it will be much more than you would get from a correspondingly long-term bond."

When it comes to fixed income, many experts said investors should consider "income" in a much different light. In a diversified portfolio, they say, there's room to manoeuvre, particularly if liquidity isn't an issue.

Prof. Milevsky said, for example, that he hears of investors who buy properties that they rent out – "that's one way of generating yield."

For David Sung, the president of Vancouver-based Nicola Wealth Management, income, or cash flow, is the forgotten part of an investor's portfolio. Too often, investors pay attention to the price of a stock – which can be very volatile – and not enough to the income it produces through dividends, he says.

Mr. Sung cites the example of the Royal Bank of Canada, whose share price dropped about 30 per cent between March, 2008 and March, 2009, "but the income that investment gave off didn't change one penny. The dividend on Royal Bank did not change one penny ."

Mr. Gorman cited another example – comparing a 10-year Government of Canada bond now with the dividend yields of Canadian banks, most of which are close to 5 per cent. And because dividends qualify for tax credits, "every buck of those dividends is like getting $1.30 in interest, after tax, roughly speaking."

Mr. Sung said that although investors must have a diversified asset mix in their portfolio, they should place emphasis on making sure those assets are income-generating.

"I would say, in many ways, the new age of fixed-income investing is an investor's increasing ability, or tolerance, to let stable cash flow provide the comfort as their investments, their stock prices or their asset prices fluctuate. Investors should see to apply this throughout their entire portfolio." That means, he added, looking beyond the traditional GICs and Canada Saving Bond model.