WEALTH FOCUS

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A QUARTERLY REPORT FROM CANACCORD WEALTH MANAGEMENT

RATES ON THE RISE

What the new rising-rate environment means to fixed-income investors.

At first glance, rising short-term interest rates may look pretty good to fixed-income investors. When banks raise their posted rates, the returns on guaranteed investment certificates (GICs) and high-interest savings accounts start to look more promising for those who depend on a steady income stream.

But in the world of more sophisticated fixed-income products, including bonds, preferred shares and convertible debentures, the effect of rising short-term interest rates is mixed.

THE BOND-RATE RELATIONSHIP

There are three axioms investors should keep in mind when it comes to fixed-income investing:

• Bond yields (the interest paid) and bond prices trade inversely, so rising interest rates result in declining prices.

• The prices of longer-term bonds and bonds with lower coupon payments are more sensitive to interest-rate changes and therefore can be more volatile.

• An increase in short-term interest rates may not indicate an increase in yields for longer-term bonds.

It's unlikely that we'll reach the peaks of the early 1980s, but even modest increases may affect fixed-income investments.

What this means: Rising rates lead to declines in bond prices, and the price of longer-term bonds (for example, of 20-year duration) will be more affected than the price of shorter-term bonds (for example, of two-year duration).

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RATES ON THE RISE

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Fixed-income investments are an important component of a diversified portfolio, whether interest rates are rising or falling.

Since the early 1980s, when mortgage rates topped 20% and Canadian Savings Bonds offered 19.5%, fixed-income investors have experienced a secular bull market in bonds, as declining interest rates pushed up the price of bonds.

Declining rates have been good news for other reasons, as well. Companies have had access to cheaper capital to use for business expansion. Individuals, too, have been able to borrow at lower rates, buoying consumer spending and the housing market. For bonds, it has meant a 30-year bull market.

STRATEGIES FOR INVESTORS

Today, however, because short-term interest rates are close to zero, there's nowhere to go but up. Assuming that the Canadian economy rebounds and doesn't slip into a lost decade or two like Japan, where interest rates remained low to protect against deflation, we are probably heading into an environment of rising interest rates. It's unlikely that we'll reach the peaks of the early 1980s, but even modest increases may affect fixed-income investments.

Here is how a rising-rate environment will affect various investments, the opportunities it may present, and strategies to consider:

Bonds. During a period of rising interest rates, it becomes less risky to choose shorter-term bonds over longer-term bonds. For example, let's assume that you are looking for a source of interest income over five years and plan to sell your bond at the end of that time.

A 20-year bond may currently offer higher yields than a shorter-term bond, but this advantage could be offset if you have to sell your bond at a loss. It may make more sense to acquire a five-year bond and plan to sell it at maturity for the full face value (excluding the risk of default).

The value of bonds

Bonds can provide significant benefits to investors:

- The potential for a steady stream of interest income and capital appreciation;
- Lower historical volatility than stocks;
- Because they tend to have low correlation with stock performance, they are a valuable tool for diversification;
- Priority repayment for bondholders over shareholders if a company fails.

Preferred shares. There are several types of preferred shares, and each group has a different general sensitivity to rates. These groups, listed in descending order of sensitivity, are as follows:

Straight (fixed rate or perpetual) preferred shares provide a fixed yield in perpetuity, which makes them the most sensitive of the groups to interest-rate changes.

Rate reset preferred shares typically reset their yields, at a fixed spread, to a benchmark interest rate every five years. The closer to the reset date, the less volatile are the shares.

Retractable preferred shares have a fixed maturity and can be retracted for cash or common stock; they are less vulnerable to price declines, and less sensitive to interest rate changes.

Floating preferred shares have a floating yield, which means their prices are minimally affected by changes to interest rates.

The bottom line? Not all preferred shares react the same way in a rising rate environment. Make sure you chose the one that best suits your needs.

Convertible debentures. These debt instruments have a hybrid structure, sharing characteristics with both bonds and stocks. They can be converted into stocks or cash at a set price. As a result, when the issuing company's stock is trading materially above the conversion price, a convertible debenture trades like an equity, regardless of the prevailing interest rate.

In contrast, when the issuing company's stock is trading materially below the conversion price, a convertible debenture trades like a similarly rated and dated bond — although convertible debentures tend to be less volatile.

In a rising rate environment, convertible debentures that are expected to benefit from rising stock prices can play a valuable role in your fixed-income portfolio.

YOUR NEXT STEPS

Fixed-income investments are an important component of a diversified portfolio, whether interest rates are rising or falling. The key is to make sure you're well positioned along the yield curve. In the near term, assuming that interest rates start to rise, that may mean focusing on shorter-term bonds, specific types of preferred shares and well-chosen convertible debentures. WF

I can help you build a robust fixed-income portfolio that works well for your specific circumstances. Contact me to learn more about this investment strategy.

ARE FLOW-THROUGH LPS RIGHT FOR YOU?

A flow-through limited partnership (LP) invests in a portfolio of flow-through shares.

Flow-through shares are one way Canadian resource companies raise capital for exploration and development, with the tax deductions associated with these activities flowing through to investors. A flow-through limited partnership (LP) invests in a portfolio of flow-through shares. Investors are limited partners, purchasing units of the LP and receiving tax deductions on a pro rata basis each year.

The benefits of investing in a flow-through LP, rather than in individual flow-through shares, include portfolio diversification, professional management and simplified administration.

TAX TREATMENT

Tax deductions offered by individual flow-through shares can significantly reduce an investor's "at-risk capital" – the value of the initial investment less tax savings. Flow-through shares also provide capital appreciation potential, though flow-through shares issued by early-stage resource companies may be more volatile than common shares issued by more established businesses.

Flow-through LPs may be structured so the amount invested is 100% tax-deductible against any source of income in the year the investment is made (except in Quebec), and additional deductions may be available in subsequent years.

Tax Tip

Use a flow-through LP to make tax-efficient charitable donations.

Here's a strategy using flow-through limited partnerships (LPs) that will enable you to receive a tax deduction this year and in the year of a charitable donation, and pay no tax on the disposition of your investment.

Let's say you invest $10,000 in a flow-through LP that is 100% tax deductible in the year of investment, with the redemption proceeds estimated to be the same as the original investment amount; your marginal tax rate is 46%. Your 100% tax deduction will save you $4,600 in income taxes this year. Deductions within the flow-through LP reduce your adjusted cost base to zero so you will be liable for capital gains tax on disposition.

Now, what if you donate your flow-through LP units to a registered charity? The capital gain will be exempt from tax. In addition, you will receive a donation tax credit for the amount of the donation — assumed to be equal to the original investment amount — resulting in another $4,600 in tax savings in the year of the donation.

Your $10,000 investment has now generated $9,200 in tax savings, resulting in a net cash outlay of $800 that provides $10,000 worth of investments to your favourite charity.

Tax deductions within the LP shelter income and reduce the adjusted cost base of the investment to zero, so proceeds realized on disposition are taxed at the preferential capital gains rate. In addition, those capital gains may be offset by realized capital losses and/or net capital loss carryforwards.

FLOW-THROUGH LP INVESTORS

Many different types of investors can benefit from a flow-through LP, including:

- High-income earners taxable at the highest marginal tax rate;
- Investors expecting lower income in the future and can therefore benefit from tax deferral;
- Recipients of large lump sums who want to shelter the payment from taxes; for example, an inheritance, a severance, or proceeds from the sale of a principal residence or second property;
- Investors with capital losses who can offset capital gains realized on the disposition of flow-through LP units;
- Investors who plan to make donations and want to maximize tax savings (see sidebar);
- Investors saving for retirement who have maximized their Registered Retirement Savings Plan contributions;
- High-income seniors who want to reduce their taxable income to maximize Old Age Security benefits;
- Corporations, including personal holding companies.

These investment vehicles are typically better suited for investors in a higher tax bracket and with a tolerance for higher risk. You should always talk to your investment advisor before making any investment decisions, so to find out whether flow-through LPs can play a role in your portfolio, give me a call.

If you're interested in investing in 2010, we need to act quickly because it's more likely money managers will be able to invest all your money (so you get the full tax benefits) if you buy units earlier in the year.

Expect higher payouts if you wait until after you turn 65 to collect; lower payouts if you collect earlier.

WILL UPCOMING CPP CHANGES AFFECT YOU?

Between 2011 and 2014, the federal government will be phasing in some important changes to the Canada Pension Plan (CPP). Expect higher payouts if you wait until after you turn 65 to collect; lower payouts if you collect earlier. Here are the details.

INCENTIVE TO DRAW CPP LATER

Over a five-year period beginning in 2012, the early withdrawal penalty will increase to 0.6% per month (from 0.5%) and the late withdrawal benefit will increase to 0.7% per month (from 0.5%). This makes it more attractive to delay receiving your first CPP cheque.

CONTRIBUTE LONGER

Under the new rules, if you start taking CPP before age 65 but continue working, you and your employer must continue to contribute until you reach age 65. After that, you and your employer can choose to continue until you reach age 70. These additional contributions can increase your CPP entitlement, with increased payments starting the year after you make your contributions. Currently, you stop making CPP contributions once you begin receiving CPP payments or at age 70, whichever is earlier.

EASIER TO QUALIFY FOR THE MAXIMUM

Your CPP payments are calculated based on your average earnings during your career. Under the new rules, 16% of your career (up from 15%) can be disregarded to adjust for years of low income. This exemption will increase 17% in 2014. This should mean more Canadians will qualify for the maximum pension amount.

CONTINUE WORKING AND TAKE CPP EARLY

Currently, people who begin taking CPP payments before age 65 have an income cap in the month preceding and the month following the first withdrawal. So, if you want to receive payments and continue working, you have to take a two-month "vacation" to qualify for CPP. Under the new rules, employees who begin to receive CPP payments in 2012 or later won't face this restriction. WF

Contact me to discuss how any of these changes may affect your planning for retirement.

Note that these changes do not affect the Quebec Pension Plan.

Tap these sources

Any or all of the following sources may contribute to your retirement income:

Government benefits, including Canada Pension Plan, Quebec Pension Plan and Old Age Security;

Employer plans, including defined contribution and defined benefit pension plans, group Registered Retirement Savings Plans (RRSPs) and deferred profit sharing plans;

Individual Pension Plans generally set up for business owners, incorporated professionals and corporate executives;

Registered Retirement Income Funds and Tax-Free Savings Accounts;

Savings in non-registered plans (open accounts);

Employment or business income.

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