The triple whammy for income investors

In the past, investing for income was often a simple matter of collecting income from safe investments like GICs and government bonds. However, in recent years, it has become increasingly difficult to secure a sufficient retirement income due to three key factors:

1 PEOPLE ARE LIVING LONGER

In 1970, men could expect to live to 69 and women to 76. Now, the average Canadian can expect to live for nearly two decades after age 65. With more years to fund, you will probably need a bigger retirement nest egg than previous generations.

In addition, our aging population is putting more pressure on publicly funded pension plans and health care. As a result, it's very possible that each of us will be increasingly responsible for more of our own expenses in retirement.

2 THE STANDARD OF LIVING IS GOING UP

Partly thanks to today's longer lifespans, retirees are enjoying more active retirements, especially in the first 10-15 years. And that tends to cost more.

3 INTEREST RATES REMAIN LOW

With today's historically low interest rates on GICs and bonds, there can be very little left over once you take inflation and taxes into account. This means you may have to save more – and consider different types of investments that offer both higher after-tax income and long-term growth.

Read on for more information on investing for income ⇨

BEST FIXED-INCOME IDEAS

Investing for income choices

If you invest for income, you have many different investment choices above and beyond traditional GICs and bonds. The following table highlights some of the more popular income investments, from less risky/less income to more risky/more income (and/or growth).

Greater stability

Investment	What it is	Why choose it	What to consider	How to use it
Guaranteed Investment Certificate (GIC)	› A deposit instrument available from banks and trust companies	› Initial deposit returned in full at maturity › Guaranteed semi-annual interest paid over stated term › Up to $100,000 CDIC insurance (per GIC)	› Low interest rates erode purchasing power › Interest fully taxable at your marginal tax rate	› Add stability to overall portfolio › Increase yield by laddering (staggered maturity dates) › Gain CDIC insurance for GIC assets above $100,000 by diversifying
Government bond	› A certificate issued by government as evidence of debt it promises to repay in full at a certain date and rate of interest	› Loan returned in full at maturity › Guaranteed semi-annual interest typically higher than GICs › Easy to sell before maturity if needed or for potential capital gains	› Lower interest rates erode purchasing power › Interest fully taxable at your marginal tax rate	› Generate semi-annual income › Add stability to overall portfolio › Increase yield by laddering
GEM	› A package of six different government bonds designed to provide monthly income	› Guaranteed income and principal as with regular bonds, except structured to provide monthly instead of semi-annual income	› Lower interest rates erode purchasing power › Interest fully taxable at your marginal tax rate	› Generate monthly income › Add stability to overall portfolio › Increase yield by laddering
Guaranteed Interest Annuity (GIA)	› The insurance industry's version of a GIC	› Initial deposit returned in full at maturity or death › Offers creditor protection and death benefit can bypass probate	› May offer higher income than GICs › Interest is fully taxable at your marginal tax rate	› Adds stability to overall portfolio › Provides estate-planning benefits through beneficiary designation › Eligible for federal income splitting
Real-return bond (or Treasury Inflation Protected Security in the U.S.)	› A government bond indexed to the Consumer Price Index (CPI)	› Protects purchasing power from inflation by increasing principal in line with CPI › Pays semi-annual interest similar to a conventional bond	› Interest payments fully taxable › Accrued principal increases taxable capital gains › Less liquid than conventional bond	› Hedge portfolio against inflation while generating income › Better suited to non-taxable accounts due to taxation
Segregated fund (Guaranteed Minimum Withdrawal Benefits)	› An insurance contract paying guaranteed lifetime income and a death benefit guarantee (reduced proportionally by withdrawals)	› Guaranteed lifetime income › Ability to reset guaranteed amount higher if market value increases	› Sales charges apply if liquidated › Guarantees reduced proportionally by withdrawals	› Add highly predictable income stream › Suitable as part of a diversified fixed-income portfolio
Annuity	› An insurance contract offering guaranteed income for life or for a fixed number of years › Select to guarantee the income stream for a fixed number of years › Annuity income is comprised of taxable interest and return of capital	› Higher yields than regular GICs/bonds › Can create a tax-efficient income stream since only a portion of the income received is taxable	› Permanently locked in at current rates › Annuity income terminates at death if there is no guarantee period or if the guarantee period has expired › If capital preservation is required the annuity deposit can be insured with continued income higher than GICs (you must qualify for life insurance)	› Generate higher income › Reduce taxation › Eligible for federal income splitting › Suitable as part of a diversified fixed-income portfolio

Higher income potential

Greater stability ↕ Higher income potential

Investment	What it is	Why choose it	What to consider	How to use it
Corporate bond	› A certificate issued by a corporation as evidence of debt it promises to repay in full at a certain date and rate of interest › Investment grade bonds rated BBB or higher › High-yield bonds rated BB+ or lower	› Generally higher interest than GICs and government bonds (semi-annual)	› Higher risk of default than government bonds › Limited availability of quality issues › Limited liquidity in adverse markets	› Generate higher income › Diversify between 6-8 issuers to reduce default risk › Up to 25% portfolio allocation to investment-grade bonds suitable for conservative investors
Preferred share	› A non-voting, non-profit-sharing share in a corporation entitling shareholders to a stated dollar value in the event of liquidation	› Pays a fixed, generally higher dividend than other share classes › Dividends taxed more favourably than interest	› Share prices decline when interest rates rise › Yields often not much higher than regular corporate bonds	› Generate higher tax-efficient income › Generally regard as part of corporate bond allocation in a diversified portfolio
Hybrid bond	› A capital trust security issued by a corporation that combines the features of preferred shares and corporate bonds	› Pays higher fixed semi-annual interest to maturity than regular bonds › Superior liquidity compared to corporate bonds	› More junior debt than corporate bonds; i.e. in the event of liquidation, bonds paid back first, then preferred shares/hybrid bonds › Interest payments fully taxable	› Generate higher income › More tax-efficient income in tax-sheltered accounts (RRSPs, RRIFs)
Tax-exempt insurance	› A life insurance contract that shelters assets from taxation and pays a death benefit › Investment options may participate in policy dividends or may include guaranteed interest options, mutual fund-type managed funds or index-linked investments	› Investment income grows tax-deferred within policy › Can use the policy values as collateral for tax-free bank loans for income	› Cash withdrawals may be subject to surrender charges and/or taxation › Bank loans are repaid at death by insurance benefit › You must qualify for insurance	› Suitable for surplus assets and/or to provide tax-free supplemental retirement income
Real Estate Investment Trust (REIT)	› An equity investment that trades on a stock exchange, but unlike a common stock pays out the majority of its cash flow to investors	› Typically pays larger distributions than GICs or bonds › Offers exposure to a basket of real estate assets	› Distributions/values not guaranteed › Distributions limit growth potential › Higher interest rates can negatively impact performance	› Potentially enhance income › Include as part of equity component of diversified portfolio — not fixed-income › Choose based on merits of underlying assets
Common share	› An equity security that provides a share of a publicly traded company	› Many stocks pay a regular dividend › Long-term growth potential › Dividends and capital gains taxed less than interest	› Stock values and dividends are not guaranteed	› Balance income with capital growth › Create more tax-efficient income stream › Look for stocks with history of increasing dividends

BEST FIXED-INCOME IDEAS

Three key strategies for income investors

With today's low interest rates, taxes and inflation, it can be a challenge to get the retirement income you need. To help you meet this challenge, and maximize your retirement income, here are three key investment strategies you should consider:

1 GRAB A HIGHER RUNG ON A BOND LADDER

With a bond ladder, you invest in several bond holdings of roughly equal size with evenly staggered maturity dates. For example, with a 10-year bond ladder, you invest an equal amount in bonds with maturity dates evenly spread out over 10 years. When the one-year bond matures, you reinvest in a new 10-year bond. The next year, when the two-year bond matures, you reinvest in a new 10-year bond. And so on.

There are several advantages offered by this approach:

- **No more guesswork.** Even for expert prognosticators, it's very difficult to predict which way interest rates are heading. You can remove the guesswork simply by "climbing" the bond ladder.
- **Predictable income.** Because only one-tenth of the bond ladder matures every year, the impact of changing interest rates is minimized. The income you receive doesn't change dramatically from one year to the next, making it easier for you to plan your expenses.
- **Enhanced income.** Long-term bonds typically offer higher rates than short-term bonds. As you climb the ladder, you gradually replace the short-term bonds with long-term bonds, which generally results in higher income.

You can also apply this approach to GICs.

2 LOOK BEYOND TRADITIONAL INCOME INVESTMENTS

The "triple whammy" of historically low interest rates, longer lifespans and higher standards of living means your retirement nest egg needs to work harder now than ever before. To get the income you need, it's important to look beyond government bonds and GICs for other alternatives:

- **Tax-advantaged insurance products** such as guaranteed interest annuities, annuities, segregated funds (Guaranteed Minimum Withdrawal Benefits) and tax-exempt insurance can protect, guarantee and enhance your income while providing a high degree of security.
- **Corporate bonds** often offer higher interest rates than government bonds – without a large increase in risk. To determine risk, check the credit rating. A high-quality, low-risk corporate bond might have a credit rating of "A" versus "AA" for a government bond. A medium-grade corporate bond might have a credit rating of "BBB" but offer a higher interest rate to attract investment.
- **Preferred shares** also offer the potential for higher yields. Preferreds pay a fixed, generally higher dividend than other share classes (plus dividends are taxed more favourably than interest). While not guaranteed, preferreds can play a very important role in a properly diversified, income-oriented portfolio.

3 REMEMBER IT'S NOT WHAT YOU MAKE — IT'S WHAT YOU KEEP

Consider investments that generate higher income – after taxes are taken into account. While interest income from investments like bonds and GICs is fully taxable at your marginal rate, other types of income receive more preferential tax treatment:

- **Dividends** from Canadian corporations are taxed lower than interest income (and in most situations capital gains) due to the Dividend Tax Credit.
- **Capital gains** from stocks also receive preferential tax treatment compared to interest income – only 50% of any capital gain is taxed at your marginal rate.
- **Return of capital** from investments like annuities can also provide considerably higher after-tax income compared to a traditional GIC because part of the annuity payments you receive are non-taxable returns of your capital.

› Contact us today for more information on strategies to enhance your retirement income.

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