The Fortnighter

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In the last issue of ***the Fortnighter***, I touched on the subject of purchasing power – the unfortunate fact-of-life that inflation (even at the low levels we are seeing today) gradually erodes the value a future stream of investment income.

One of the downsides of most guaranteed investments is the fact that the issuer doesn't care if your expenses, or the country's cost of living, go up – you get the same fixed amount for the life of the security. At a modest 2% inflation rate (Canada's average over the past 25 years), the income from a 5-year GIC is actually only 92 cents on the dollar in its final year. Buy a 10 year bond and its final year's payment is a little over 83 cents. That's a 17% decline in purchasing power in just 10 years!

With today's longer (and more expensive!) retirements, protecting purchasing power is clearly an import issue for investors. Looked at another way – it's a risk, just like "losing money" is a risk most people associate with investing in stocks. I don't know about you, but the thought of having 17% less income only 10 years into my retirement scares me a lot more than the ups and downs of the market.

If you are thinking this analysis is a segue into owning stocks to protect purchasing power, you are correct. And the reason has to do with the fundamental difference between equity and income investments.

Buy a GIC, a bond or a money market fund and you are lending money to a business. Buy a stock and you own the business. One is passive, the other active – and "active" means participating in the fortunes of the underlying company and the potential to grow your money.

Let's consider a couple of examples, CN Rail and TD Bank, and just look at dividends not growth. CN is not considered an income stock - its shares currently pay a dividend of \$2.30 to yield a respectable 1.6% (about the same as a 5-year GIC). 10 years ago, CN's dividend was 54 cents! That's an annual compound growth rate of over 15% - **8X** the inflation rate. TD Bank's dividend is currently \$3.16, or a yield of about 5%. In 2010, TD's dividend was \$1.24. That's about a 10% increase per year. Names of other "dividend growers" that come to mind: McDonalds, Johnson & Johnson, Telus, TransCanada, Abbott Labs – the list is pretty extensive.

Should investors jettison their 5-year GICs for CN and TD shares? No, because GICs are guaranteed and stocks are not – and 100% guaranteed still plays an important role in portfolio construction. But what if an investor had a "balanced portfolio" with 40% in 5-year GICs and the remainder in CN and TD shares? Based on historical numbers, such a portfolio would generate annual cash flows of about 2.5% (which isn't bad) but more importantly, that cash flow would grow at an inflation-busting 8% per year. Something to consider.