Fixed Income Investing – Part VII

Guaranteed Investment Certificates

Over the years, Guaranteed Investment Certificates ("GICs") of major issuers in Canada have been considered for their conservative nature and attractive yields. In fact, since the 2008/09 financial crisis GICs have often offered an interesting yield premium compared to investment grade corporate bonds of five years and shorter. This article highlights the benefits of including GICs in a diversified portfolio, but reminds the reader that they are not without risk.

GICs as a substitute for short-term bank bonds

As investors look to reallocate funds to shorter-duration investments to mitigate the risk of rising interest rates, GICs continue to represent a short-term substitute to financial institution deposit notes and subordinated bonds. Rarely have GICs been considered as good investments in lieu of regular corporate bonds, but as yields remain low in general, there are compelling arguments for GICs to be an integral part of a fixed income portfolio strategy for the following reasons:

- Not only will the best GIC rates from Schedule I[1] financial institutions offer attractive yields in comparison to cash and cash equivalent securities, but the yield will often be similar — if not higher — than the rates on both the deposit notes and subordinated debt currently offered on the secondary market in the one- to five-year sector;
- The addition of GICs should help reduce a portfolio's price sensitivity (or "duration") risk to changes in interest rates; and
- GICs can represent a better investment option for short-term maturities when constructing passive portfolio strategies, such as a laddered bond portfolio.

GICs are not risk-free

Despite recent higher yields, GICs have historically offered lower rates than comparable fixed income securities due to their embedded guarantee. Over the years, the term "Guaranteed" in Guaranteed Investment Certificate has come to represent a sense of investors' blind faith in the quality of the issuers.

In reality, the term comes from their Canadian Deposit Insurance Corporation ("CDIC") coverage. Unlike most fixed income securities, GICs benefit from CDIC insurance that covers up to $100,000 invested at each member financial institution. This is the security investors are generally seeking when selecting GIC investments.

However, the security of investments above the CDIC-insured amount of $100,000 is not guaranteed, and in the context of a default or bankruptcy of the issuing institution, this excess invested in the GIC would be fully at risk. Unfortunately, some investors have made the erroneous assumption that since the first $100,000 is guaranteed then, by extension, larger balances are also secure, and this is not the case.

Not all institutions are created equal

In regard to GIC risks, inflation and taxes are generally the most important to consider. Most GICs offer very limited secondary liquidity which, if the issuer permits, normally comes at a cost in the form of a penalty. Rarely have issuer-specific risks been explicitly addressed and discussed. In the corporate bond market, credit spreads are indicators of the general credit quality of an issuer and can be used, along with credit ratings, to evaluate the investment risks. However in GIC markets, yields are more representative of the competitive pressure and specific issuer funding needs, rather than credit quality. In reality, despite a sense of similarity among issuers, they are not all created equal.

For instance:

- Not all issuers are rated by major credit rating agencies, have similar business models or, more importantly, have access to multiple sources of funding;
- The major Canadian banks, as an example, do have access to capital markets for their excess funding needs, but other banks will rely primarily on retail deposits as their core source of funding; and

[1] Schedule I banks are domestic banks and are authorized under the Bank Act to accept deposits, which may be eligible for deposit insurance provided by the Canadian Deposit Insurance Corporation ("CDIC"). For more information on Schedule I banks, please visit the Canadian Bankers Association website.

CONTINUED

- Without access to wholesale funding sources, an institution's level of flexibility may be greatly reduced, and increases the risk of failure, especially for highly-levered issuers.

Under normal conditions, such risks are estimated to be relatively low, but could increase considerably in periods of economic weakness, especially when the real estate market slows and interest rates rise. Such a scenario could be reminiscent of the last financial crisis in the U.S. when banks and trusts failed when they lost deposits and could not access sources of longer-term funding.

Even Canada has a bankruptcy history

Since 2007, more than 500 U.S. banks and trusts have failed as a result of global financial turmoil. Of this number, over 100 mortgage lenders succumbed in the first two years of the financial crisis, as trouble in the real estate market accelerated.

During that period, Canadian financial institutions were generally spared from any major financial distress issues with the exception of the asset-backed commercial paper scandal that resulted in losses for clients, and more recently, the liquidity concern at Home Capital Group. In effect, the Canadian market has not suffered any major financial failures since the mid-1990s (see **Figure 1**), contributing to the general confidence in the GIC market. However, over the years Canada has had its share of failures. Since 1967, 43 banks and trusts have failed in Canada. In the 1980s, failures were related to inadequate regulation, bad lending practices and, in three cases, criminal acts. In the 1990s, they were largely the result of poor management and major loan losses, as such collapses coincided with a major slowdown in the real estate market.

Figure 1: Notable Bank and Trust Failures in Canada

Year	Institution
1985	Northland Bank
1986	Continental Bank of Toronto
1986	Bank of British Columbia
1991	Saskatchewan Trust Company
1991	Standard Trust
1992	Central Guaranty Mortgage and Trust Company
1992	First City Trust
1993	Prenor Trust
1993	Dominion Trust
1994	Monarch Trust
1994	Confederation Trust
1995	Income Trust Company
1995	North American Trust Company
1995	NAL Mortgage Company
1996	Security Home Mortgage Corporation

Source: Canadian Deposit Insurance Corporation

Importance of diversification

While the likelihood of default for the major Canadian banks is remote, this may not be the case for all the issuers. As interest rates are rising and the potential for a real estate slowdown looms in Canada, a recurrence of a negative cycle similar to that of the early 1990s may have a detrimental effect on funding sources for some issuers.

For smaller investments, a portfolio of GICs can still easily be diversified among the many individual issuers distributed by BMO Nesbitt Burns, and continue to be fully insured by the CDIC. But, as a portfolio size increases, and individual issuer investments exceed the CDIC-insured limit of $100,000, investors may expose their portfolio to greater risks.

GIC rates are not a reliable indicator when it comes to risk valuation, and may not properly compensate for the risk beyond the insured limits. As for any fixed income investment, it is important for investors to understand the credit quality of individual issuers and CDIC limitations before investing. For that reason, the BMO Nesbitt Burns Portfolio Advisory Team recommends that investors apply the same prudent portfolio principles and risk management guidelines for GICs that they use for all of their portfolio investment decisions.

Please speak to your BMO Nesbitt Burns Investment Advisor if you have any questions about this article, or would like to discuss the fixed income component of your portfolio.

BMO Wealth Management provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Wealth Management cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.
BMO Wealth Management is a brand name that refers to Bank of Montreal and certain of its affiliates in providing wealth management products and services. Not all products and services are offered by all legal entities within BMO Wealth Management.
BMO Private Banking is part of BMO Wealth Management. Banking services are offered through Bank of Montreal. Investment management services are offered through BMO Private Investment Counsel Inc., an indirect subsidiary of Bank of Montreal. Estate, trust, planning and custodial services are offered through BMO Trust Company, a wholly owned subsidiary of Bank of Montreal. BMO Nesbitt Burns Inc. provides comprehensive investment services and is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. All insurance products and advice are offered through BMO Nesbitt Burns Financial Services Inc. by licensed life insurance agents, and, in Quebec, by financial security advisors. ®"BMO (M-bar roundel symbol)" is a registered trade-mark of Bank of Montreal, used under licence.
All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Wealth Management.
ID2218 (09/18)