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Guaranteed Investment Certificates

A Reminder, GICs are NOT Risk Free

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In our March *Fixed Income Strategy*, we discussed the attractive yields offered on Guaranteed Investment Certificates (GICs) by major issuers in Canada. As investors are looking to reallocate funds to shorter duration investments, including corporate credit securities, to mitigate the risk of higher interest rates, we recommended GICs as a short-term substitute to financial institution deposit notes and subordinated bonds. Rarely have we considered GICs as good investments in lieu of regular corporate bonds, but in the current low yield environment we believe that there are compelling arguments for GICs to be an integral part of a short-term fixed income portfolio strategy for the following reasons:

1) The best GIC rates from Schedule I[1] financial institutions are 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.

2) Given the small probability of a rate hike by the Bank of Canada (BoC) in the near future, and the resultant dearth of reinvestment opportunities, a short-term GIC would offer a generous yield pick-up over current bank bonds.

3) The addition of GICs should help reduce a portfolio's price sensitivity/duration risk to changes in interest rates.

4) In line with our recommended strategy, we believe GICs 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 generally 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 Canadian Deposit Insurance Corporation (CDIC) coverage. Unlike most fixed income securities, GICs benefits 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, investment above CDIC insured amounts is not guaranteed and in the context of a default or bankruptcy of the issuing institution, the GIC would be fully at risk. Unfortunately, some investors have tended over the years to make the erroneous assumption that, since the first $100,000 is guaranteed then, by extension, larger balances are also secure.

Not All Institutions are Created Equal

When GIC risks are addressed in general, we often point to inflation and taxes as the most important. We also highlight the fact that most GICs offer very limited secondary liquidity which, if it does exist, normally comes at a cost in the form of a penalty. Rarely have issuer's specific risks been explicitly addressed and discussed.

[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 here.*

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All figures in C$ unless otherwise noted

In the corporate 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 homogeneity among issuers, they are not all created equal.

- 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 others will rely primarily on retail deposits as their core source of funding.
- 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 are at risk of rising. 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.

Canada also has 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 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. In effect, the Canadian market has not suffered any major financial failures since the mid-1990s contributing to the general confidence in the GIC market (see Figure 1). However, over the years we have had our 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 slowdowns in the real estate market.

Figure 1: Notable Banks 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 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 the portfolio size increases, and individual 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, we recommend that investors apply the same prudent portfolio principles and risk management guidelines for GICs that they use for all of their portfolio investment decisions.

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