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Private Client Division

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Investing in Strip Bonds

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INVESTING IN STRIP BONDS

When you invest in debt securities, it's important to choose the type of instrument that meets your personal investment objectives. Key considerations include credit quality, level and frequency of interest payments, and term-to-maturity.

For investors who require income, there is a wide variety of interest-bearing bonds to choose from. For investors who do not currently require income, or who are saving for future goals, strip bonds are an ideal choice.

Strip bonds offer many benefits, including a wide range of issuers and terms-to-maturity, compound interest, and competitive returns. For these reasons, strip bonds are a popular investment, particularly for registered accounts such as Self-Directed RRSPs and RRIFs.

Moreover, during periods of falling interest rates, strip bonds are appealing to trading-oriented investors for their growth potential.

WHAT ARE STRIP BONDS?

Strip bonds are created when the interest payments are notionally separated from the principal amount of a bond or debenture. Once separated, the principal amount (or residue) and the interest payments (or coupons) are considered independent investments.

Like treasury bills, strip bonds are priced at a discount to their maturity value. The extent of the discount reflects the issuer's credit rating, prevailing interest rates and the term-to-maturity of the investment. The difference between the discounted purchase price and the maturity value is an investor's return.

For example, a Government of Canada strip bond with a term of 10 years and a maturity value of $15,000 can be purchased for $8,336*. The difference between the purchase price and the maturity value ($6,664 in this example) represents a yield-to-maturity of six per cent compounded annually.

HIGH QUALITY ISSUERS

Like their whole bond equivalents, strip bonds are evidence of a debt. Consequently, strip bonds created from high-quality government bonds and corporate debentures offer a high degree of security.

POWER OF COMPOUND INTEREST

As strip bonds are discount securities, an investor pays the present value of the maturity amount. This translates into a relatively small cash commitment at the time of purchase. Due to the longer term power of compound interest, a modest investment today can grow substantially over time. For example, at a rate of six per cent compounded annually, the value of a strip bond will double over a 12-year period.

Unlike conventional interest-bearing debt securities, the interest on a strip bond compounds until maturity. Compound interest is an advantage for investors who do not require income, as it can be difficult to efficiently reinvest periodic cash flows. This problem, known as reinvestment rate risk, does not occur with strip bonds because there are no interest payments prior to maturity.

* as at November 1, 1999

WIDE RANGE OF TERMS

Terms-to-maturity range from six months to 30 years. This extensive selection allows investors to fine tune the timing of cash flows to coincide with future cash needs.

COMPETITIVE RETURN

The return-to-maturity on a strip bond is generally higher than on an interest-bearing bond of equal term and quality. The return-to-maturity is generally competitive with and often exceeds GICs. The extent of the yield advantage will vary depending on market conditions.

PRICE VOLATILITY

As with conventional interest-bearing securities, the market price of a strip bond will fluctuate with prevailing interest rates. When interest rates rise above the yield on the strip bond, its market price will tend to fall. Conversely, when prevailing interest rates fall below the yield on the strip bond, its market price will tend to rise.

However, the market price of a strip bond will be significantly more volatile than the price of a conventional interest-bearing bond with the same credit risk and term-to-maturity. When prevailing rates rise, the market price of a strip bond will tend to fall to a greater degree than the market price of a conventional interest-bearing debt security with the same credit risk and term-to-maturity. Conversely, when prevailing rates fall, the market price of a strip bond will tend to rise to a greater degree than the market price of a conventional interest-bearing debt security with the same credit risk and term-to-maturity.

The primary reason for such price volatility is the fact that no interest is paid prior to maturity. As a result, there is no opportunity to reinvest interest payments at prevailing rates of interest prior to maturity. Without this reinvestment opportunity, the full impact of a change in interest rates is reflected in the strip bond's market price.

The table below illustrates the change in the market price of strip bonds compared to conventional bonds given a one percentage point change in interest rates. As with conventional bonds, price volatility on strip bonds increases with term-to-maturity.

MARKET PRICE VOLATILITY

	Price @ 6%	Price @ 5%	% chg.	Price @ 7%	% chg.
6% 5-yr bond	100.00	104.38	+4.38%	95.84	-4.16%
5-yr strip bond	74.41	78.12	+4.99%	70.89	-4.73%
6% 20-yr bond	100.00	112.55	+12.55%	89.32	-10.68%
20-yr strip bond	30.66	37.24	+21.46%	25.26	-17.8%

Numbers are for example purposes only.

TRADING OPPORTUNITIES

The increased price sensitivity of strip bonds to interest rate changes provides periodic trading opportunities. For example, when interest rates are forecast to fall, trading oriented investors will purchase strip bonds for their growth potential. Conversely, when interest rates are forecast to rise, traders are inclined to reduce their exposure to long-term strip bonds.

Investors who buy strip bonds with the intention of holding until maturity are unaffected by such fluctuations in market value, as the maturity value of the investment remains constant.

ANNUAL TAXATION

When held to maturity, the difference between the discounted purchase price and the maturity value is taxable as interest income. When purchased in a taxable account, investors are required to include in income in each year a notional amount of accrued interest, notwithstanding that no interest is received in the year. When purchased in a non-taxable account, the tax on accrued income can be deferred until the funds are withdrawn.

In summary, high-quality strip bonds are an ideal investment for your Self-Directed RRSP or RRIF. Compound interest, a wide range of terms and issuers and a known return-to-maturity make strip bonds a wise choice for investors seeking safe returns. For further information, please consult your BMO Nesbitt Burns Investment Advisor or visit us on the Web at www.bmonesbittburns.com to find the BMO Nesbitt Burns office nearest you.

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