PWL

A Guide to Fixed-Income Investing

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This report was written by Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the author and do not necessarily represent the views of PWL Capital Inc.

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6. Fixed-Income Vehicles

a. Individual Bonds

Individual bonds, in and of themselves, are fine investments. However, because of the fragmented nature of the market, they are very costly to acquire. With the current low interest rates, the transaction cost of building a diversified portfolio of individual bonds is likely to eat most of the returns.

Default risk is another flaw of individual bonds. Aside from federal government bonds, which pay the lowest yields, most bonds entail a risk of default. This risk has a low probability, but if it materializes, it has a high impact: most bonds are worth 40 cents on the dollar or less following a default.

A handful of individual bonds do not offer a proper cushion against default risk. Only a broadly diversified set of issuers can dilute the impact that a default would have on a portfolio. Because of the diversification they offer, we believe bond ETFs and mutual funds are, in most instances, superior investments to individual bonds.

b. Passive Bond ETFs

By contrast to individual bonds, bond ETFs benefit investors with broad diversification at a low cost. While commissions on bond transactions are expensive for individuals, institutions (especially the large ones) benefit from huge bargaining power. Therefore, bond ETFs can provide investors with extreme diversification at an extremely low cost.

c. Passive Mutual Funds

The main advantage of bond mutual funds is that they allow investors to make systematic contributions (for savers) or withdrawals (for retirees). On the minus side, mutual funds charge higher fees than do passive ETFs. For example, the TD E-Series Canadian Bond Index Fund (one of the lowest-cost passive bond funds in Canada) has an average Management Expense Ratio (MER) of 0.50%, compared to the 0.09% for the BMO Aggregate Bond Index ETF (the largest and one of the least expensive bond ETFs in Canada).

Another advantage of mutual funds over ETFs is the ease of acquiring them: you just ask your advisor to buy shares of the mutual fund and you will pay exactly the same price as other investors on that day: the shares' net asset value at closing. On the other hand, purchasing shares of an ETF involves entering a trade on the stock exchange, which is more complicated.

In a nutshell, passive mutual funds provide the benefits of discipline for savers and simplicity for retirees. For those with small amounts to invest, the discipline benefits of mutual funds will probably outweigh the cost advantage of ETFs. For example, a 0.41% cost advantage on a $10,000 investment will only cost $41 per annum, which is possibly worth the benefits of staying on track with your savings plan. When the portfolio gets much larger, the cost advantage of ETFs becomes more significant.

d. GICs

GICs have advantages and drawbacks. First, if you have only a small amount to invest (let's say $5,000), your institution is unlikely to offer you its best interest rate. By contrast, if you can benefit from the best GIC rates in the market, you're likely to obtain yields that resemble those of corporate bonds, while enjoying a credit quality similar to that of federal government bonds, since GICs are insured by the Canadian Deposit Insurance Corporation (CDIC). Please note that only GICs denominated in Canadian dollars and with original maturities of five years or less are insured. The insurance only covers a maximum of $100,000 per financial institution and per type of account. For more details: https://www.cdic.ca/your-coverage/protecting-your-deposit/

There is another important drawback to keep in mind: GICs are not liquid, and your capital is, under most circumstances, frozen until maturity.

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