THE UNIVERSITY OF BRITISH COLUMBIA

USING GUARANTEED INVESTMENTS IN YOUR INVESTMENT STRATEGY

You will need to consider if Guaranteed Investments are right for you and how best to use them. Guaranteed Investments include Guaranteed Funds and Guaranteed Investment Certificates (GICs). The remainder of this article will refer to Guaranteed Investments as GICs.

The "Laddering Strategy"

One potential GIC strategy is to use "laddering" as a means of both cash-flow planning and as protection against possible increases in interest rates. Laddering refers to the technique of staggering the GIC maturity dates. For example, let's say you want to invest $100,000 in GICs and you want some flexibility with these funds. You could stagger the GIC maturities by investing $20,000 for 1 year, $20,000 for 2 years, $20,000 for 3 years, $20,000 for 4 years and $20,000 for 5 years. You would then have approximately $20,000 maturing every year. Further, if you did not need these funds on their maturity, you could reinvest them in another 5-year GIC. Therefore, you would have approximately $20,000 maturing every year and you would (eventually) earn the average 5-year GIC rate, which historically has been higher than a 1-year GIC rate.

This laddering strategy provides flexibility and also protects your investment from changes in interest rates. If interest rates were to rise (say due to inflationary pressures) then at least 20% of your GIC funds (assuming they are rolled over) would be at the higher interest rate, which would provide some protection against rising interest rates. If interest rates were to decrease, then only 20% of your funds would be at the lower interest rates, which would provide some protection against falling interest rates.

Approaching and During Retirement

When you are still working and accumulating retirement savings over a long time period, stock market volatility is not as an immediate concern as long as your portfolio is properly diversified. One of the greatest risks in retirement planning, however, is having the stock market drop substantially just before or just after you retire (assuming that a portion of your retirement savings is invested in the stock market). Proper diversification techniques alone will not offset this problem.

One way to address this problem is to hold some GICs in your portfolio as you approach your desired retirement age so that you will have a certain amount of money maturing when you retire. This could also allow you to manage the volatility of returns from the stock portion of your portfolio more effectively. For example, you could plan to have three to five years' worth of retirement income in GICs that mature when you want to retire. If the stock market declines in value in the year in which you intend to retire, you can draw your income from the matured GICs instead of the stock portion of your portfolio. This would allow time for the rest of your investments to (hopefully) recover during the stock market correction without being forced to redeem funds from the more volatile (i.e. stocks) portion of your account to maintain your desired income.

When generating income at or during retirement, it is important **not** to withdraw funds from an investment that is declining in value. If you were to retire at a time when the stock market is performing poorly (and you need to generate income from this portion of your portfolio), you may end up depleting your capital at an alarming rate. Ultimately, this will reduce the chance of your investments being able to generate the income you need throughout your remaining retirement years.

You could use GICs to implement the following risk reduction strategy. This example is based on investing three (3) years' worth of your required annual income. For example, let's say that you need $50,000 of annual income. First, invest one year's required income ($50,000) in the Short Term Investment Fund (STIF) and this will be used for your first year's income needs. Additionally, invest another one year's income ($50,000) in a 1-year GIC and invest another one year's income ($50,000) in a 2-year GIC.

The benefit of using GICs for this strategy is both the interest rate and principal amounts are guaranteed. Their value will not fluctuate with market changes and their value is known for a specific future maturity date. A bond fund is **not** as suitable for this purpose because its value will fluctuate with changes in interest rates – as interest rates rise, bond market values decline.

The rationale behind this strategy is that the portion of funds invested in the STIF will deplete itself over the first year. After the first year, if the growth (i.e. stock) portion of your FPP account has grown in value then you take the following year's income from this growth portion to replenish the allocation in the STIF. If, however, the stock market has performed poorly and the growth portion of your pension funds has decreased in value, then you could use the maturing GIC to replenish the STIF allocation. If the maturing GIC is not needed for that year's income, it could be re-invested in another 2-year GIC.

This strategy means that unless there is a stock market decline that persists over three years, you would not have to take income from the stock portion of your pension investments while these stocks are decreasing in value. So, while the stock market is declining, you will not be digging into the capital (for at least three years) and hopefully you have enough fixed income investments to weather the storm.

This strategy works only because you avoid taking income from any part of your portfolio that is declining in value. The rationale for this strategy is to increase the life span of your portfolio.

Timing Considerations

As mentioned, one of the greatest risks involved in retirement income planning is the risk of the stock market correcting (dropping) right before or right after you retire.

Your portfolio should be aligned with your retirement objectives at least five years before your retirement date. So, five years before retirement you should consider having at least two to three years' worth of your desired retirement income in GICs that will mature the day you retire.

It's important to note that your portfolio must be monitored each year, as you must also decide whether to take the following year's income from the fixed income portion of your account or from the growth portion of your account. In the years when the stock market earns high returns, not only should you use this growth for income purposes, but you should also take additional funds from the growth account to add to the fixed income portion of your account, thus rebalancing your portfolio.

Always Consider Inflation

Inflation is usually measured by the year over year change in the Consumer Price Index (CPI). It measures how much a "basket of commonly purchased goods and services" increases in price over time. The following chart demonstrates that if you would like an income of $50,000 per year during retirement, you will need to spend more every year to maintain that standard of living.

For example, if the inflation rate was 4%, in 20 years, you would need an income of $109,556 in order to buy the **same** basket of goods which you could buy today for $50,000.

Inflation Rate	10 years	20 years	30 years
2%	$60,950	$74,297	$90,568
3%	$67,196	$90,306	$121,363
4%	$74,012	**$109,556**	$162,170
5%	$81,445	$132,665	$216,097

Inflation is one of the biggest potential drawbacks with GICs. In any overall investment strategy it is imperative that you invest to beat inflation. The ultimate goal of investing for retirement is to generate an income that maintains the lifestyle you want in retirement. The only way you can do that is to have your investments earn more than the rate of inflation.

GICs and Long-Term Investing

GICs can be a powerful retirement investment strategy as you approach retirement to reduce and mitigate possible stock market volatility. However, in most cases, GICs are not a good long-term investment for building wealth. A GIC portfolio has historically returned substantially less than a diversified portfolio over time (i.e. the UBC Balanced fund) and thus needs to be used wisely.

A difference in returns dramatically affects the value of your investments over a longer period of time. Compare the following:

- If you invest $20,000 at age 35 and earn 3% per year:
  At age 65, you would have $48,545 in your account.

- If you invest the same $20,000 at age 35 and earn 5% per year:
  At age 65, you would have $86,439 in your account.

The 2% difference in investment return would represent an 84% difference in your account balance.

GICs can be a valuable investment to be used in your portfolio; however, it is important to consider that personal situations vary greatly. You should consult with your financial advisor about your personal circumstances and investment goals. ■

This article was originally provided by Clay Gillespie of RGF Integrated Wealth Management for the UBC Faculty Pension Plan Q2 2012 *Pension News* newsletter. Clay Gillespie is the Managing Directory, Financial Advisor and Portfolio Manager at RGF.

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