Can you afford to buy Canada Savings Bonds?

IT'S YOUR MONEY

Paul J. Rockell

As regular as the leaves turning color!

During the month of October, the radio and television stations are filled with commercials (paid for with your tax dollars) stressing the winders of Canada Savings Bonds.

CSBs are unique investment instruments that are accepted unquestioningly. They are perceived to be guaranteed, no risk investments and they are purchased unwittingly every fall by many Canadians.

However, risk is not overcome by simply allowing an investor to get their money back anytime. When you consider the three major changes that have been introduced by the government in recent years, you'll soon discover Canada Savings Bonds hold little appeal for the discerning investor.

First, CSBs hold no minimum rate guarantee after the first year. In the past there were floor rates, but not now. There's no more built in protection from a drop in interest rates.

Second, recent issues of CSBs have been priced less competitively than other investment alternatives and even when short term rates change significantly during the year and Canadians start cashing their bonds, the government is slow and stingy in making adjustments. Third, tax reform has eliminated the $1,000 investment income deduction, making CSBs less attractive to investors who used that deduction to shelter bond interest from tax. They are now taxed from the first dollar of interest.

Finally there is the effect of inflation. Lets say, for example, that you bought a $1,000 bond and planned to hold it for five years. Last October the rate was 7.75 per cent (but probably six per cent or less this year) and with interest rates trending down and no rate guarantee on the bond after year one, you may only average five to six per cent for the five years.

Lets assume inflation will average three per cent over the next five years. In real terms that means your original $1,000 will lose three per cent of its value in true purchasing power each year. True it will still have a face value of $1,000, but it will only buy $858.73 of goods and groceries five years from now.

Now lets consider the effect of income tax. At the tax rate of 41 per cent, which is your marginal rate with taxable income over $28,000, you will have only $59 out of every $100 in interest that your bond earns.

If this year's rate is six per cent, the net effect of tax and inflation is that out if $60 interest per $1,000 bond, you will pay $1 in taxes and lose $30 to inflation, leaving you with a net gain of $5.40. In the lowest tax bracket you would be left with a bit more and in the higher tax brackets , a bit less.

Many people buy CSBs on the payroll savings plan. Do you know that you have to pay approximately $22 per week for 48 weeks to buy a $1,000 bond? That's $1,056. You are paying interest to buy the bond with after tax money. Then the government taxes you on the interest the bond earns. Ottawa rarely misses a tax opportunity.

Are CSBs really a risk-free place to put your money? I don't think so.

What are the alternatives? Well, it depends on your investment objectives. If you are just going to cash in the bond next year to buy Christmas presents or head to Florida, many people don't bother checking alternatives. Money market T-Bill mutual funds are even more liquid, just as safe, and often earn more.

If you are saving for the medium term, say five to 10 years, (maybe a house down payment) Canada Savings Bonds will yield very little real growth after taxes and inflation, it may take 10 years rather than five to reach your objective.

If you are saving for retirement either inside or outside of an RRSP, you owe it to yourself to check out the many alternatives that will best suit you. If you are retired, there are excellent high-income mutual funds which could provide more income. Also, is you don't know what a Systematic Withdrawal Plan is, you should make it your business to contact an independent financial planner and find out.

If you are saving for future retirement or are already retired and facing lower income because of declining interest rates, it could be in your best interest to talk to an independent financial planner. He or she will have knowledge of tax saving alternatives as well as the availability of a variety of financial products from a good number of financial institutions to tailor a custom financial program for you.

All of this without paying a fee for his or her time. Mostly independent financial planners earn their incomes from finders fees associated with financial products that you may buy. You don't have to accept their advice, but you'll receive some good ideas when you talk to one.

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