Are Your Investments Paying You Enough?

By Rob Schmidt CFP, FMA, ACUIC
Investment Advisor, Qtrade Advisor

Generating income is becoming more challenging with interest rates at a historical low. Many of us remember the interest rates of the 1980’s and into the 1990’s with attractive deposit rates that ranged into the double digits. Now we're fortunate if we can get 3%. That has a dramatic impact on an investor’s cash flow and the ability to provide a comfortable retirement income.

Will interest rates increase? Yes, to some extent, but when and by how much is the next question. Leaving your money in liquid or short term deposits while you wait for rates to rise can be a risky plan. Focusing on short term, liquid savings products can result in giving up significant income while you wait. If rates don't increase, you will need an even higher rate to make up for the amount that you gave up while waiting.

The next problem and quite often the bigger problem with interest income is income tax. Interest is taxed at your highest marginal tax rate. You want to ensure your quality of life is maintained in the fashion you desire. Taxes can seriously eat into your after-tax return which can put your lifestyle at risk.

The following investment types all generate income and each has its own benefits and risks:

**Traditional Fixed Income** - includes Guaranteed Investment Certificates (GICs) and Bonds. GIC’s are basic interest bearing deposits usually ranging up to 5 years and are issued by various financial institutions. They are usually guaranteed by Canada Deposit Insurance Corporation (CDIC) to a maximum of $100,000. Bonds can be issued by companies or different levels of government and will range from short term to over 30 years. The safety is based on the strength of the issuer. The value of a bond will fluctuate, sometimes significantly, depending on what interest rates are doing. Rising rates will generally bring the value of a bond down. Interest earned on GIC’s and bonds is taxed at your highest marginal tax rate.

**Equity Investments** - Common and Preferred Shares can be an appealing source of tax-friendly dividend income that often increases over time. Some of Canada’s largest companies can provide a relatively safe investment for growth and growing income as part of your portfolio. Dividends paid are frequently higher than bond or GIC rates and have the added benefit of being taxed at a lower rate. Dividends from Canadian corporations are eligible for a Dividend Tax Credit resulting in the investor keeping a higher percentage of the income earned. The value of the underlying investment can fluctuate significantly, so it is important to understand what you own.

**Real Estate** - owning Real Estate can produce attractive cash flow through rental income. Direct investing in real estate has its drawbacks along with its benefits, such as the amount of money required and the liquidity of the investment. There are however other ways to invest in real estate including Real Estate Investment Trusts (REITs) or specialty Mutual Funds.

**Mutual Funds** - conservative mutual funds can provide an excellent source of tax efficient income. With the thousands of mutual funds available to Canadian investors it is important to understand the mandate and structure of the fund extremely well. Types of funds that can provide regular income include balanced funds, bond funds, dividend funds, and monthly income funds. All have their unique risks and benefits.

**Corporate Class Funds** - this structure of mutual funds takes tax-efficiency to another level. Structured as a corporation rather than a trust like a traditional fund provides added flexibility to reduce and defer income taxes in non-registered investment portfolios (outside of an RRSP or TFSA). Within this structure, interest income can be either deferred or converted to a more tax efficient form such as dividends or capital gains. The goal is to provide a better after-tax return for the investor.
The Effect of Taxes on your Investment Return

<table>
<thead>
<tr>
<th><em>Tax rates based on an income of $41,544 to $83,088 in Saskatchewan</em></th>
<th>$100,000 earning 3.5% Interest</th>
<th>$100,000 earning 3.5% Dividend</th>
<th>$100,000 producing a 3.5% Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before Tax Income</td>
<td>$3,500.00</td>
<td>$3,500.00</td>
<td>$3,500.00</td>
</tr>
<tr>
<td>Effective Tax Rate</td>
<td>35.00%</td>
<td>10.67%</td>
<td>17.50%</td>
</tr>
<tr>
<td>Tax Paid</td>
<td>$1,225.00</td>
<td>$373.45</td>
<td>$612.50</td>
</tr>
<tr>
<td>Net Income</td>
<td>$2,275.00</td>
<td>$3,126.55</td>
<td>$2,887.50</td>
</tr>
<tr>
<td>Return After Tax</td>
<td>2.27%</td>
<td>3.13%</td>
<td>2.89%</td>
</tr>
</tbody>
</table>

*2011 Saskatchewan Tax Rates – Canada Revenue Agency*

Sheltering the right investments can help too. All investment portfolios require a mix of safe interest-bearing investments along with some conservative growth to protect your purchasing power from inflation. Placing the higher-taxed investments like GIC’s and bonds in your sheltered Registered Plans such as RRSP, RRIF or TFSA allows for a more tax-friendly portfolio. Have you maximized your Tax Free Savings Account contribution yet?

How is your portfolio structured for tax efficiency? Has it just evolved into what it is today? Products have progressed over the years. Have your investments kept up? Is it time to have a comprehensive review? A comprehensive review is looking at the whole picture and not just an account or product. How your portfolio is structured is as equally important as what you’re invested in.

About Rob

Rob knows what he’s talking about and after you’ve met with him about your investment situation you will too. Rob has thirty one years of experience in the financial services industry. He has advanced his career through many challenging positions including lending, investments, finance, sales and management. Rob isn’t just a “numbers guy,” he can also be found fixing things around the house.

Regina Quance Office
2615 E Quance Street
Regina SK S4V 3B7
PHONE 306-546-1040
EMAIL rschmidt@tcuwm.sk.ca

There’s more to investment income than just finding the best interest rate. While it isn’t that difficult to shop around for rates, it requires some serious expertise and thought to make sure you receive the greatest overall return on your investments. TCU Wealth Management has been built to help you make informed decisions. Feel free to contact myself or any one of the TCU Wealth Management Team in Regina or Saskatoon for any of your money management needs. We look forward to helping you. You’ve worked hard to earn your money. You want to be sure you keep what you’re entitled to.