

10-12-07 – G & M – Why investors can't have it both ways – GIC's

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Investor Clinic

Why investors can't have it both ways

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From Wednesday's Globe and Mail

Published Tuesday, Dec. 07, 2010 5:17PM - Last updated Tuesday, Dec. 07, 2010 5:29PM

People want it both ways.

They want to gorge on pizza and chocolate cake, and still lose weight. They want to drive an SUV, and still get good gas mileage. And when it comes to investing, they want to take minimal risk and still get big returns.

Sorry, folks, doesn't work that way.

This thought crossed my mind as I read a press release from Bank of Montreal touting a new "market-linked" guaranteed investment certificate that offers "the potential for bigger gains with the same safety net attached." Hey, sounds good, right? We could all use bigger gains with no extra risk.

So this week, we're going to lift the hood on this product – officially called the BMO Blue Chip GIC. We're going to delve into the arcane terms and conditions that investors need to understand before they sign on the dotted line. Then we're going to show you why this product – and similar ones offered by other financial institutions – are a great deal for the bank, but a lousy deal for you.

The Sell

Buying the BMO Blue Chip GIC is a bit like spinning a roulette wheel where you can only win – or so it seems. The GIC has a guaranteed minimum return of 0.2 per cent over its one-year term. That's the worst case.

The best case is that investors can earn up to an additional four percentage points – the "variable return" – for a total of 4.2 per cent. That seems pretty good considering most one-year GICs are yielding less than half of that. But as we'll see, this roulette wheel favours certain outcomes over others.

The Variable Return

The GIC's variable rate of return – that is, the premium over and above the guaranteed 0.2 per cent – is determined by the performance of a “reference portfolio” of 10 blue-chip stocks: Power Corp. of Canada, Goldcorp Inc., SNC-Lavalin Group Inc., Thomson Reuters Corp., Fortis Inc., Toronto-Dominion Bank, Rogers Communications Inc., Brookfield Properties Corp., TransCanada Corp. and Canadian Natural Resources Ltd.

These are stocks that any investor would be proud to own, except that if you buy the BMO Blue Chip GIC, you don't actually own the stocks. Nor do you collect the dividends. The stocks are merely used as a “reference” for calculating the variable return. Problem is, the formula the bank uses to calculate the variable return is complex and heavily tilted in its favour.

The Formula

For starters, if a stock in the portfolio posts a positive return – regardless of how big – the “effective return” of that stock is deemed to be 4 per cent. That's great if the stock rises 1 or 2 per cent, because the “effective return” will be boosted to 4 per cent. The bad news? If a stock soars 50 or 100 per cent, the “effective return” is still 4 per cent. In other words, any big gainers will have little impact on the portfolio. Making matters worse, dividends are not included in the return calculation. In the real world, of course, dividends matter a great deal. Here, they are conveniently ignored.

It Gets Worse

Now, let's look at how losses are treated. If a stock drops by between zero and 10 per cent, the “effective return” is the same as the actual loss. Only when a stock drops by more than 10 per cent is the “effective return” capped at negative 10 per cent. The bottom line here is that the formula is asymmetrical: Stocks that plunge have more influence than those that soar.

We're Almost There

Now we come to the final step: Determining the variable return of the GIC.

The variable return is calculated as the average of the “effective returns” of the stocks in the reference portfolio. In other words, add up the “effective returns,” divide by 10, and that's your variable return. Now think about the implications here: Because of the way the formula is constructed, the only way to achieve the maximum variable return of 4 per cent is for all 10 stocks to rise. If just one or two stocks fall, the variable return will shrink, possibly a lot.

To use a baseball analogy, even if you hit a bunch of home runs, a few strikeouts could quickly wipe out your gains. Let's illustrate this. Imagine a scenario where seven of the 10 stocks rise by 100 per cent each, and the others fall by 8, 10 and 15 per cent, respectively. If this were a real portfolio – assuming equal investments in each stock – the return would be a juicy 67 per cent. Plus, the investor would get the dividends, which would add nearly three percentage points in yield.

Now, care to guess what the Blue Chip GIC would return under identical circumstances? 3 per cent? 2 per cent? 1 per cent? Nope. The minimum 0.2 per cent. Worse, after inflation, you'd be losing money. (If you're wondering about the math, the seven winning stocks would generate a total “effective return” of 28 per cent. Subtract the three losses of 8 per cent, 10 per cent and 15 per cent – capped at 10 per cent – and you'd be left with a variable return of zero.)

So Much for Safety

What if markets collapse, you ask? Won't it be better to make 0.2 per cent instead of losing 20 or 30 per cent? Absolutely. But if you want safety, you could put a portion of your money in a one-year GIC paying 1.75 per cent (or more if you lock in for a longer period). That's a lot better than 0.2 per cent, and it's both predictable *and* guaranteed.

With some of your money locked up safely, you could invest another chunk of your capital directly in blue-chip stocks or in a low-cost index fund. That way, if the stock market rises, you would actually get market-like returns – including dividends – instead of an “effective return” based on a lop-sided formula.

For its part, the bank says the product, which matures one year from its issue date of Dec. 8, has met with strong consumer response. “We talk to our customers regularly and overwhelmingly they have told us they feel the product effectively balances their objectives of growth and protection at a fair price,” Martin Nel, vice-president of personal lending and investment products at Bank of Montreal, said in an e-mail. “We’ve priced this product to do well in the marketplace. It’s the right product for the times for those looking for a potentially higher return than a traditional GIC without risking principal.”

Running the Numbers

But BMO's own performance data are less than flattering. The bank generated a series of hypothetical results for the product, assuming it had been issued at monthly intervals between October, 2006, and September, 2009. Result: In 69.4 per cent of cases, the GIC would have returned a paltry 0.2 to 1.2 per cent. In just 5.6 per cent of cases, the return would have ranged from 3.2 per cent to the maximum 4.2 per cent. This is a safe investment alright – for the bank.

The lesson here is clear: If you want market-like returns, you have to accept market-like risk. And if you want safety, there are better ways to achieve it.