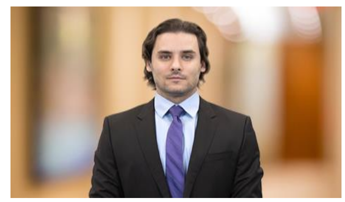
Peak rates and GICs: History suggests bond investors may have reason to be optimistic going forward

Authored by:

Jean Sebastien Nadeau, MBA, CFA, FRM
Co-Portfolio Manager



Daniel Chivu, CIM
Sr. Manager
Multi-Asset Portfolio Specialist

The past two years presented a unique situation for income investors as the appeal of Guaranteed Investment Certificates (GICs) gradually increased with the Bank of Canada's (BoC) rate hiking cycle. The timing and magnitude of BoC's hiking path was not easily predictable however, with inflation and growth offering several head fakes through 2023, prompting calls for a pivot as early as last spring following the U.S. banking turmoil which threatened to spread to other parts of the world. The worst-case scenario did not materialize though, while at the same time, inflation and various metrics of growth began to trend higher into the summer months, prompting the BoC to restart the hiking cycle. We believe this likely caused some buyer's remorse for investors who locked in GIC rates early, only to see them continue rising and missing out on the additional yield.

But even if they were able to time their investment to coincide with the peak of the rate cycle (a notoriously difficult task even for professional money managers), GIC investors would still have been short-changed, having gained no benefit from the subsequent drop in yields later in the year, and missing out on a large percentage of the year's fixed income returns which bond investors fully captured in the 4th quarter of 2023.

There are several additional drawbacks of GICs that funds in the AGF Fixed Income Suite potentially avoid, in particular the AGF Fixed Income Plus Fund and AGF Total Return Bond fund, discussed in this piece, making bond funds a better option for income investors as we approach the end of the current hiking cycle and the eventual pivot from the BoC. While the timing of the first-rate cut remains uncertain, we believe fixed-income investors who position themselves in the AGF Fixed Income Suite early on may potentially reap additional benefits not captured by GIC investors.

A GIC may not be a guarantee.

A misconception with GICs (which likely stems from their name), is that they are guaranteed to pay out the advertised rate and principal, as they don't carry credit risk. While it would be simplistic to say it's fully incorrect, there is certainly a nuance to the answer that should raise some questions for investors.

GIC investors are not exposed to portfolio credit risk the same way bond investors would be since the GICs themselves do not hold investments, but they are exposed to the credit risk of the issuer, which could potentially become insolvent. While CDIC (Canada Deposit Insurance Corporation) insurance provides some protection, it caps the amount at $100,000 regardless of joint or individual ownership, leaving little comfort for investors with larger amounts invested. Institutions such as the main banks are more insulated from this risk as they are generally well-capitalized, but also offer less attractive rates than the smaller credit unions, which are more at risk of becoming insolvent.

If the probability seems low, we need only look back one year to the U.S. banking turmoil in which several multi-billion dollar, publicly traded institutions closed their doors overnight as their deposits were drained due to mismanaged investments. While the Federal government and larger banks eventually stepped in to guarantee deposits, there was no obligation for it to do so, highlighting a very significant credit risk faced by GIC investors that is often not considered, particularly by those held with smaller lenders not deemed systemically important.

All things equal, bond fund investors benefit from CIPF (Canadian Investment Protection Fund) Coverage of up to $3 million for their TFSA, RRSPs, and all other accounts, far exceeding the $100,000 limit of CDIC.

Unlocking Liquidity: A closer look at GICs and the AGF Fixed Income Suite

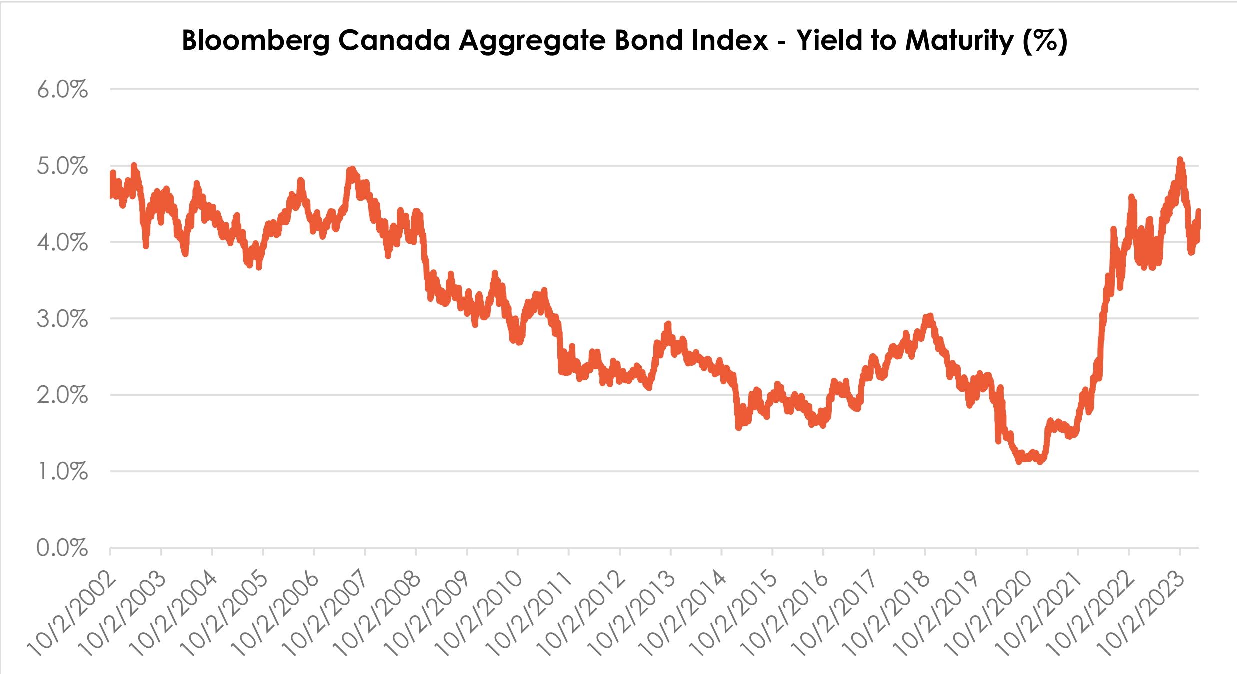
While the prospect of a guaranteed return may sound alluring to investors looking to park excess cash while waiting out market volatility, GICs also suffer from other limitations.

GIC holders also significantly reduce their liquidity, as the highest rates often come with minimum lock-in periods of one year, if not the full life of the GIC, and steep penalties for withdrawing funds early, if at all allowable. In the case of an investor looking to park their cash while waiting for a better opportunity to enter the capital markets in bonds or equities, they may find that the market bottoms out long before their GICs mature, effectively causing them to miss most of the eventual recovery.

By comparison, the AGF Fixed Income Suite allows investors to park their savings in some of the lowest-risk instruments available on public markets as measured by the average portfolio credit rating[1] while earning the most competitive government and corporate bond yields available in nearly two decades, in a fully liquid portfolio structure with no withdrawal or lock-in restrictions. Bonds have also frequently been negatively correlated with stock market returns, providing an

[1] AGF Fixed Income Plus Fund and AGF Total Return Bond Fund Average Credit Rating is A-rated as of January 31, 2024.Source: AGF Investments Inc.

additional advantage while waiting out any equity market turmoil and appreciating, allowing investors to possibly shift some of the profits into equities at a later date.



Source: Bloomberg as of January 31, 2024. One cannot invest directly in an index.

Furthermore, a lack of fixed-income liquidity in retirement portfolios paying out regular income may force investors to withdraw from their equity funds during market sell-offs, potentially causing them to deplete their accounts faster than anticipated. We believe having a healthy allocation to the AGF Fixed Income suite could offset some of the income burden from equities, by providing a stable income flow, limiting the need to sell-off investments during periods of market turmoil.

The hidden costs of being too conservative: The Absence of Potential Capital Appreciation

In addition to carrying the credit risk of the institution where funds are being deposited, GICs harbour several other risks that are harder to quantify in the traditional sense, but should still be part of an investor's due diligence process.

At the heart of the issue lies the concept of opportunity cost, as GIC investors commit their funds for a specified period at a pre-determined rate. In doing so, they forego any potential benefits from factors that would positively impact bond prices but provide no additional benefit for their GIC holdings. In locking in their coupon rate, they sacrifice the potential opportunity for higher returns on a similar investment as interest rates come down.

While the risk of incurring significant opportunity costs has been admittedly low over the past 24 months as bond funds typically suffer in environments of rapidly rising interest rates, the opposite is true when peak rates have likely been reached. GICs only shelter investors from losses on the way up in rates, as the only source of returns is from the generated interest, and they do not benefit from the rise in rates as their interest rates are generally fixed [even step-up GICs only offer modest increases]. In contrast, bonds purchased near the top of the rate cycle earn higher interest as well as benefit from capital appreciation when interest rates fall, providing an additional source of returns for bond investors that is not available with GICs.

Navigating Possible Tax Implications: GICs vs. Fixed-Income Funds

While GICs can be sheltered within tax-advantaged accounts like TFSAs or RRSPs, investors may also choose to hold them in non-registered accounts, as those do not come with any restrictions or withholding taxes upon withdrawal and offer more flexibility for emergency expenses or serve investors who have already reached their contribution limits for their sheltered accounts.

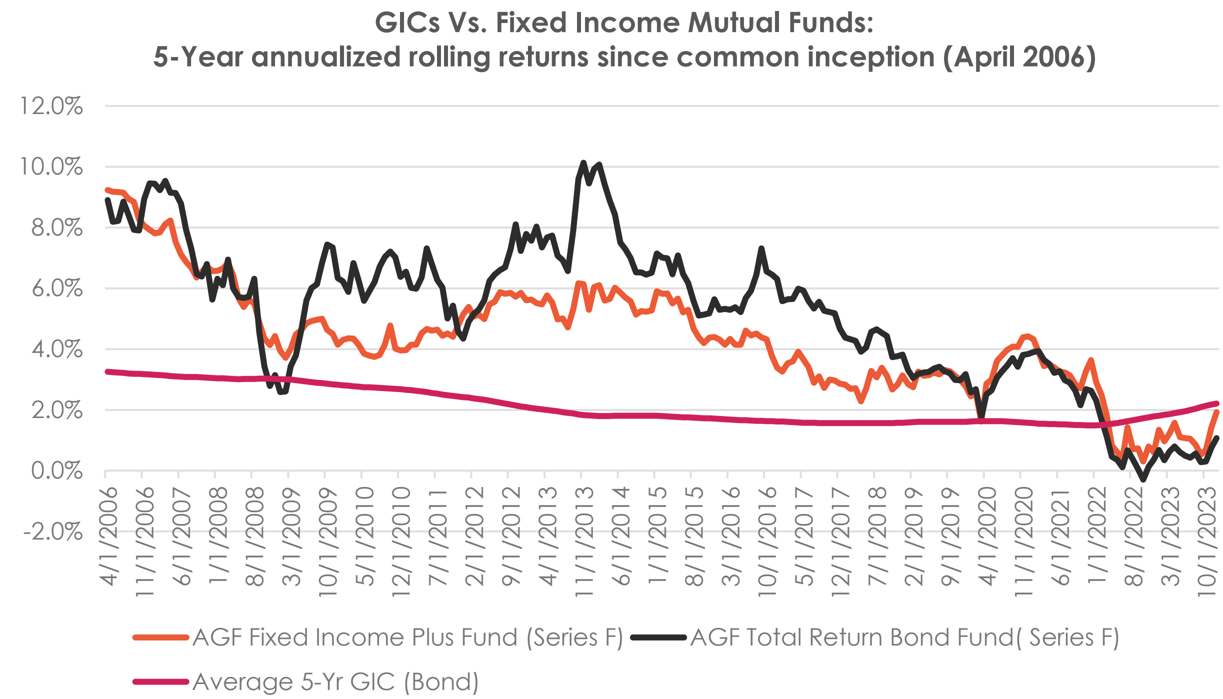
This has the potential to create a problem from a taxation perspective, as the accrued interest payments on GICs must be recorded as earned income even if they haven't yet been paid out to the investor. In the case of GICs with maturities that go beyond the regular tax filing season, it creates a mismatch of cash flow for the investor, who is forced to pay taxes on income that has not yet been received and may not be received for several months, depending on the maturity or yearly compounding date of the GIC.

Secondly, interest income is fully taxed at the investor's marginal tax rate and does not benefit from the advantageous adjustments made to Capital Gains and Dividend income. The regular distributions made by fixed-income funds are often a combination of interest income and capital gains, potentially reducing the tax burden on investors.

Long-term returns historically favour bond funds

Beyond some of the drawbacks associated with GICs listed above, they have also historically failed to provide long-term returns as favourable as products in the AGF Fixed Income suite. While GIC returns may exceed those of bonds for short periods, these short-term returns generally do not stand the test of time.

When looking at the 5-year annualized rolling returns of the AGF Fixed Income Plus Fund (Series F) and AGF Total Return Bond Fund (Series F) vs GICs, to smooth out the effects of short-term volatility, there are only two instances where the GIC returns outperformed the AGF suite, both coinciding with unique global macroeconomic events; the Great Financial Crisis, and the COVID-19 Pandemic and subsequent rate hiking cycle. During any other period over the last two decades, the AGF Fixed Income Suite outperforms GICs by a significant margin, spanning several economic and rate cycles.



Source: AGF Investments Inc & Bloomberg, as of Dec 31, 2023.**Past performance is not indicative of future results.**

Overall, GICs can be a useful tool in providing investors with a rate of return during volatile market environments, albeit a fairly modest one over medium-long periods. At the same time, they suffer from several drawbacks that minimize their overall appeal for periods longer than a year, including lower liquidity, tax considerations, limited compounding, and historically weaker returns when compared to the AGF suite of fixed-income funds. While fixed-income funds are more exposed to interest rate risk and can underperform in an environment where inflation remains sticky and the Central Bank is forced to raise rates again, we believe recent data and comments from the BoC strongly suggest rates are at their peak, with the next move likely being a rate cut.

Annualized Returns as of January 31, 2024 (in Canadian Dollars, net of fees)	3 Month Return	YTD Return	1 Year Return	3 Year Return	5 Year Return	10 Year Return
AGF Total Return Bond Fund (Series F)[1,2]	5.14%	-0.13%	2.52%	-1.70%	0.79%	2.01%
AGF Total Return Bond Fund (Series MF)[1,2]	4.90%	-0.22%	1.62%	-2.55%	-0.08%	1.18%
Blended Benchmark	7.82%	-0.20%	5.51%	-2.07%	1.05%	4.20%

Annualized Returns as of January 31, 2024 (in Canadian Dollars, net of fees)	3 Month Return	YTD Return	1 Year Return	3 Year Return	5 Year Return	10 Year Return
AGF Fixed Income Plus Fund (Series F)[3,4]	7.21%	-0.98%	3.00%	-2.85%	1.22%	2.00%
AGF Fixed Income Plus Fund (Series MF)[3,4]	7.00%	-1.06%	2.14%	-3.58%	0.47%	1.08%
Bloomberg Canada Aggregate Index	6.38%	-1.48%	1.99%	-2.84%	0.73%	2.00%

Source: AGF Investments Inc. & Morningstar, as of January 31, 2024. **Past performance is not indicative of future results**. *One cannot invest directly in an index.* [1]Harmony Canadian Fixed Income Pool merged into AGF Fixed Income Plus Fund on June 28, 2019. AGF Canadian Bond Fund and AGF Inflation Plus Bond Fund merged into AGF Fixed Income Plus Fund on May 20, 2016. The merger may have material effect on the performance of the fund. [2] On September 1, 2019, AGF Fixed Income Plus Fund benchmark changed from the FTSE Canada Universe Bond Index to the Bloomberg Canada Aggregate Index. The benchmark change was applied from that date forward. [3]AGF Global Bond Fund merged into AGF Total Return Bond Fund on May 15, 2020. The merger may have material effect on the performance of the fund. [4]*Blended Benchmark is composed of 40% Bloomberg Global High-Yield Bond Index (Hedged to CAD) / 40% Bloomberg Emerging Markets Bond Index (Hedged to CAD) / 20% Bloomberg Global Aggregate Index*.AGF Fixed Income Plus Series MF MER: 1.50%, Series F MER: 0.68%, as of September 30, 2023. AGF Total Return Bond Fund Seres MF MER: 1.78%, Series F MER: 0.91% as of September 30, 2023. AGFI may, in its discretion, temporarily waive some or all of the expenses of the Fund, which will result in a reduction in the MER. AGFI may cease to offer any such waiver at any time without notice. FundGrade A+® is used with permission from Fundata Canada Inc., all rights reserved. The annual FundGrade A+® Awards are presented by Fundata Canada Inc. to recognize the "best of the best" among Canadian investment funds. The FundGrade A+® calculation is supplemental to the monthly FundGrade ratings and is calculated at the end of each calendar year. The FundGrade rating system evaluates funds based on their risk-adjusted performance, measured by Sharpe Ratio, Sortino Ratio, and Information Ratio. The score for each ratio is calculated individually, covering all time periods from 2 to 10 years. The scores are then weighted equally in calculating a monthly FundGrade. The top 10% of funds earn an A Grade; the next 20% of funds earn a B Grade; the next 40% of funds earn a C Grade; the next 20% of funds receive a D Grade; and the lowest 10% of funds receive an E Grade. To be eligible, a fund must have received a FundGrade rating every month in the previous year. The FundGrade A+® uses a GPA-style calculation, where each monthly FundGrade from "A" to "E" receives a score from 4 to 0, respectively. A fund's average score for the year determines its GPA. Any fund with a GPA of 3.5 or greater is awarded a FundGrade A+® Award. For more information, see www.FundGradeAwards.com. Although Fundata makes every effort to ensure the accuracy and reliability of the data contained herein, the accuracy is not guaranteed by Fundata.

AGF Fixed Income Plus Fund won in the Canadian Fixed Income CIFSC Category, out of 311 funds. The FundGrade A+ start date was 1/31/2014 and the FundGrade A+ end date was 12/31/2023.

The views expressed are those of the author and do not necessarily represent the opinions of AGF, its subsidiaries or any of its affiliated companies, funds, or investment strategies.

This material is for informational and educational purposes only. It is not a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. It is not intended to address the needs, circumstances, and objectives of any specific investor. This information is not meant as tax or legal advice. Investors should consult a financial advisor and/or tax professional before making investment, financial and/or tax-related decisions.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in share or unit value and reinvestment of all dividends or distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

The commentaries contained herein are provided as a general source of information based on information available as of January 31, 2024 It is not intended to address the needs, circumstances, and objectives of any specific investor. The content of this commentary is not to be used or construed as investment advice, as an offer to buy or sell any securities, and is not intended to suggest taking or refraining from any course of action. Every effort has been made to ensure accuracy in these commentaries at the time of publication, however, accuracy cannot be guaranteed. Market conditions may change and AGF Investments Inc. accepts no responsibility for individual investment decisions arising from the use or reliance on the information contained herein.

Holdings are subject to change and do not represent all of the securities purchased, sold or recommended for the portfolio. It should not be assumed that investments in the securities identified were or will be profitable and should not be considered an endorsement or recommendation by AGF Investments.

This document may contain forward-looking information that reflects our current expectations or forecasts of future events. Forward-looking information is inherently subject to, among other things, risks, uncertainties and assumptions that could cause actual results to differ materially from those expressed herein.

The information contained in this document is designed to provide you with general information and is not intended to be tax advice applicable to the circumstances of the investor. Investors should consult their investment professionals and tax advisors prior to implementing any changes to their investment strategies

"Bloomberg®" and Bloomberg Canada Aggregate Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by AGF Management Limited and its subsidiaries. Bloomberg is not affiliated with AGF Management Limited or its subsidiaries, and Bloomberg does not approve, endorse, review or recommend AGF Fixed Income Plus Fund. Bloomberg does not guarantee the timeliness, accurateness, or completeness, of any data or information relating to AGF Fixed Income Plus Fund.

Publication date: February 22, 2024

Invested in Discipline