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Strip bonds laid bare

Fixed income can be a smart investment

Strip bonds are excellent investment vehicles. They differ from traditional bonds and a lack of understanding may cause investors to shy away. But, strip bonds can be very advantageous in long-term planning so it's worth taking the time to learn.

Strip bonds are fixed income products. They are formed when conventional bonds are separated into two components for individual resale, the coupon and the residual or principal amount, with the resulting individual securities maturing at specific dates. They are generally favorably rated as they are issued by governments and high quality corporations.

Also known as zero-coupon bonds, there are a number of features unique to strip bonds. They do not pay interest throughout the term of the investment. Instead, the original yield is compounded semi-annually and paid on maturity. Since they are purchased at a discount and mature at par, the interest earned is the difference between the purchase value and the stated maturity value.

The price of any bond is inversely related to interest rates – that is, when rates rise bond prices fall. Price movements for strip bonds are more extreme than conventional bonds and, at first glance, this may appear negative. In reality, it can be very advantageous for the long-term investor.

Since strips are more volatile, the rates used to price them invariably keep them competitive, and the investor is compensated for increased volatility with an attractive yield. Further, if an investor holds the strip

to maturity, any interim price volatility doesn't matter because the future value is known with certainty.

However, if unforeseen circumstances do force an investor to sell before maturity, strip bonds have an active secondary market. They are very marketable and can easily be sold in different multiples.

Unlike conventional bonds, strips are available in \$1 increments above the minimum investment, allowing investors to put every available dollar to work. Currency diversification is also possible as strip bonds are available in U.S. dollar denominations.

Flexibility is another advantage with terms ranging from one month to 50 years. The term options allow investors to ladder investments; staggering maturities to minimize reinvestment risk and create a regular cash flow. This is ideal for investors who have known future financial requirements, such as RIF payments.

Strip bonds are well suited to tax-deferred accounts such as RRSPs and RESPs. If parked in a registered account until maturity, the strip bond will grow unhindered with tax-free compounding.

The power of compounding should not be overlooked. A person who has a known requirement for \$50,000 in 20 years can achieve that goal by investing \$19,576.92 in a 20-year strip bond yielding 4.8%.

Savvy investors can also turn their strip bond investment into a personalized structured product. If an investor purchased a 20-year strip priced at \$38.62

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with a face value of \$100, then took the \$61.38 difference and parked it in cash, he would have \$161.38 at the end of the 20-year period.

If that \$61.38 were instead invested in an equity that grew at an annualized rate of 6% per year, the investor would have \$296.85 at the end of the same period - the \$100 return on maturity from the strip and the \$196.85 return from the equity portion.

While bonds may be boring to some, to others they are a smart investment. For long-term investors, the right

bonds are even smarter. Those who understand the power of compounding interest are those who collect it.

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