How bonds and GICs differ: What's the right fixed income investment?

Since the end of the pandemic, rapid interest rate hikes and declining bond values drove investors to seek better opportunities for cash and short-term fixed income. Guaranteed Investment Certificates (GICs) became popular due to their appealing yields and ability to preserve capital—particularly attracting investors after substantial bond losses in 2022.

As inflation moderates, and interest rates decline with the Bank of Canada (BOC) cutting its overnight rate three times in 2024, the investing environment has changed. Some investors are considering shifting focus from GICs back to bonds.

Below, we outline a few of the ways that bonds and GICs differ to highlight how they might fit into an investor's portfolio.

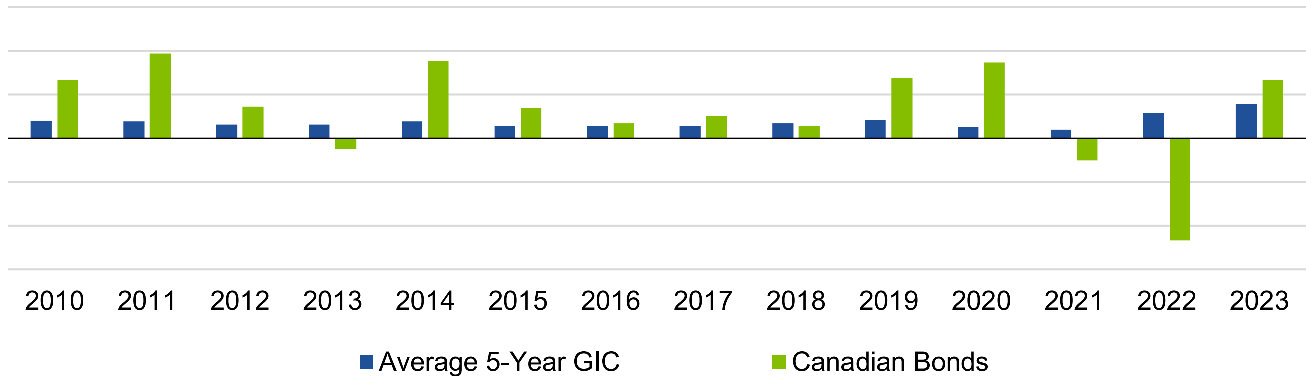
Bonds versus GICs

	Bonds	GICs
Safety of capital	No. Bond values fluctuate with market conditions. Note: if bonds are held to maturity, you are provided your principal plus your interest payments.	Yes. A GIC has a guaranteed principal and return when held to maturity. They may also be protected by Canada Deposit Insurance Corporation.
Enhanced liquidity	Yes. Bonds have greater flexibility and liquidity. Most bonds can typically be sold within a couple of days.	No. GICs impose penalties for early withdrawals.
Tax advantages	Yes. Coupon/interest payments are taxed at the investor's full marginal tax rate. However, capital gains from bond value appreciation are taxed at only 50% of the marginal tax rate.	No. Outside of a registered account, GICs don't offer any tax savings. Interest payments taxed at the investor's full marginal tax rate.
Reinvestment risk	Yes (but less risk than GICs). Bond investors face less reinvestment risk due to varying maturities and regular coupon payments. This income stream allows gradual reinvestment, reducing the impact of reinvestment risk in a declining interest rate scenario. As interest rates drop, bond prices generally rise, offering potential capital gains if sold.	Yes. At maturity, GIC investors receive their principal along with accumulated interest, but in a falling interest rate environment, they might struggle to reinvest these funds at attractive rates.
Higher potential return	Yes. Opportunity for both income payments and capital gains. Bond liquidity also allows investors to respond more quickly to changing market conditions.	No. Interest payments only, with investors locked in at the rate when the GIC was purchased.

Historical performance of bonds vs. GICs

If we look at historical performance, bonds perform better over the long term, while GIC returns are more consistent. The chart below compares the annual performance of Canadian bonds and the average five-year GIC return. While bond returns are more volatile, GICs have only beat bond performance four times since 2010.

Historical performance 2010-2023



Source: Canadian bonds: FTSE TMX Canada Universe Bond Index; 5-Year GIC: Bank of Canada . As of December 31, 2023.

As the markets shift into a rate-cutting cycle, the opportunity cost of GICs over short-term bonds rises. Bonds could potentially stabilize and enhance portfolio diversification, potentially providing higher long-term returns than GICs. This expectation is based on the inverse relationship between bond yields and prices; during the interest rate hike cycle, many bonds traded at a discount, allowing investors to benefit from interest payments and capital gains as prices adjust back toward par.

How different scenarios can impact bonds

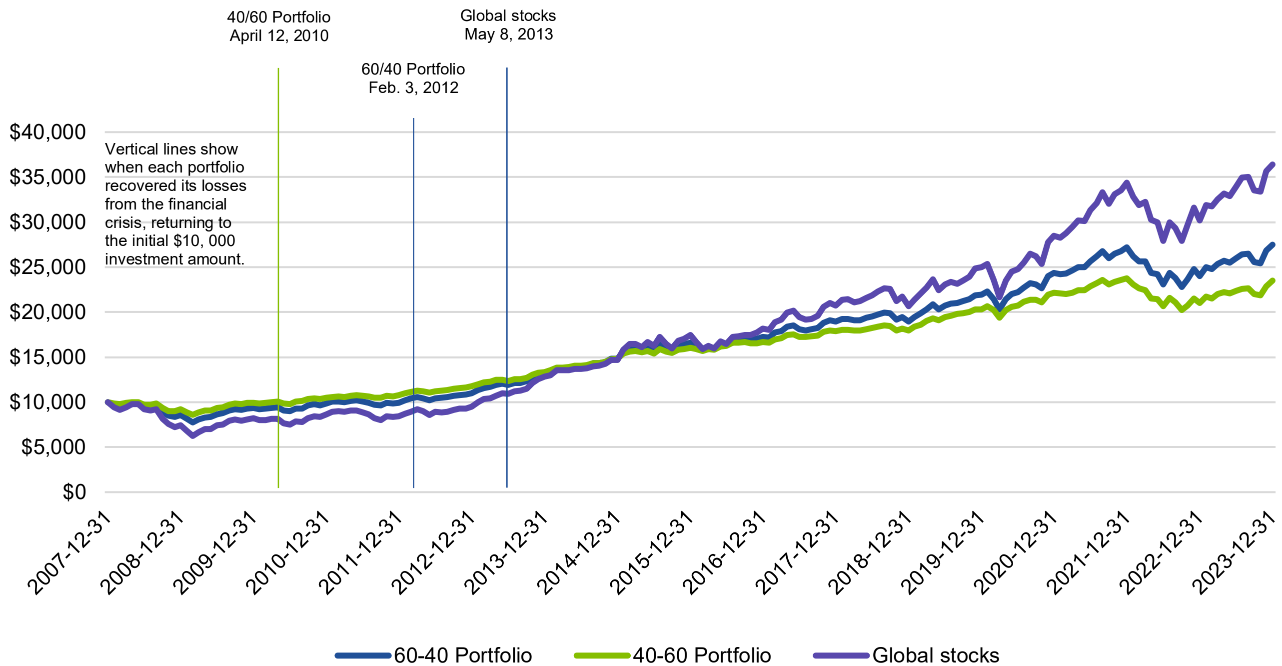
- An economic recession and unexpected rate cuts could boost bond prices
- Expected rate cuts could potentially lead to lower short-term bond yields as new bonds are issued at lower rates*. Persistent inflation with stable rates would negatively impact bond prices.

Fixed income for diversification purposes

Diversification is a key risk-reduction strategy for investment portfolios. By including a variety of investments across different asset classes, industries, geographies, diversification minimizes the risk associated with any single asset.

Different investments react uniquely to market conditions, so a diversified portfolio is less likely to experience poor performance across the board. When a portfolio includes a variety of assets, some may perform well, and some may perform poorly – but it's less likely that they will all perform poorly at the same time. What an investor earns on the investments that perform well can help to offset losses on the investments that perform poorly. Bonds and other fixed-income securities are particularly effective for diversifying stock-heavy portfolios and, have historically helped investors recover more quickly from stock market downturns (see below).

Get back on track faster with bonds



As of December 31, 2023. Source: Global stocks: MSCI World Index; 40/60 Portfolio: 40% global stocks (MSCI World Index), 60% global bonds (Bloomberg Barclays Global Aggregate Bond Index, C$ hedged); 60/40 Portfolio: 60% global stocks (MSCI World Index), 40% global bonds (Bloomberg Barclays Global Aggregate Bond Index, C$ hedged)

In this chart Global stocks fell further during the financial crisis than a diversified portfolio made up of both stocks and bonds. And even though stocks eventually caught up to the balanced portfolios, and have surpassed them in recent years, they took significantly longer to recover from their decline. See how the portfolio with a 60% allocation to bonds (green line) recovered its losses roughly two years earlier than the one with a 40% allocation to bonds (blue line)? That's how powerful bonds can be in offsetting the volatility of stocks.

Getting started with bonds

One of the easiest ways to add bonds to a portfolio is through a bond fund. Bond funds give you instant access to a diversified basket of bonds, removing single issuer risk and eliminating guesswork about which bond(s) to choose. In addition, you also receive the benefits of a professional portfolio manager actively managing the Fund to add value and manage risk. Finally, most bond funds offer investors fixed monthly pay distributions that investors can opt to reinvest or take in cash to meet their unique investment needs.

From money market to global bonds to impact bonds, NEI has a diverse range of bond funds; all actively managed with fixed monthly distributions that investors can rely on for stability, consistent income and growth potential.

Learn more

Source:*Morningstar- https://www.morningstar.com/markets/what-feds-rate-cut-means-bond-investors

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