

Are GICs Right for You?



These days, the topic of inflation is everywhere in the news. Prices are rising and the cost of living has increased considerably.

While some inflation is manageable, high inflation can impede economic growth. To help control excessive consumer spending, many central banks have been raising interest rates. In theory, this should calm inflationary pressures before the economy overheats.

For borrowers, high rates are never ideal as they'll have to pay more to the lender. Think about credit cards, mortgages, car loans and lines of credit. For savers, however, high rates can generate more income. A common savings vehicle is the Guaranteed Investment Certificate (GIC). Let's explore GICs and whether they might be suitable for you.

Understanding GICs

Financial institutions like banks and credit unions offer GICs. You commit your invested money for a set period of time (e.g., three years or some other term). Each year the financial institution pays you the predetermined annual rate. Usually, the longer the term, the higher the interest rate. When the term matures, your principal is returned or you may rollover the GIC for another term.

You can take the interest payment in cash or reinvest it at the same rate as your GIC – this is known as compound interest. You'll receive all the accumulated interest and your principal (i.e., the initial investment) once the GIC matures. Whatever your choice, you make the decision when you open the GIC.

GICs are secure, have flexible terms and may qualify to be insured by the Canada Deposit Insurance Corporation. Are they right for you? Let's explore three primary uses of a GIC:

- 1. To diversify into risk-free products.** Investing in stocks, mutual funds, exchange-traded funds, etc. may provide attractive long-term growth, but there's also the risk of losing money. While GICs typically have a modest growth component, your invested principal is safe and your return is usually known in advance.
- 2. To make investing convenient and easy.** You can buy a GIC in minutes at your financial institution or online. Unlike trying to pick an appropriate stock or fund, your GIC decisions only focus on how much to invest, what type of GIC you need (more on that below) and the length of term.
- 3. To match your financial objectives.** Whatever your short- and long-term goals, you can match them to corresponding GICs. For example, if you're buying a car in two years, invest in a two-year GIC. If a goal like retirement is far into the future, consider five-year GICs. Stocks and funds may decrease in value, creating a financial shortfall when you access your money. There's no such concern with GICs.

Common types of GICs

- Non-redeemable: In exchange for locking in your money for whatever term you choose, the financial institution pays you a higher interest rate. You may only access your money before maturity under exceptional circumstances.
- Cashable: You gain the flexibility to withdraw your money before the term is finished, but the trade-off is a lower interest rate than a corresponding non-redeemable GIC.
- Market linked: This type of GIC guarantees your principal and interest is tied to the performance of a specific market index (e.g., S&P/TSX Composite). You'll participate in market gains based on a pre-set formula. The better this market performs, the more interest you'll earn, up to a certain limit. If the market performs poorly, you receive little or no interest, so be aware of this risk.

Potential drawbacks of GICs

GIC rates rise when inflation hits, but even with higher rates you'll still likely lag the rate of inflation. That means you'll lose buying power – a scenario you can help offset by diversifying your portfolio with stocks or funds designed to achieve greater long-term growth than GICs.

Also, when compared to potential capital gains or dividends generated by stocks and funds, interest earned on GICs (outside of registered accounts like RRSPs, RRIFs and TFSAs) is taxed at your highest marginal tax rate, leaving you with less cash than you may think.

To learn more about how we can build a suitable plan based on your needs for income and growth, please contact us today.

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