ADDING STRUCTURED PRODUCTS TO INVESTOR PORTFOLIOS

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Summary

- Investors seek balance across competing goals that include liquidity, returns, and capital preservation.
- Diversification makes sense. Ensuring portfolios are not too concentrated on a particular asset class or risk helps navigate between these competing investment goals.
- Cash is often a large component of portfolios, particularly for investors with relatively short investment horizons. It offers liquidity, but has little nominal return and typically loses value in real terms.
- In the current low-yield environment, the ability of sovereign developed market (DM) bonds to protect portfolios during periods of equity market stress and provide a reliable income stream has declined.
- Reallocating a portion of cash and sovereign bond holdings to Guaranteed Investment Certificates (GICs) or Market Linked GICs (MLGICs) is recommended for conservative investors. Both products maintain a focus on short-term capital preservation. MLGICs also provide an opportunity for capital growth.
- For investors with longer investment horizons, equities should be the cornerstone of portfolios and the primary source of expected capital growth. An allocation to MLGICs offers the potential to participate in equity market upside, along with principal protection that provides comfort against shorter-term equity volatility.

1. Introduction

In spring 2020, equity markets experienced sharp losses as they responded to the reality of the COVID-19 pandemic. Although many markets soon recovered, this event encouraged investors to focus on identifying effective strategies to manage downside risk.

As the economic recovery continues and business and consumer confidence improve, a balanced approach to portfolio construction is expected to remain beneficial. This includes a continued focus on strategies that mitigate the risk of capital loss. In the current low yield environment, DM government bonds are less able to act as a hedge against this risk, and so investors have often turned to cash. Following the 2008 Global Financial Crisis (GFC), the value of deposit products has grown by 66%, to $1.5 trillion, accounting for 31% of Canadian financial wealth[2]; a majority of this wealth is held in cash. But cash offers little nominal return and has a negative real return.

In this paper, we consider the merits of adding Guaranteed Investment Certificates (GICs) and structured products to investor portfolios. We conclude that these products, and particularly Market Linked GICs (MLGICs), can help conservative investors maintain participation in equity markets without sacrificing the capital preservation attributes associated with cash allocations.

2. What are GICs and MLGICs?

As baby boomers approach retirement, interest in investment solutions that offer a combination of liquidity and capital preservation is expected to grow. Cash will remain relevant as a core portfolio holding, but its lack of return is an impediment, and in many cases, investor cash holdings may be too high. These holdings can be reduced in favour of return-enhancing solutions that exhibit similar risk profiles to cash. Available solutions include GICs and MLGICs. In aggregate, these solutions currently comprise 28% of Canadian deposit products, equivalent to $340 billion.[3]

GICs

Unlike cash, GICs offer investors the potential to maintain the real purchasing power of their capital, at the cost of a modest decrease in portfolio liquidity. Lower liquidity results from the requirement that deposits be invested in GICs for a specified time period, or term. In exchange for this commitment, GICs provide a guaranteed fixed return, commensurate with the term; a longer commitment is associated with a higher guaranteed return. GICs are expected to provide risk-adjusted returns comparable to those offered by money market funds.

MLGICs

MLGICs also represent an option for investors with short-term income requirements and a focus on capital preservation. They offer 100% principal protection and are designed, like GICs, to help investors preserve capital. But MLGICs also allow participation—on a capped basis—in any realized gains in equity or bond markets to which they are linked (Table 1); this linked gain does not include dividends. Similar to GICs, the opportunity to realize higher returns and maintain downside protection comes at the cost of less liquidity; MLGICs also require deposits to be invested for a specified term, typically 2, 3, or 5 years.

The total return to an MLGIC is known only at the end of its term. This return could be greater or less than a traditional GIC over the same period, depending on the performance of the underlying linked asset. MLGICs will underperform GICs in periods of negative financial market returns; during these episodes, GICs will continue to provide investors with a guaranteed return, whereas allocations to MLGICs will generate a return of zero. Over the long term, MLGICs are expected to outperform GICs, reflecting the higher expected return to equities and bonds relative to money market funds.

Table 1: Representative CIBC MLGIC product offering

MLGIC client profile	Underlying linked product relationship
Income	3-month Bankers' Acceptance (BA) Rate
Income and Growth	10 equally weighted stocks (5 Canadian and 5 international)
Growth	Solactive Canada Bank Index

Source: CIBC Asset Management Inc., Bloomberg. As at March 1, 2021.

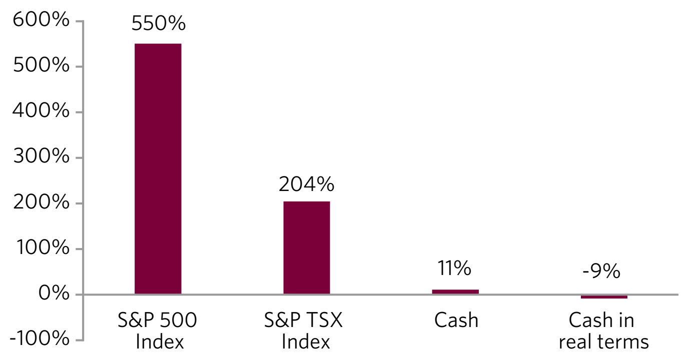
MLGICs in Balanced portfolios

1. Replacement for excessive cash holdings

Choosing an appropriate portfolio cash allocation and the most suitable investment vehicles are important decisions for investors. Since March 2009, cash has returned a cumulative 11% in nominal terms, but has lost 9% of its real purchasing power due to inflation. An initial cash deposit of $1,000 in March 2009 increased to $1,110 by the end of January 2021. A similar investment in Canadian and U.S. equities would have increased to $3,044 and $6,505, respectively, over the same period (Figure 1).

By reallocating cash holdings to MLGICs, investors can gain some exposure to equities without sacrificing principal protection. In this way, investors can improve expected portfolio returns.

Figure 1 - Returns to cash and equities since March 2009



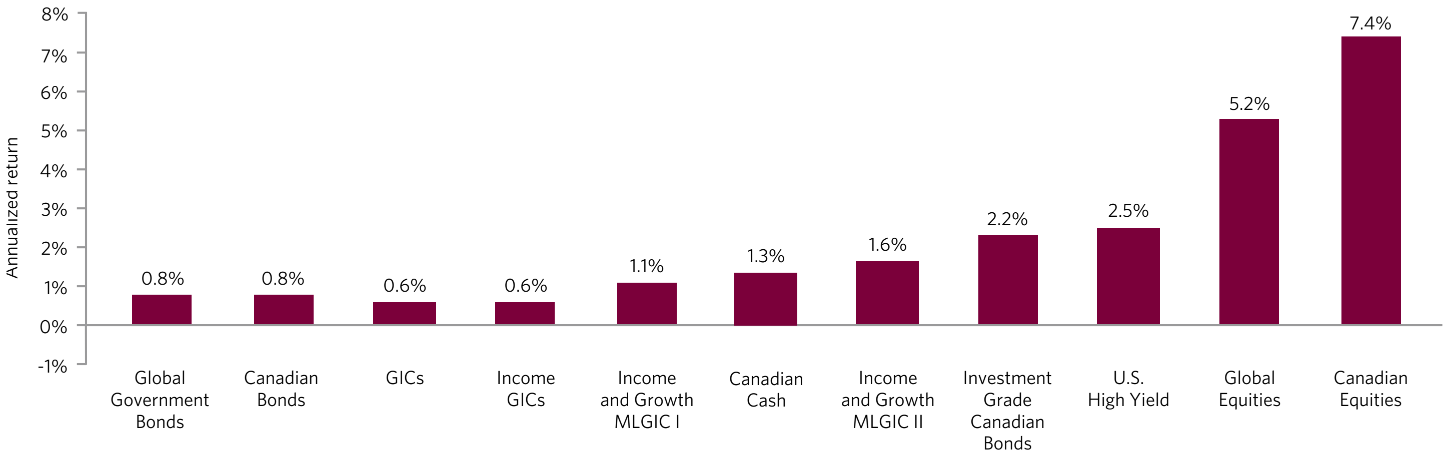
Source: CIBC Asset Management Inc., Bloomberg. Sample is March 2009 – January 2021.

2. Managing event risk

MLGICs can be used as a hedging vehicle for clients looking to mitigate the risk of capital loss during periods of equity market stress. This protective characteristic mimics a core historical feature of sovereign fixed income. In the future, the ability of sovereign fixed income to mitigate portfolio losses during periods of equity market weakness has waned due to the unprecedented low levels of bond yields.

Low bond yields also imply low expected returns to sovereign fixed income (Figure 2). In this environment MLGICs are expected to provide an additional return premium, proportional to the risk premium over fixed income provided by the underlying equity index. This suggests investors should reallocate at least some existing core fixed income holdings to MLGICs.

Figure 2 - Expected long-term asset class returns (CAD)

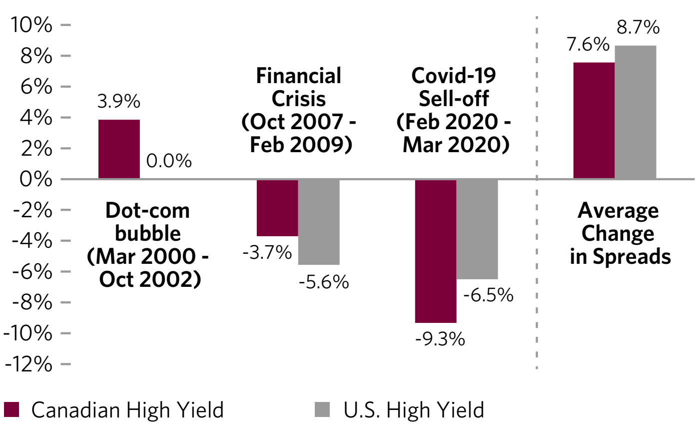


Source: CIBC Asset Management Inc. Returns reported in CAD terms. As at March 8, 2021.

The long-term expected return to MLGICs is not as attractive as fixed income credit strategies, including High Yield (HY) and Corporate bonds.

HY fixed income, in particular, offers a considerably higher expected annualized return than sovereign fixed income, to compensate for exposure to credit risk inherent in leveraged companies. A pairing of MLGICs with HY makes sense. HY performance typically suffers during equity market drawdowns (Figure 3). And so a combination of higher expected HY returns in normal markets and the protection offered by MLGICs during periods of stress could be attractive to investors looking to balance competing objectives of liquidity, returns, and capital protection.

Figure 3 - High Yield performance and behaviour of credit spreads during crises

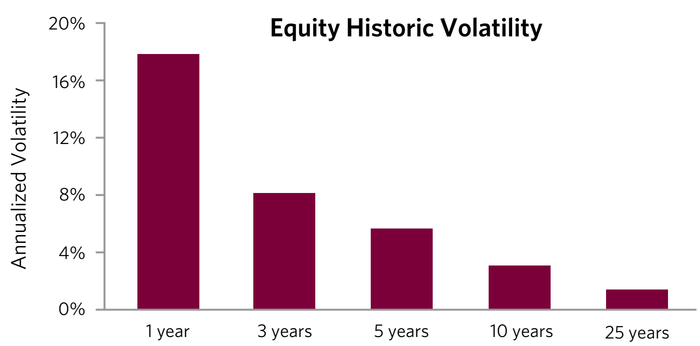


Source: Bloomberg, CIBC Asset Management

3. Don't ignore the long-term role of equities

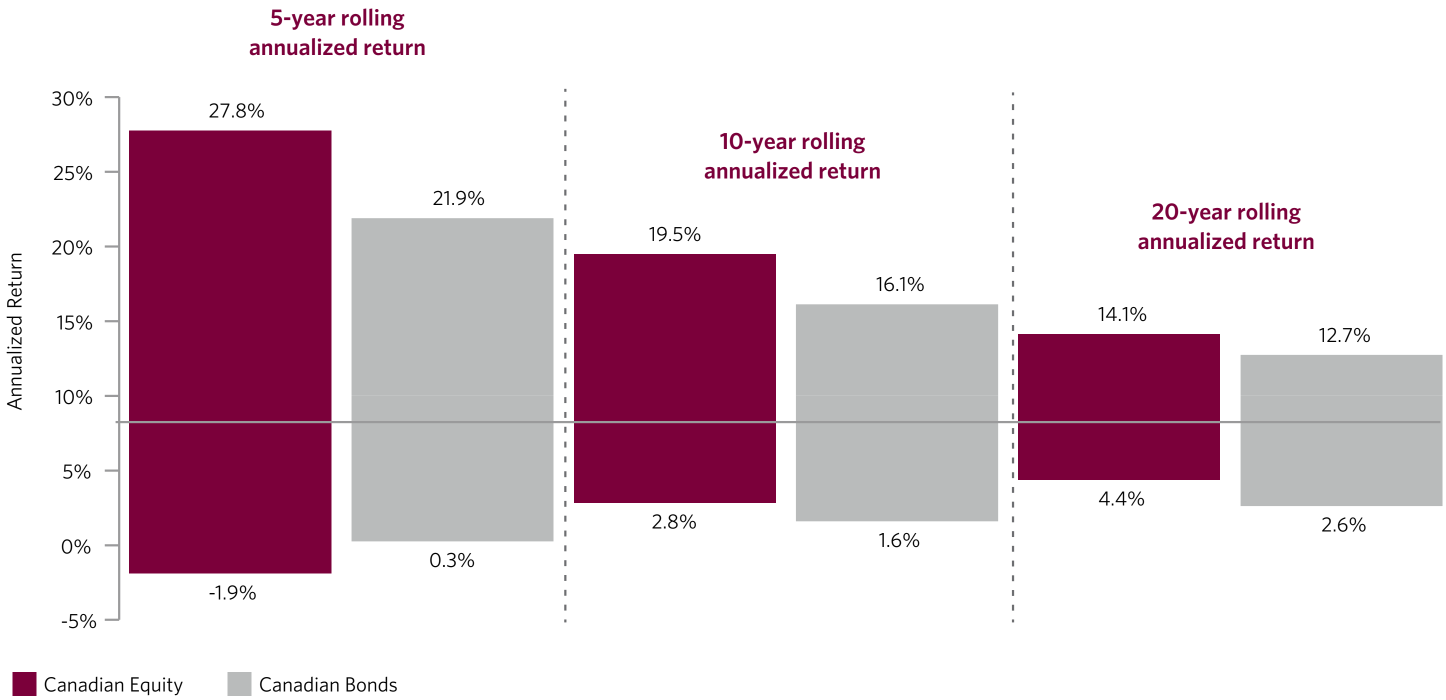
As discussed, one reason to invest in MLGICs is their ability to provide downside protection during volatile equity markets. This motivation diminishes as investment horizons increase, in line with a decline in equity market volatility (Figure 4).

Figure 4 - Canadian equity (S&P TSX Composite Index) volatility over 1-, 3-, 5-, 10- and 25-year periods[4]



Source: CIBC Asset Management Inc., Bloomberg. Data as at January 31, 2021.

Figure 5 - Probability of negative returns across asset classes declines as investment horizon lengthens

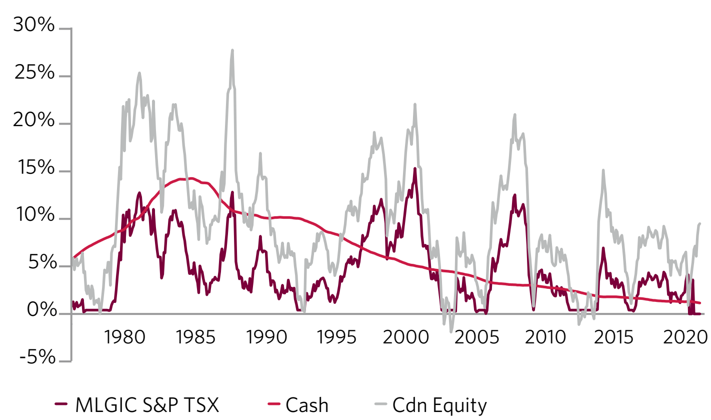


Source: CIBC Asset Management Inc., Bloomberg 1950-2020. Canadian Equities and Canadian Bonds represented by S&P TSX Composite Index and FTSE TMX Bond Universe, respectively.

Lower volatility reduces the probability of experiencing losses from an investment in equities (Figure 5). Using annual data from 1950, the lowest annualized return to an investment in equities calculated over rolling 5-year periods was -1.9%. Over rolling 20-year periods, the same investment in equities realized a minimum annualized gain of 4.4%. Equities have historically been the principal source of wealth accumulation for long-term investors, and they are expected to remain a central component of most Balanced portfolios.

A decreasing probability of experiencing losses from an allocation to equities as investment horizons lengthen also reduces the likelihood of MLGICs outperforming equities over the same horizon. Based upon our proxy and 5-year rolling returns, there were only two instances during the past 50 years —2003 and 2013—when an allocation to MLGICs would have outperformed equities (Figure 6).[5]

Figure 6 - 5-year rolling performance of MLGICs versus Canadian equities and cash



Source: CIBC Asset Management Inc., Bloomberg. Data from October 1986 to January 2021.

Statistical probabilities notwithstanding, MLGICs have a role to fulfill in portfolios for all but the most risk-tolerant, long horizon investors. For return-seeking investors who are also sensitive to downside equity risks, protecting against unexpected, large negative outcomes makes sense to achieve better peace of mind. An allocation to MLGICs is appropriate, but does come at the cost of a loss of expected return, relative to an investor who maintains a larger allocation to equities.

Figure 7 - Suggested allocations to MLGICs based on investor profile

Conservative profile

Reallocate 5%-10% from cash and government bonds to GICs and MLGICs.

Balanced profile

Tactical allocation of a maximum of 5% to MLGICs from government fixed income

Income and Growth profile

Tactical allocation of a maximum of 5% in place of insurance products. No strategic allocation is recommended for long-term investors.

Recommended allocation to MLGICs

MLGICs can fulfill an important role in portfolios for all but the most long-term and risk tolerant investors. Protecting against unexpected, large negative outcomes can make sense to achieve better peace of mind. Reallocating away from cash holdings into MLGICs is appropriate for most investors (Figure 7). But it does come at the cost of a reduced expected return when compared to long-term investors with greater tolerance for larger equity allocations. We recommend that MLGICs be incorporated into Balanced portfolios to manage downside risk in place of some existing sovereign fixed income holdings. This allocation should be small and tactical, and not a key component of longer-term strategic portfolio allocations.

For relatively conservative investors with shorter-term horizons, who are also focused on returns, MLGICs are an attractive substitute for most existing cash holdings. MLGICs allow a degree of participation in the expected annualized returns of linked asset classes, while addressing investor concerns over current heightened equity market valuations.

Conclusion

Diversification is a critical component of a well-constructed portfolio. Ensuring investor portfolios are not too concentrated on a particular asset class or specific risk helps navigate between competing investment goals. Too much concentration undermines the ability of investors to achieve long-term goals. While cash provides liquidity and helps preserve the nominal value of capital, it also offers little expected return. For investors with relatively short-term horizons and a focus on returns, MLGICs represent an attractive substitute for most existing cash holdings. For investors focused on longer-term capital growth, a direct allocation to equities should represent the cornerstone of portfolios. Bonds, including High Yield, can provide a complementary, stable source of income. MLGICs offer the potential to participate in equity market upside, and access principal protection that provides comfort against shorter-term equity volatility.

Combining an appropriate mix of these investments in a portfolio that acknowledges life stage and investment goals can help achieve a winning solution.

Let’s connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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[2,3] Investor Economics (2020), Household Balance Sheet Report - Canada.

[4] Volatility is measured as historical standard deviation of annualized monthly returns.

[5] To assess how the historical performance of MLGICs compares to equities, we need to calculate a proxy series. Over the sample from October 1986 to January 2021, MLGICs are proxied by a CIBC current offering linked to the TSX 60, backfilled based on returns to the S&P TSX index from January 1976, with 65% market participation and a 5-year maturity. This is an approximation given that the terms of structured product offerings are updated on a monthly basis based on a number of variables including current levels of risk-free interest rates, and changes in the volatility of underlying indexes.

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