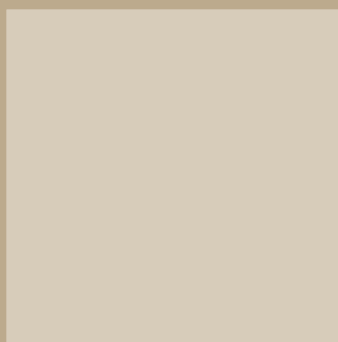


# Income Solutions that you can depend on: Guide to Fixed Income Securities



**Portfolio Advisory Group**





# Table of Contents

<b>What are Fixed Income Securities</b>	<b>2</b>
<b>Why Invest in Fixed Income Securities</b> <i>Income, Safety, Liquidity, Balance, Choice</i>	<b>2</b>
<b>The Many Forms of Fixed Income Investments</b> <i>Interest-Bearing Securities; Discount Notes; Mutual Funds</i>	<b>3</b>
<b>Rewards &amp; Risks of Fixed Income Investing</b> <i>Income; Safety; Capital Gains and Liquidity; Tax Considerations</i>	<b>4</b>
<b>Fixed Income Securities – A Buyer’s Guide</b> <i>Bond Types and Features; Term to Maturity; How Bonds are Priced; The Importance of Yield Government, Corporate and Foreign Currency Bonds;</i>	<b>6</b>
<b>Fixed Income Securities – Product Descriptions</b> <i>GICs; Treasury Bills; Banker’s Acceptances; Commercial Paper; Savings Bonds; Preferred Shares; Stripped Coupon Bonds; Mortgage-Backed Securities; Structured Notes; Fixed Income Mutual Funds;</i>	<b>10</b>
<b>Appendices</b>	
<b>I. The Importance of Credit Ratings</b>	<b>12</b>
<b>II. Checklist for Choosing The Right Fixed Income Securities</b>	<b>14</b>
<b>III. Fixed Income Product Table</b>	<b>15</b>

# What are Fixed Income Securities?

The two best-known asset classes are equity and fixed income securities.

When you buy equities, you are essentially buying part-ownership of a company. You therefore participate in both its profits and losses, measured by any dividend income you receive plus capital gains or losses from the ups and downs of the stock market.

In contrast, a traditional fixed income security is essentially an IOU – an obligation stating that the borrower (known as the issuer) will repay the borrowed money on a certain date, called the date of maturity. In addition, as the name suggests, many fixed income securities pay regular interest or income to investors at a fixed interest rate, known as the coupon rate.

Just like stocks, most debt investments trade in the marketplace, and may fluctuate in price. Therefore, you may

record a capital gain or loss if you sell them prior to maturity. However, fixed income investments are generally considered safer than equities because they provide a steady stream of income and a set pay-back price if held to maturity. In addition, the safety of a fixed income security is reflected in the credit rating of the issuer.

Since fixed income securities pay regular income at their coupon interest rate, their value is related to the interest rates of the country and currency in which they have been issued. For example, when interest rates decrease, the price of a bond generally will increase, because the bond's coupon rate becomes more attractive compared to current market interest rates. In contrast, when interest rates rise, bond prices generally fall. For investors, considering the future trend of interest rates is an important part of understanding fixed income securities.

## Why Invest in Fixed Income Securities?

### **Income**

Investors primarily buy bonds and other fixed income securities for the income they generate, be it to fund their retirement, education, or any other cash flow need.

### **Safety**

Fixed income securities are also the choice of investors seeking safety of capital, as they carry, depending on their credit quality, a greater degree of principal

protection and guarantee of investment returns than most other investments.

### **Liquidity**

Among many investors, stocks are better known and understood than fixed income securities. Yet in Canada, the fixed income market is actually about 30 times larger in trading volume than the equity market. Due to the size of trading volume, market liquidity, relating to how easily a security can be purchased or converted into cash is extremely high.

## Balance

Fixed income securities are an important part of most investment portfolios. Research has shown that choosing the right balance between fixed income and equity securities is the single most important factor in investment success.

Investors look to fixed income products for a variety of benefits. Each particular fixed income security may also offer additional advantages depending on its

unique features. The universe of fixed income product is large and ever expanding. ScotiaMcLeod offers investors access to and experience on a full range of fixed income solutions.

## Choice

Today's investors can choose among more fixed income product than ever before. These range from the tried and true – Government and Corporate Bonds, GICs and Savings Bonds – to innovative products, such as strip bonds and structured notes.

# The Many Forms of Fixed Income Investments

*Today the market offers many forms of fixed income investments. Fixed income securities are often classified according to the time they have left until maturity. Those that are short-term (with a maturity of up to one year) are referred to as money market or cash investments, because due to their short maturity date they become cash within a shorter time frame. Cash investments include Government Treasury Bills, Bankers Acceptances, Commercial Paper, term deposits, short-term GICs and money market mutual funds. Other debt instruments, such as bonds, are typically longer in term, with terms of maturity ranging to 30 years. Another way of classifying fixed income securities is based on whether or not they pay interest to their holders before maturity.*

## Interest-Bearing Securities

Traditionally, fixed income investments are interest-bearing. They pay interest to investors on a regular basis, usually once or twice a year, until the investment matures. Examples include Canada Savings Bonds, GICs, and government and corporate bonds.

Example: An investor purchases a semi-annual paying bond with a coupon rate (interest rate) of 6% and a face or par value of \$100. Thus the bond pays interest of \$6, \$3 twice a year. When the date of maturity is reached, the investor also is repaid the par value – \$100 plus any accrued interest.

## Discount Notes

A second type of fixed income security, known as discount notes, does not pay interest. Instead, it is purchased at a discount to its face value, and is redeemed at full price at maturity. Examples are Treasury Bills and strip bonds.

Example: A strip bond is purchased for \$92, a discount to its face value of \$100. It pays no interest, but on the date of maturity the investor is paid \$100, giving a total return of \$8.

## Mutual Funds

Another way to invest in fixed income securities is to buy mutual funds, such as money market or bond

funds. These mutual funds provide investors with a diversified portfolio of fixed income products, with many of the benefits of investing directly in the securities. However, when investing in fixed income mutual

funds, you receive the appreciation or depreciation of the value of that fund, but you do not receive the regular cashflows that may come from the underlying securities in the fund.

## Rewards & Risks of Fixed Income Investing

*The rewards and risks of investing in fixed income securities flow from the unique features of each product. For example, some securities offer regular income; others offer the potential for capital gains. Some are highly liquid; others are locked in until a set maturity date.*

*The following section defines the key features that may apply to a fixed income investment. To help you see which features relate to a particular kind of fixed income security, check the reference table at the back of this guide.*

Although fixed income investments (bonds) are generally considered to be safe, they are subject to two types of risk. The first is *interest rate* risk. Once you have purchased a bond, and you are locked in to a set rate of interest for a specific term, there is always the chance that rates will rise and the rate you are earning may no longer be competitive. The longer the term of your bond, the greater the chance that rates will rise at some point. The second type of risk is *credit risk*, the possibility that your principal will not be repaid or that the issuer will default on the interest payments. Different investments will offer varying degrees of security depending on specific features of the investment and the issuer's ability to service the debt and repay the principal upon maturity. Investments issued by the Government of Canada are of the highest quality because the government has an almost unlimited ability to meet debt obligations through tax levies or printing money. Corporate issues rank behind federal, provincial, and municipal most government issues in

quality, primarily because they have limited resources. An easy way to compare the quality of various debt or preferred issues is by referring to bond ratings published by firms such as the Dominion Bond Rating Service, Standard & Poors Investing Service.

Fixed income investments vary in price as interest rates change during the period preceding maturity. As interest rates rise, fixed income securities prices generally fall to provide the market rate of return. Conversely, falling rates imply higher prices. Fundamental factors which might influence the issuers' ability to pay also affect prices. All but sophisticated and wealthy investors should avoid purchasing fixed income securities that are unrated or rated below BBB. Although yields are normally higher to reflect the increased risk, issuers may fail to pay interest or be unable to make required principal payments, resulting in a loss of capital or a delay in the receipt of funds.

Another type of investment risk is related to the type of security and its place in the pecking order of preference in liquidation. Equity investments, or common stock, are most susceptible to the risk of loss if a company's fortunes deteriorate. On the other hand, a collateralized bond, for example, debt secured by an airplane owned by an insolvent airline, can still be repaid, even in bankruptcy.

While investing in foreign securities makes sense for diversification and enhanced returns, they may be more volatile in the short term and are subject to many additional risk factors, both political and economic.

Finally, market prices are a function of human emotions as well as rationally determined supply and demand. Therefore, even when fundamental investment objectives are achieved, individual security or general market prices can decline, often for protracted periods of time. Investors must have patience and perseverance as well as the courage to invest or hold when things look the bleakest.

The client must make the final purchase or sale determination. While your ScotiaMcLeod Investment Executive should be relied upon for unbiased advice, on occasion those recommendations will not produce the expected results because of the complex nature of the risks described above. Since neither your Investment Executive, nor ScotiaMcLeod shares in the rewards of successful investments, the client necessarily bears the risk of loss from unsuccessful investing. Investing is a serious business, which, while offering prospectively good returns, merits a client's careful attention to the decision-making process. Investors should remember that the higher the potential reward, the greater the potential risk of an investment.

## **Reducing Risk Through Diversification**

The best way to reduce risk is by diversifying your portfolio, by investing in different asset classes, duration and industries.

We recommend that you complete our Personal Investment Review to help you determine your tolerance for risk and to help you see at a glance, what amount of assets you hold in each category. This document should then be reviewed with your Investment Executive, at least annually, to ensure that your portfolio is in the proper balance given your personal circumstances and current market conditions. Your ScotiaMcLeod Investment Executive can assist you in building a diversified portfolio and in helping you understand the amount and type of risk inherent in each type of investment you hold.

While it is a client's right to expect his/her financial advisor to use his or her best efforts in recommending investments that will perform for the client and are suitable for his/her financial circumstances, it is the client's responsibility to ensure that their Investment Executive takes the time to look at the Big Picture™ of their finances. In this way, the client can most intelligently bear the risks and reap the rewards of his/her investment selections.

## **Rewards**

### **Income**

Many fixed income securities offer income in the form of regular interest payments. The rate of interest is known as the coupon rate, and is generally paid annually or semi-annually. Interest-bearing securities are helpful to investors who require a steady flow of income to meet their expenses, or for those who are looking to steadily build their savings over time.

Depending on their yield, inflation, and the current market situation, fixed income securities also may offer competitive returns compared to other forms of investments such as equities.

### **Safety**

For many investors, a key benefit of fixed income securities is their relative safety. Safety comes from the fact that many products offer regular interest payments. As well, although the price of the security may fluctuate in the marketplace, at maturity the issuer is obliged to repay the face value to the investor.

The ability of the bond issuer to fulfill its obligation is also an important aspect of bond safety. In some cases, bonds are secured by the issuer's physical assets, specified in the bond contract. In contrast, a debenture is usually not secured by specific assets. Since government bonds are never secured by assets but instead by the general credit of the government, they are technically debentures. In practice, however, they are referred to as bonds.

Many debt securities are issued by governments and well-established corporations, providing greater security to the investment. The issuer's credit rating helps an investor judge the safety of an investment. Canadian and U.S. rating agencies provide independent credit ratings for most major bond issuers. Should the worst happen, a company's fixed income investments are considered safer than its shares because debt-holders rank ahead of shareholders when a company goes bankrupt.

Your advisor can help you assess which fixed income securities are safest and most appropriate for you.

### **Capital Gains and Losses**

Fixed income investments offer the potential for capital gains or losses. The gain or loss comes from the difference between the price at which the security is bought and the price at which it is sold.

Like stocks, many fixed income securities trade on a secondary market. Market prices fluctuate due to changes in interest rate movements, which in turn are related to changes in the supply and demand for credit, monetary policy, fiscal policy, exchange rates, economic conditions, market psychology and concerns about inflation.

Traditionally, fixed income securities were considered a buy and hold investment. Investors would buy them at a certain price, gain regular income, and then be repaid the face value at maturity. These days, however, many investors choose to trade fixed income securities prior to maturity. If market prices rise, they profit; but if prices fall, they may incur a capital loss. Successful trading of fixed income securities is linked to positioning your fixed income securities to the future direction of interest rates.

### **Liquidity**

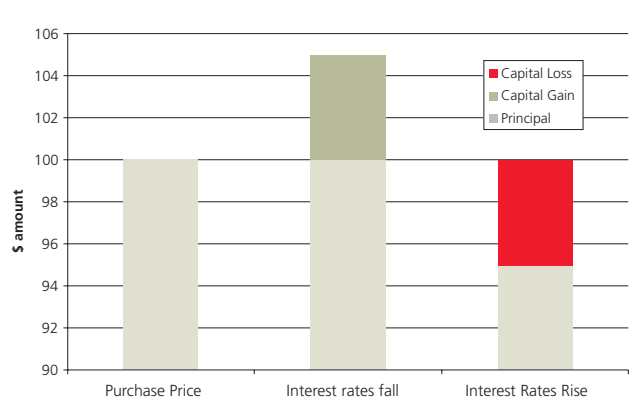
Liquidity is the ability to buy and sell an investment quickly, at a reasonable price. Unlike stocks that are listed on an exchange, most debt securities trade on the secondary over-the-counter debt market, allowing you to sell your investment if you wish, at a price set by current market conditions. Some fixed income securities, such as GICs are non-redeemable/non-transferable and lock an investor in for a set period of time.

## Tax Considerations

When purchasing a fixed income security, there are certain tax considerations that should be considered. A traditional fixed income security will provide periodic interest payments (coupon payments). These are taxable as interest income.

When you purchase a bond, you buy it at a set price determined by the marketplace. The difference, if any, between what you paid for the bond and what you receive when you sell or redeem the bond can be considered a capital gain or loss.

### Taxation on the Sale of a Bond Prior to Maturity



We at ScotiaMcLeod advise you to consult a tax specialist when reviewing the tax implications of your fixed income investments. Your tax advisor will be able to address tax issues as they pertain to your personal situation.

# Fixed Income Securities – A Buyer’s Guide

## Bonds

To recap, bonds are issued by governments and corporations in order to raise money. The bond represents an obligation, committing the issuer to repaying the borrowed amount (the principal or face value) on a certain date (the maturity date). Traditionally, in the period before maturity, the borrower pays interest on set dates, usually twice a year, at a fixed rate called the coupon rate.

In the following sections, we highlight the key features and varieties of bonds and give examples of how they are priced in the marketplace.

## Bond Types and Features

Bonds come in many different forms. They vary depending on their term to maturity; whether their issuer is a government or corporation; the currency in which they are denominated; their special features, including call provisions; and whether they are traditional interest-paying bonds or zero-coupon bonds.

## Term to Maturity

The term to maturity of a bond can be anywhere from one year to more than 30 years. Bonds that have up to five years remaining to maturity are normally considered short-term bonds; while medium-term bonds have from five to ten years remaining to maturity, and long-term bonds have more than ten years remaining to maturity. Bonds with a term to maturity of less than one year are usually traded alongside money market securities.

## How Bonds are Priced

Like stocks, bonds are traded in the marketplace, and their prices fluctuate over time. Bond prices are quoted as percentage points of the face value and do not include any accrued interest. For example, if a bond is quoted with a price of \$95, a bond with a face value of \$1,000 will cost \$950, plus any accrued interest.

When a bond trades at par (\$100), it means the bond’s price equals its face value. If a bond trades below par, it is said to be trading at a discount. If it trades above par, it is said to be trading at a premium.

Although many factors affect bond prices, the most important is interest rates. In general, when interest rates decline, bond prices rise. That’s because the fixed interest rate offered by the bond becomes more attractive as current interest rates in the market go down. For example, if you own a bond with a coupon rate of 8%, and the current interest rate declines to 6%, your bond’s price will rise on the market. Likewise, when interest rates rise, the yields offered by bonds look less attractive, and prices in general fall.

Other factors affecting the price of a bond include the credit rating of the issuer; the time remaining until maturity; liquidity; and special features of the bond.

The following table shows how the price of a bond will vary when the yield to maturity and the coupon are the same, but the due date of the bond is different. The difference in the price of the bonds reflects the fact that bonds, in most cases, mature at par. The Government of Canada 5.75% due September 1, 2006

has a closer proximity to maturity than the Government of Canada 5.75% due June 1, 2033.

Bond	Government of Canada 5.75% due September 1, 2006	Government of Canada 5.75% due June 1, 2033
Yield to Maturity	5.00%	5.00%
Price	\$ 102.16	\$ 111.57

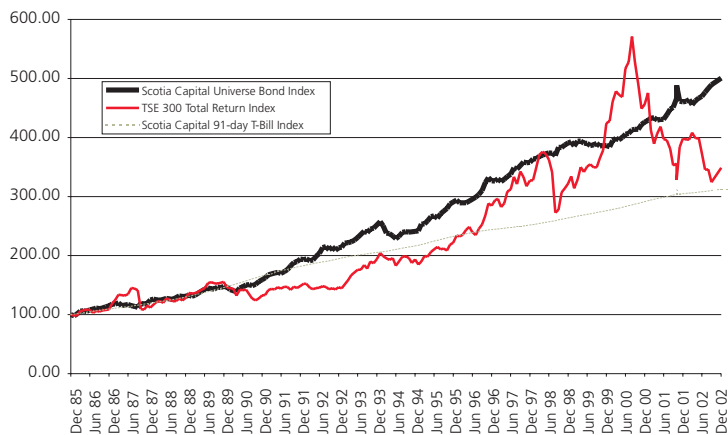
\* as of June 26, 2003

### The Importance of Yield

When you buy a bond, it is important to understand the rate of return that the investment offers, both now and over time. For a traditional bond, the rate of return is calculated as the yield to maturity. In essence, the yield to maturity is the return you would make if you held the bonds to maturity, taking into account both your capital gain or loss plus the stream of interest payments you would receive until the end of the term of the bond, assuming each interest payment is reinvested at the original yield. This is called the effect of compounding.

### Comparative Growth Paths

Value of \$100 invested on December 31, 1985



### Government Issues

In Canada, bonds are issued by federal, provincial and municipal governments, and agencies associated with those governments, such as Crown Corporations. These bonds are not secured by any specific assets, but instead are backed by the general credit of the issuing government.

Bonds issued by the Government of Canada represent the benchmark for all Canadian fixed income securities.

Although Canada bonds are not secured by specific assets, the Federal Government has the ability to print money to pay down the principal and interest to cover its debt. No other level of government is provided with this privilege.

Provincial government bonds vary according to each province's financial health and taxation power. They usually carry lower credit ratings than the Federal Government. Thus provincial bonds usually trade at a higher yield, but are still considered safe investments because of the government guarantee.

Hundreds of municipalities issue their own bonds. Municipalities do have lower borrowing needs, and therefore their issues tend to be less liquid than provincial or Canada bonds. However, municipalities have direct taxing authority over property and in the majority of cases must have balanced budgets and conservative management of their balance sheet. For these reasons, they are also considered safe investments and achieve an investment grade rating.

## Corporate Issues

Corporations do not have the benefit of sourcing their income from the tax base. Instead, they rely on the profitability of their business to generate income. Since corporate profitability is affected by the economic climate, consumer behaviour, future industry prospects, and the political environment, there is a wide variety of safety in the bonds issued by corporations.

The Canadian corporate bond market has evolved over the years from a market exclusive to “blue chip” companies to a market available to a wide variety of credit ratings. “Investment grade” bonds usually have ratings ranging from AAA to BBB. In the past three years, Canada has developed a market for “high yield” or “non-investment grade” bonds, usually rated BB or lower. High yield securities are very speculative in nature and are not suited to every investor’s goals and objectives.

The main types of corporate debt issues include:  
(in order of repayment ranking)

**First Mortgage Bonds**, where fixed assets, usually a property, are pledged as security for the debt.

**Asset-backed Securities**, are secured by assets such as insured mortgages, accounts receivable, etc.

**Bonds and Debentures**, which range from straightforward vanilla issues to complex varieties. When buying a corporate bond, it is important to understand both the unique features of the bond as well as the credit rating and credit outlook of the corporation. Debentures do not have specific assets pledged to support the debt, but contain other protective covenants such as where they rank in the issuer’s obligations. Such rankings (in order of repayment priority) include senior notes, debentures, and subordinate notes

**Capital and Preferred Securities** offer a premium yield to other debt of the issuer in exchange for less protection, including ranking, coupon deferral features, and potentially payment in shares instead of cash.

## Foreign Currency Bonds

Investors today have the opportunity to buy fixed income securities that are issued in currencies other than the Canadian dollar. The international bond market is comprised not only of bonds issued in foreign currencies by foreign countries and corporations, but the various levels of Canadian governments and corporations also issue their own bonds denominated in foreign currencies.

Governments and corporations regularly make investments outside of their domestic markets. In order to remove the risk of adverse movements in the exchange rates where their investments are held, governments and corporations utilize the ability to finance in outside countries, to better match their assets and liabilities. In Canada, where the United States is our largest trading partner, it stands to reason that many Canadian companies finance in the United States to match their receivables. Bonds issued by non-domestic governments and corporations in the U.S. domestic market, denominated in U.S. dollars, are known as yankee bonds.

Governments and corporations can also finance in a foreign currency outside of the domestic market of that particular foreign currency through issuing eurobonds. Eurobonds are issued under the jurisdiction of the European market but are eligible to be purchased by both domestic and foreign investors. Bonds issued in this manner denominated in Canadian dollars are known as Euro-Canadian-dollar bonds, and can offer attractive alternatives for Canadian investors.

Finally, governments and corporations can also issue global bonds. These bonds are issued usually in a government's or corporation's domestic currency with the caveat that the bonds will trade and settle for payment in the world's major financial centers.

Foreign currency bonds provide investors all the benefits of investing in bond markets, including the matching of foreign currency income requirements. They are also suitable for Canadian investors seeking to diversify their holdings among foreign currencies, in order to protect against adverse movements in the Canadian dollar

### Special Features

Bonds may also have special features. Below is a list defining the most common of special features:

**Callable** bonds give the issuer the right to retire bonds on or after a future date. When a bond is called for redemption, the yield is altered. Investors therefore should always compare the yield-to-call against the yield-to-maturity. A common callable feature is the "Canada Call" which allows the issuer to call back the issue at the greater of par or a price based on the yield of the equivalent term Government of Canada bond, plus a certain yield spread. This spread is normally much lower than the spread when the bond was originally issued, and the exercise of the call on these bonds normally represents a significant gain to the holder.

**Extendible or Retractable** bonds give the holder and/or the issuer an option of holding a longer or shorter-term maturity at a specified coupon rate. The flexibility to extend or retract the maturity date gives investors and/or borrowers better protection against changes in interest rates.

**Floating Rate** bonds have a unique coupon rate that typically adjusts quarterly or monthly, in response to changes in a benchmark interest rate (usually the yield on 3-month Banker's Acceptance Notes). Floating-rate bonds work to protect investors in volatile or rising interest rate environments since their rates adjust to the prevailing interest rate.

**Fixed-Floating Rate** bonds, commonly issued by Canadian Banks and Insurance companies, are bonds that have a fixed coupon rate for an initial period, after which the issuer has the option to either call the bonds or extend the maturity. If extended, the bond will pay a floating coupon rate which normally is reset quarterly at a rate equivalent to the 3-month Banker's Acceptance's rate plus a premium of usually 1% – very expensive when we consider that typically these issuers can borrow at a floating rate roughly equal to the 3-month Banker's Acceptance rate. Therefore, historically these bonds have never been, and are likely not to be, extended beyond their fixed coupon period.

**Convertible** bonds allow the investor to convert the bond into common shares at a specified price for a stated period of time.

# Fixed Income Securities – Product Descriptions

## Guaranteed Investment Certificates (GICs)

Guaranteed Investment Certificates (GICs) are interest-bearing notes issued by banks and trust companies and as a result, are protected by the Canadian Deposit Insurance Corp. (CDIC) up to a maximum of \$60,000 per issuer. GICs pay the investor regular interest at a set rate, but the principal must remain invested for a certain period of time. GICs usually have terms ranging from one to five years. Normally the longer the period, the higher the interest rate offered.

## Treasury Bills

T-Bills are short-term notes issued by the Government of Canada or by Canadian Provinces. They have varying terms to maturity, up to one year. Treasury Bills do not bear interest. Instead, they are sold at a discount to their face value, and the annual yield or interest rate is determined by the difference between the discounted purchase price and the maturity value (par). Government of Canada T-Bills are considered to be virtually risk-free, and can be traded at any time.

## Banker's Acceptances

A Banker's Acceptance (BA) is a commercial draft (i.e. a written instruction to make payment) drawn by a borrower for payment on a specified date. Issue terms range from one day to one year. Each Banker's Acceptance is "accepted" or guaranteed at maturity by the borrower's bank. BAs are suitable for money market investors accepting bank credit risk in return for a higher yield over Government of Canada T-Bills.

## Commercial Paper

Paper is a promissory note which can be secured or unsecured, issued by a corporation or trust. Issue terms range from one-day to one-year. Commercial Paper ranks equal, or senior, to unsecured long-term debt, and junior to secured debt. Corporations that access the money market are large firms with an established financial history and rating agencies rank the paper according to the issuer's ability to meet short-term debt obligations. These types of issues are suitable for money market investors who are willing to accept a corporate credit in order to obtain a higher yield.

## Canada Savings Bonds and Canada Premium Bonds

Canada Savings Bonds are not marketable instruments – they are not freely traded. They are however safe and liquid, and can be redeemed anytime, although interest is not paid out until after the initial three-month holding period. The Federal Government issues them annually to the public. They are available in both compound and regular interest formats, with varying maturities. Similar to Canada Savings Bonds, Canada Premium Bonds offer a higher yield, however, in return they are only redeemable on an annual basis.

## Provincial Savings Bonds

Similar to Canada Savings Bonds, Provincial Savings Bonds are issued by certain Provincial Governments exclusively to residents of those provinces. However, they are marketable instruments, and can be sold prior to maturity. Some issues are also redeemable on set redemption dates.

## Preferred Shares

Preferred shares are a hybrid of fixed income securities and equities. They are a form of ownership in a company, but also provide regular income through a fixed dividend, typically paid quarterly. Preferred shares do not normally carry voting rights, as common shares usually do. However, preferred shareholders rank ahead of common shareholders should a company wind up its affairs. For Canadian investors, an advantage of preferred share ownership is the tax credit received on dividend income.

## Mortgage-Backed Securities

Mortgage-backed securities are created when a financial institution pools a group of mortgages and packages them as securities. In Canada, the underlying mortgages are either government-insured first residential mortgages, or commercial real estate properties secured by a first lien. They pay interest and principal monthly. Government-insured residential mortgage-backed securities are unconditionally guaranteed by Canada Mortgage and Housing Corporation (CMHC) and National Housing Association (NHA), are highly liquid, and provide a level of security equivalent to that of government securities. Commercial mortgage-backed securities are not guaranteed by CMHC, and offer a higher yield. They come in a variety of credit ratings ranging from AAA to BBB depending upon their credit enhancements.

## Strip (Zero Coupon) Bonds

Strip or zero coupon bonds are created when investment dealers take a traditional bond and separate it into its two basic components: the semi-annual interest coupons, and the principal or face value repayable at maturity. The two components are then sold separately.

Like Treasury Bills, both stripped coupons and the final principal balloon payment (known as the residual) are sold at a discount, reflecting the term to maturity and the credit quality of the issuer. This discounted value is the new price for each individual investment. Strip bonds have become extremely popular investments. They typically are derived from federal or provincial government securities and are high quality and liquid investments. As well, yields on strip bonds tend to be higher than those of the traditional underlying issue.

Strip bonds also eliminate reinvestment risk. Since they produce no cash flow until maturity, the problem of reinvesting coupon payments (links to investment risk) at rates that are continually changing is eliminated. In this way, investors know at the outset what their yield will be if held to maturity. There also is a large and liquid secondary over the counter zero coupon bond market, so investors are not locked into holding them until maturity.

However, because these investments do not offer regular income, strip bond prices tend to be more volatile than traditional bonds with coupons, reacting more to changes in market yields. In addition, the Canada Customs and Revenue Agency (CCRA) requires a certain amount of the difference between the purchase price and the maturity value to be recognized annually as accrued interest. This feature makes them unattractive to hold in a cash account since interest is claimed but not paid. To defer paying tax, many investors hold strip bonds within tax-exempt accounts such as RSPs.

## **Structured Notes**

As the term suggests, these are bonds that can be structured to meet both investors' and borrowers' unique investing or funding requirements. Some of the structured notes that have been issued are: Monthly Pay Bonds, Step Up Extendible Bonds, and Coupon Accrual Bonds. Another popular form of structured note is the Index Linked Note, which allows investors to participate in the rise of a particular index, while guaranteeing the return of the initial investment. The issuers of structured notes typically are federal crown corporations, provinces and the major chartered banks – the top credits available in the bond market.

## **Fixed Income Mutual Funds**

Mutual funds are pools of investors' savings that offer the benefits of diversification and professional management. Investors own units representing an interest in the portfolio.

Several types of mutual funds invest in fixed income securities. Money market mutual funds invest in instruments such as Treasury Bills, and pay regular interest income. Bond funds invest in a range of bonds in order to generate income and capital gains. There are both domestic and international bond funds on the market. Dividend funds usually hold a large proportion of preferred shares, as well as other fixed income investments. Balanced funds seek to hold an appropriate mix of fixed income, equity and cash investments in order to balance risk and reward.

# The Importance of Credit Ratings

One of the most useful tools available to the fixed income investor is the credit rating.

Simply defined, a credit rating is the opinion of the general credit worthiness of the borrower with respect to a particular debt security or other financial obligation, based on relevant risk factors by a recognized credit rating agency. Since fixed income investments are primarily designed to preserve an investor's capital while paying interest income, the credit worthiness of the borrower is extremely important.

In the Canadian fixed income market the two most commonly used rating agencies are the Dominion Bond Rating Service (DBRS) and Standard & Poor's (S&P). Although their opinions may vary regarding the credit worthiness of a particular issue or issuer, both DBRS and S&P use a very similar rating scale for long-term credit ratings.

The rating scale is meant to provide an indication of the risk that the borrower (obligor) will not fulfill their obligations in a timely manner with respect to both interest and principal commitments. The rating scale also takes into account the protection afforded by, and the relative position of, the investment in the event of bankruptcy or reorganization. Listed below is the credit rating scale used for long-term debt, ranging from the highest quality credit to default, with a brief definition of the credit worthiness associated with the rating:

## Credit Rating Scale

**AAA** – Bonds rated “triple A” are of the highest credit quality. The obligor's ability to meet its financial commitment on the repayment of principal and interest is

extremely strong. Issuers achieving the “AAA” rating have stable earnings, operate a dominant position in a strong and profitable industry, show strong liquidity and coverage ratios, and have established a track record of superior performance. Due to the extreme criteria very few entities are able to achieve the “triple A” rating.

**AA** – Bonds rated “double A” are of superior credit quality and only differ from obligations rated “triple A” to a small degree. The obligor's ability to meet its financial commitments is very strong. Issuers achieving the “AA” rating are considered strong credits, offer above average strength in areas of profitability and liquidity, and are unlikely to be affected by foreseeable market conditions.

**A** – Bonds rated “single A” are of satisfactory credit quality. The obligor's ability to meet its financial commitment is strong. However, issuers receiving the “A” rating are more susceptible to the adverse effects of changes in circumstances and economic conditions.

**BBB** – Bonds rated “BBB” are of adequate credit quality. The obligor's ability to meet its financial commitment is considered adequate. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

**BB** – Bonds rated “BB” are defined as speculative. The obligor's ability to meet its financial commitment is considered uncertain. Issuers in the “BB” category have limited access to capital markets and additional liquidity support. They face ongoing uncertainties or exposure to adverse business, financial, or economic condi-

tions that reduce their capacity to meet commitments on their obligations.

**B** – Bonds rated “B” are highly speculative. The obligor’s ability to meet its financial commitment on an ongoing basis is highly uncertain. Although the obligor is currently meeting its financial commitment, adverse business, financial, or economic conditions greatly reduce the issuer’s capacity or willingness to meet its obligations.

**CCC / CC / C** – Bonds rated in any of these categories are very highly speculative. The obligor, without the presence of favourable business, financial, and economic conditions, is in danger of not meeting its financial commitments.

**D** – Bonds rated “D” are in default of either interest or principal. Unlike other ratings, “D” is not prospective. It is only used where a default has occurred.

As an additional enhancement, credit rating agencies also modify each rating to show the issuer’s relative standing within the major rating categories. In the case of DBRS, a borrower may be further classified as being high or low within the rating category. S&P also provides modification to their ratings, however, they tack on a plus (+) or minus (-) symbol.

To further assist investors in determining the credit worthiness of an issue or issuer, credit rating agencies will provide a rating outlook or place the issuer on a watch list. This happens when an event or deviation from an expected trend has occurred and further information is required to provide an accurate appraisal of the issuer’s credit worthiness. Subsequent to an issuer

being placed on watch, a rating agency will perform a rating review and release the results in a timely fashion. Both DBRS and S&P use the same rating outlook terminology: negative (potential downgrade), positive (potential upgrade), and stable.

To reassure depositors and investors, regulatory bodies created the term “investment grade” to describe obligations that would be eligible for investment by institutions such as banks, insurance companies, and trust companies. The term has gained widespread use in the investment community. An obligation that is recognized as investment grade falls within the four highest rating categories, AAA, AA, A and BBB. The lowest accepted investment grade rating is BBB (low) or (-).

Issues that are rated BB or lower are referred to as “high yield” or “speculative” grade. Market liquidity in these issues does not have the same depth as investment grade bonds. Investors who participate in the high yield market will attempt to maintain smaller positions, spreading them out across a variety of sectors and issues. Investors who do not have the magnitude to broadly diversify their holdings would be advised to participate in high yield investments through a mutual fund offering this service.

# Checklist for Choosing the Right Fixed Income Securities

**As you assess each investment, consider the following factors:**

## 1 Income, Yield and Capital Gains

How much interest will you receive and how often? What will the yield be if held to maturity? Or if it is called before maturity? If you sell before maturity, how much money will you receive? Is there potential for capital gains or losses?

## 2 Term to Maturity

Is the term right for your investment horizon? Can you sell before maturity without penalty?

## 3 Quality and Safety

Is the investment safe? Who guarantees it? What is the issuer's credit rating?

## 4 Liquidity

Can you sell quickly if you need to? If you sell quickly, could you lose money?

## 5 Features

Does the security have any special features? Do you understand all the terms involved?

## 6 Tax Implications

Is it RRSP/RRIF eligible? How often do you have to declare the interest from the investment? Have you discussed the tax implications with your personal tax advisor, if necessary?

## 7 Pricing and Costs

What's the price of the investment? What denominations is it available in? What costs or fees are involved?

## 8 Suitability

Is the risk profile of the investment in line with your own risk tolerance? Does it provide the features and benefits, such as regular income or tax advantages, that you want in an investment? Does it fit in with the overall asset allocation planned for your portfolio? Have you discussed the purchase with your ScotiaMcLeod advisor?

*Answering these questions gives you the framework for evaluating each investment. Your ScotiaMcLeod advisor has the expertise to help you weigh the risks and rewards of each product, taking into consideration your objectives and the current market environment. Working together, you and your advisor will make the most of the fixed income portion of your portfolio.*

# Guide to Selected Fixed Income Securities

<b>Security</b>	<b>Quality</b>	<b>Backed by</b>	<b>Income Frequency</b>	<b>Suitable for</b>
T-Bills	Highest	Federal Government	Maturity	Investors seeking short-term investment
Canada Savings Bonds	Highest	Federal Government	Annual/Compounding	Very conservative investors seeking income
Provincial Savings Bonds	High	Provincial Government	Annual/Semi-Annual/Compounding	Very conservative investors/residents of province
GIC.s	Highest	Canada Deposit Insurance Corporation – up to \$60,000 principal and interest per issuer	Annual/Semi-Annual/Monthly/Compounding	Very conservative investors seeking income over fixed term
Government of Canada Bonds	Highest	Federal Government	Semi-Annual	Conservative investors seeking quality and income
Provincial Bonds	High	Provincial Government	Semi-Annual	Conservative investors seeking higher yield than federal bonds
Municipal Bonds	Varies	Municipality	Semi-Annual	Investors seeking higher yield than federal or provincial bonds
Corporate Bonds	Varies	Corporation	Semi-Annual	Investors seeking higher yield than government bonds
Strip Bonds Federal Provincial	High	Federal/Provincial Government	Maturity	RRSP/RRIF investors who do not require regular income
Strip Bonds Corporate	Varies	Corporation	Maturity	RRSP / RRIF investors who do not require regular income
CMHC NHA Mortgage-Backed Securities	Highest	Federal Government	Monthly	Investors seeking monthly income
Commercial Mortgage-Backed Securities	Varies	Commercial Real Estate Properties secured by a first lien	Monthly	Investors seeking monthly income and higher yields than CMHC mortgage-backed securities
Non-Canadian Foreign Currency Bonds	Varies	Foreign Government or Corporation	Annual/Semi-Annual/Monthly/Compounding	Investors comfortable with international diversification and risk

## The Portfolio Advisory Group

The Portfolio Advisory Group helps ScotiaMcLeod's advisors provide market strategy, portfolio reviews, and equity and fixed income research designed specifically for individual investors. Specialists within the Portfolio Advisory Group have expertise in Canadian and U.S. equities, fixed income securities, income products, and equity derivatives. The Portfolio Advisory Group has also developed a series of very successful model equity and fixed income portfolios, used by ScotiaMcLeod advisors as a guide for creating and managing their own clients' portfolios. The model portfolios are well diversified, follow strict portfolio management criteria, and satisfy dif-

ferent investment objectives in Canadian equities, U.S. equities, and fixed income securities.

The Portfolio Advisory Group has a proven performance record as a superior provider of top-ranked research, value added services, and practical investment strategies. We work closely with ScotiaMcLeod advisors to continually develop the best products and services to build and strengthen our most important asset: our clients.

† As indicated in rankings conducted by a prominent, global financial research firm.

## Building Relationships for Life



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