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Looking at Investment Returns

By admin

A major Canadian financial institution ran an investment promotion earlier this year that promised attractive returns for GIC-type investors, who needed higher returns to generate income. While dealing with an advisor from this particular institution on another matter, the conversation turned to the details of their offer.

The highlighted promotion offered a much higher monthly income than a normal payout GIC. The advisor confirmed that the product was a Term Certain Annuity for 15 years, linked to stock market index returns. He also confirmed that, at the end of the 15 years, the buyer may or may not get back their original capital, or nothing at all, depending on the performance of the economy and the stock markets.

The point of this story is to highlight one specific type of investment return that investors may receive as part of their RRSP, TFSA or other investment accounts. This is referred to as a ROC type investment or "return of capital". This special type of investment return is often noted on investment tax slips as part of any distributions distributed during the year; however, this return is never counted as earned income.

Other types of investment returns include taxable dividends (profit sharing), interest income (the most "tax-expensive" type of income for high income earners) and capital gains. When most people refer to their investment returns or goals, they often mean capital gains.

However, distributions of all types can form an important part of asset building and asset preservation strategies. Younger investors, who are usually more focused on growth, are advised to reinvest their dividends (DRIP or dividend reinvestment program) to buy more shares of units of an investment fund. This can result in capital gains as the value of each unit rises and the quantity increase in units over time, which may also increase the overall return of an investment portfolio. Either or both situations may result in a higher capital value of an investment over time.

As investors approach retirement and begin to consider their options for drawing income from their investments, it is possible to have all distributions paid out directly to the account owner rather than being reinvested. Ideally, this allows the investor to maintain the number of units owned while drawing out the desired income. An investor may also experience capital growth in the unit value over time as the economy grows, as well as possible growth in the distributions paid out for each unit owned.

There are two ways to look at the "yield" or ROI (Return on Investment) of a dividend paying investment. The first method is based on the original investment amount (or Book Value):

Capital Invested: **$10,000**
Distributions: **$500 annually**
Yield is: **5%**

The yield will always remain at 5% as long as that investment is held, even if the investment value goes up or down over time.

The second method is based on current market value. Let us consider that, over five years, the capital value grew to $15,000. The dividend yield stays the same at $500:

Market Value: **$15,000**
Distributions: **$500 annually**
Yield is about: **3.34%**

Someone might look at that new distribution yield and look for another investment that will pay out a higher amount of say 5%. However, it is always recommended to first confirm that actual dollars paid out by the new investment exceed the $500 currently being earned. Otherwise the tax costs, if any, and transaction costs may not be worth making a change.

Call us today to discuss to discuss your retirement [1] and passive income cash flow needs. We have some exciting ideas that can help you meet your income targets!

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