Take More Interest in Your Income

Everyone knows that variety is the spice of life, but it's also an essential ingredient in your fixed-income portfolio. When developing a long-term investment strategy for retirement, you'll need to consider your income needs, but it's important to take all varieties of income into account.

Three Types of Income: Variable, Reliable and Rising

In a comprehensive income strategy, all three types of income – variable, reliable and rising – play an important role in your investment portfolio. Each has benefits and trade-offs, but when used together, they can help you meet your income needs. Your personal situation, including how much income you need and your risk preferences, will determine the mix of variable, reliable and rising income investments that is most appropriate for you.

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MAKING SENSE OF INVESTING

Variable Income

Benefit	Either preservation of principal or portfolio diversification
Trade-off	Unpredictable long-term income

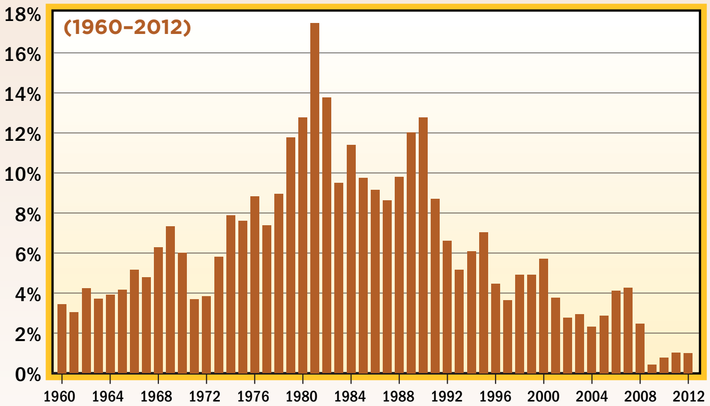
Variable income investments can help preserve your principal and/or meet your current income needs. In addition, some of these investments offer greater liquidity, meaning they can be easily bought or sold in the market – with the exception of GICs, which usually can't be sold prior to maturity.

However, there are some trade-offs with these investments as well. As the name implies, these investments provide income that typically varies over time and, as a result, is less predictable. While they appear to provide reliable current or short-term income, they do a poor job of providing consistent income over the long term. The reason is short-maturity investments must be replaced when they expire if you need a continuous stream of income. And when they mature, you must decide whether to reinvest at the current market rate, which could be lower. Because interest rates often change, we believe it's unwise to rely on variable income investments alone to provide your long-term income.

Interest Rates Are Hard to Predict

Even seasoned professionals can't consistently predict how interest rates might change. As a result, the rate that variable income investments provide over time can be erratic, as shown in the chart.

Historical Six-month Canada Treasury Bill Rates



Source: Bank of Canada, Edward Jones.

While these investments can supplement your income, it's risky to assume that most of your long-term income needs can be met this way. Because of their unpredictable and variable nature, owning too much can be detrimental to the stability of your portfolio's income. Instead, we recommend a more balanced approach that includes reliable and rising income investments as well.

Investment Options

Guaranteed Investment Certificates (GICs) issued by banks are CDIC-insured and provide a fixed rate but are typically short-term. The same is true for GICs issued by insurance companies (also known as fixed-rate annuities), which are ASSURIS-insured. In either case, when GICs mature, you must decide whether to reinvest at the current market rate, which could be lower. Over time, the income generated from reinvesting in short-term GICs will fluctuate unpredictably. Similarly, short-term bonds (with maturities less than five years) and money market investments also provide variable income.

Another option is bond funds, which provide variable income streams that can be affected by interest rate changes and economic cycles. Unlike GICs, bond funds do not have a maturity date or fixed interest rate and don't offer protection of your principal. But key benefits of bond funds are their broader bond diversification and professional management for investors who may not have the assets to build a laddered individual bond portfolio.

Reliable Income

Benefit	More predictable long-term income
Trade-offs	Longer maturity, more price fluctuation and more risk to principal

Reliable income investments can add predictability to your long-term income stream. By adding this kind of investment, you can help offset some of the fluctuations in your variable income investments. For example, intermediate- and long-term bonds can help reduce the risk of your income fluctuating because you lock in their interest rate for six to 30 years. This gives you the potential for stable income over that time period. But with this predictability comes more risk to principal prior to maturity.

Investment Options

Intermediate- and long-term bonds add reliable income to your investment strategy, but you may also want to consider segregated funds with a guaranteed minimum withdrawal benefit (GMWB) if you're beginning your transition to retirement within two years. Of course, depending on the option you choose, there are always trade-offs you must accept to get more reliable income. These may include greater price volatility, difficulty selling in the market, increased fees or the potential loss of your principal.

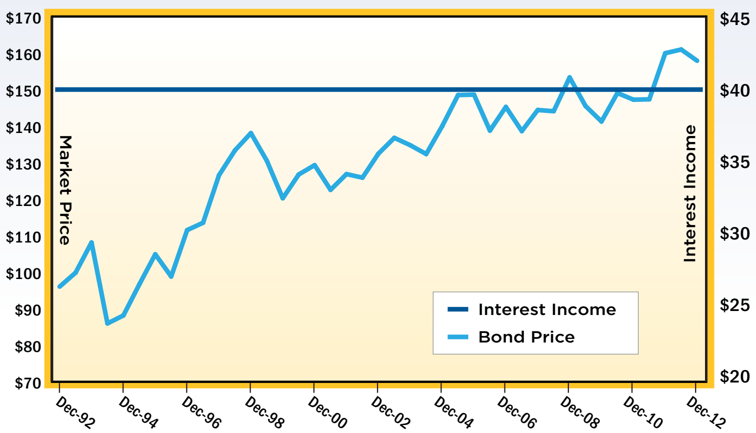
The Long and Short of It

Long-term bond prices can change more than short-term because you are waiting longer until maturity. This greater price volatility could result in loss of principal if you need to sell the bonds before maturity. Income payments from those bonds aren't impacted when interest rates change, but principal value could fluctuate.

Intermediate-term bonds (six- to-15-year maturities) lie between the extremes of short-term (up to five years) and long-term bonds (16 to 30 years). Their prices don't fluctuate as much as longer-term bonds, and their interest payments offer better income stability when compared to short-term investments.

Laddering – or owning bonds with different maturities – can help make your income more reliable. A one- to five-year bond ladder can help add reliability because only 20% of that income would come due in any year. By owning short-, intermediate- and long-term fixed-income investments, you can balance the risks of price changes and income fluctuation. Laddering can also help protect your portfolio from interest rate changes because it doesn't depend on rates rising or falling for success.

8% Government of Canada Bond Due 6/01/2023



Source: Bloomberg, Edward Jones.

WATCH THE CALL

It's important to consider a bond's call protection. If the bond issuer decides to redeem your bonds prior to their maturity, your income would be cut off. Some bonds can be called at any time, while others can't be redeemed prior to the maturity date. Most bonds have a "call protection period," which is a time when they cannot be redeemed by the issuer. Be sure to guard against having too little call protection to prevent your income from sudden fluctuations if bonds are called.

Rising Income

Benefits	Inflation protection and liquidity
Trade-offs	More price fluctuation and risk to return of initial investment; dividend income may be decreased or eliminated at any time

When considering your long-term income strategy, don't forget about inflation. Your expenses – like groceries and gasoline – will rise over time, and you could spend 25 years or more in retirement. That's why it's important to have investments that can provide rising income to help keep pace with inflation and complement the reliable and variable income investments in your portfolio.

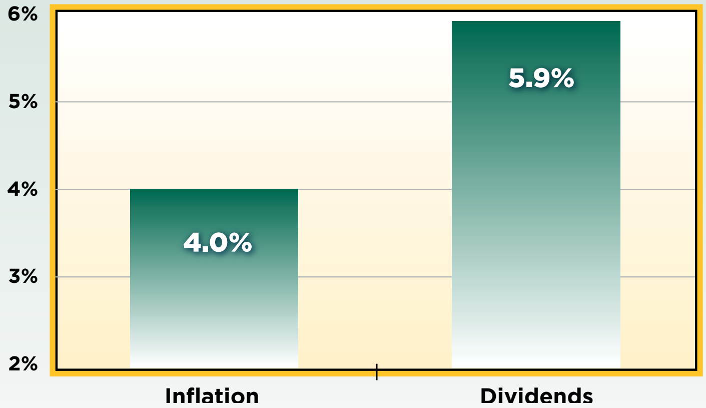
Investment Options

Investing in companies with a history of increasing their dividends can give you rising income. Rising income can be obtained from individual stocks or through equity mutual funds/segregated funds. Funds can help diversify your portfolio and protect your purchasing power because equities have historically done a better job of keeping up with inflation over the long run. As a result, investments with the potential for rising income can become an important part of your total income over time.

The trade-off for the rising income potential is that equity investments tend to fluctuate in value more than fixed-income investments and could return substantially less than your original investment. In addition, it's possible for the dividends to decrease or be eliminated at any time without notice. In other words, not all equity investments will provide rising income. And too much concentration in rising income investments may cause your portfolio to experience significant ups and downs.

S&P 500 Dividends vs. Inflation

Average Annual Return Since 1960



Source: Bloomberg, Statistics Canada; 12/31/2011. Inflation measured by the Consumer Price Index. The S&P/TSX Composite is an unmanaged index and cannot be invested in directly.

BALANCE IS KEY

Variable, reliable and rising income all play a key role in a well-diversified investment portfolio, and it's important to maintain balance. For instance, too much in variable income investments can be detrimental to your income's predictability because you'll have to find comparable rates when your short-term investments come due. Putting too much in long-term bonds, though they provide reliable income, can expose you to greater price volatility when interest rates rise. And too much in rising income could add unnecessary market volatility to your portfolio.

Keep only enough GICs and other short-term investments to cover your short-term income and savings needs. The bulk of your retirement income can be satisfied with some combination of reliable and rising income investments. Your individual situation will determine the balance that's appropriate for you. Work with your Edward Jones advisor to determine how to fulfill your income needs for today and for the long term.

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