Tax Advantages of Fixed Income ETFs

For income-oriented investors looking for limited to no portfolio volatility GICs and HISA have become a top option. As interest rates have risen to levels not seen in over a decade, bond yields (yield to maturity) have also significantly increased. Investors can now purchase bonds that are deeply discounted relative to their maturity value ($100)[1]. Most significantly on the short-end of the term where price volatility repayment risk tend to be the lowest. As a result, the fixed income market may actually offer a more attractive investment opportunity than GICs and HISAs for taxable investors. The after tax difference can be significant for high-net-worth investors creating an opportunity for Advisors to add value. Fixed income ETFs are a good way to access this advantage as one can buy a basket of bonds targeted to a specific credit and duration exposure, similar to individual bonds.

The advantage of buying an ETF that has a basket of bonds trading at a discount is that a portion of the future return will come from price appreciation (difference between the discounted price and the maturity value of $100) which is treated as a capital gain for tax purposes.

Using a capital gain's inclusion rate of 50%, means that half the capital gain is tax-free, while the other 50% is added to taxable income, with the coupon (interest) income. This compares to a GIC and HISA's where 100% of the return comes from periodic interest income which is taxed as regular income.

Tax Breakdown using Fixed Income ETFs

BMO Ultra Short-Term Bond ETF (ZST)

ZST holds a basket of investment grade corporate bonds with under 1 year to maturity. The objective is to hold these bonds to maturity with the added benefit is intraday liquidity.

- Current Yield to Maturity (YTM)[2] is 5.26% and the coupon is 2.70%[3]
- The difference between the Yield to Maturity and the coupon is also reflected in the discount that the basket of bonds is trading at, currently the average bond price within the portfolio is $98.83.

[1] Yields and Bond Prices are inversely related. So, a rise in a bond price will decrease the yield and a fall in the price will increase the yield.
[2] Yield to Maturity: The total expected return from a bond when it is held until maturity – including all interest, coupon payments, and premium or discount adjustments.
[3] As of March 31, 2024

- Using a one year time horizon with an investment of $100[4], with no changes to interest rates or credit spreads, the pre- tax total return will equal 5.26% and for taxable investors will be a combination of income and capital gains.

BMO Ultra Short-Term Bond ETF (ZST) vs. 1 Yr Non-Redeemable (GIC)

			Before Tax Return		After Tax Return				
	Coupon	YTM[5]	Interest Income ($)	Capital Gains ($)	Interest Income ($)	Capital Gains ($)	After Tax Return ($)	After Tax Return (%)	Difference
ZST	2.70	5.26	$2.70	$2.56	$1.25	$1.87	$3.12	3.12%	0.56%
GIC	5.50	5.50	$5.50	$0.00	$2.56	$0.00	$2.56	2.56%	-0.56%

CAD GIC - Best Available on ratehub.ca 3/31/24

Tax Calculation

ZST

Interest Income

- 2.70% Coupon x $100 Initial Investment = **$2.70 Pre Tax Interest Income**
- $2.70 Income Before Tax x (1- Marginal Tax Rate[6]) = **$1.25 After Tax Interest Income**

Capital Gain

- (5.26% YTM - 2.70% Coupon) x $100 Initial Investment
  = **$2.56 Pre Tax Capital Gains** *realized at maturity*
- Capital Gains before Tax x (1 - Capital Gains Inclusion Rate)
  + [Capital Gains Before Tax x (1 - Capital Gains Inclusion Rate) x (1 - Marginal Tax Rate)]
  = **$1.87 After Tax Capital Gains**

Total Return

- $2.70 Interest Income + $2.56 Capital Gains = **$5.26 Pre-Tax Return**
- $1.25 Interest Income + $1.87 Capital Gains = **$3.12 After Tax Return**

GIC

Interest Income

- 5.50% Coupon x $100 Initial Investment = **$5.50 Pre-Tax Interest Income Earned**
- $5.50 Coupon x (1 - Marginal Tax Rate) = **$2.56 After Tax Return**

*Given current market dynamics, an investor can generate a higher after-tax expected return (approx **+21%**) by investing in an ETF such as ZST vs a GIC.*

Note: ZST is currently making monthly cash payments of $0.21, which is a blend of the interest income and capital gains. This gives one the tax advantages but maintains the cash flow. For investors that do not want the cash flow, they can purchase ZST.L where the income is compounded.

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[4] Initial investment of $1,000 – holding period 1 year (assumes that the investor sells the ZST at 1 year)
[5] YTM is calculated gross of fees.
[6] Assuming the tax rate is 53.53. Top marginal tax bracket will differ depending on province of residence

BMO Short-Term Discount Bond ETF (ZSDB):

ZSDB holds a basket of Canadian investment grade government and corporate bonds with maturity between 1-5 years. The objective it to invest in bonds with lower coupons, while matching the underlying characteristics of the universe, making it more tax efficient. The added benefit is intraday liquidity.

- Current Yield to Maturity (YTM) is 4.40% and the coupon is 1.39%.[7]
- The difference between the Yield to Maturity and the coupon is also reflected in the discount that the basket of bonds is trading at, currently the average bond price within the portfolio is $92.51.
- Using a one year time horizon with an investment of $100[8], with no changes to interest rates or credit spreads, the total return for taxable investors will be a combination of income and capital gains.

BMO Short-Term Discount Bond ETF (ZSDB) vs. 1 Yr Non-Redeemable (GIC) vs. iShares Core Canadian Short Term Bond Index ETF (XSB) or similar ETFs such as ZSB[9] and VSB[10].

			Before Tax Return		After Tax Return				
	Coupon	YTM[11]	Interest Income ($)	Capital Gains ($)	Interest Income ($)	Capital Gains ($)	After Tax Return ($)	After Tax Return (%)	Difference
ZSDB	1.39	4.40	$1.39	$3.01	$0.65	$2.20	$2.85	2.85%	
GIC	5.50	5.50	$5.50	$0.00	$2.56	$0.00	$2.56	2.56%	-0.29%
XSB	3.09	4.57	$3.09	$1.48	$1.44	$1.08	$2.52	2.52%	-0.33%

Tax Calculation

ZSDB

Interest Income

- 1.39% Coupon x $100 Initial Investment = $1.39 **Pre Tax Interest Income**
- $1.39 Income Before Tax x (1 - Marginal Tax Rate[12]) = $0.65 **After Tax Interest Income**

Capital Gain

- (4.40% YTM - 1.39% Coupon) x $100 Initial Investment
  = **$3.01 Pre Tax Capital Gains** *realized at Maturity*
- Capital Gains before Tax x (1 - Capital Gains Inclusion Rate)
  + [Capital Gains Before Tax x (1 - Capital Gains Inclusion Rate) x (1 - Marginal Tax Rate)]
  = **$2.20 After Tax Capital Gains**

Total Return

- $1.39 Interest Income + $3.01 Capital Gains = **$4.40 Pre-Tax Return**
- $0.65 Interest Income + $2.20 Capital Gains = **$2.85 After Tax Return**

[7] As of March 31, 2024
[8] Initial investment of $1,000 – holding period 1 year (assumes that the investor sells the ZSDB at 1 year)
[9] ZSB – BMO Short-Term Bond Index ETF.
[10] VSB – Vanguard Canadian Short-Term Bond Index ETF
[11] YTM is calculated gross of fees.
[12] Assuming the tax rate is 53.53. Top marginal tax bracket will differ depending on province of residence

GIC

Interest Income

- 5.50% Coupon x $100 Initial Investment = **$5.50 Pre-Tax Interest Income Earned**
- $5.50 Coupon x (1 - Marginal Tax Rate) = **$2.56 After Tax Return**

Comparing ZSDB to a traditional 1-5 year Canadian bond fund (XSB, for example), you see that there is a meaningful benefit in the strategy for taxable investors.

*Given current market dynamics, an investor can generate a higher after tax expected return (approx **+11%**) by investing in an ETF such as ZSDB vs a GIC.*

While our comparison uses GICs and HISAs, they still remain an attractive option for tax-exempt investors, as well as for individuals seeking the $100,000 CDIC coverage that they provide.

Performance

Fund Name	Ticker	1 Year	3 Year	5 Year	10 Year	Since Inception
BMO Ultra Short-Term Bond ETF	ZST	5.44%	2.64%	2.29%	1.90%	1.97%
BMO Short-Term Discount Bond ETF	ZSDB	3.79%	–	–	–	0.93%

Disclaimer:

Distribution yields are calculated by using the most recent regular distribution, or expected distribution, (which may be based on income, dividends, return of capital, and option premiums, as applicable) and excluding additional year end distributions, and special reinvested distributions annualized for frequency, divided by current net asset value (NAV). The yield calculation does not include reinvested distributions. **Distributions are not guaranteed, may fluctuate and are subject to change and/or elimination. Distribution rates may change without notice (up or down) depending on market conditions and NAV fluctuations.** The payment of distributions should not be confused with the BMO ETF's performance, rate of return or yield. If distributions paid by a BMO ETF are greater than the performance of the investment fund, your original investment will shrink. Distributions paid as a result of capital gains realized by a BMO ETF, and income and dividends earned by a BMO ETF, are taxable in your hands in the year they are paid. **Your adjusted cost base will be reduced by the amount of any returns of capital. If your adjusted cost base goes below zero, you will have to pay capital gains tax on the amount below zero.**

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