

# 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)<sup>1</sup>. 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)<sup>2</sup> is 5.45% and the coupon is 2.86%<sup>3</sup>
- 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 \$98.23.

---

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> As of July 20, 2023

- Using a one year time horizon with an investment of \$100<sup>4</sup>, with no changes to interest rates or credit spreads, the pre- tax total return will equal 5.45% 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)

	Coupon	YTM <sup>5</sup>	Before Tax Return		After Tax Return		After Tax Return (\$)	After Tax Return (%)	Difference
			Interest Income (\$)	Capital Gains (\$)	Interest Income (\$)	Capital Gains (\$)			
ZST	2.86	5.45	\$2.86	\$2.59	\$1.33	\$1.90	\$3.23	3.23%	0.67%
GIC	5.50	5.50	\$5.50	\$0.00	\$2.56	\$0.00	\$2.56	2.56%	-0.67%

#### Tax Calculation

##### ZST

###### Interest Income

- 2.86% Coupon x \$100 Initial Investment = **\$2.86 Pre Tax Interest Income**
- \$2.86 Income Before Tax x (1 - Marginal Tax Rate<sup>6</sup>) = **\$1.33 After Tax Interest Income**

###### Capital Gain

- (5.45% YTM - 2.86% Coupon) x \$100 Initial Investment = **\$2.59 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) ] = **\$1.90 After Tax Capital Gains**

###### Total Return

- \$2.86 Interest Income + \$2.59 Capital Gains = **\$5.45 Pre-Tax Return**
- \$1.33 Interest Income + \$1.90 Capital Gains = **\$3.23 After Tax Return**

##### GIC

###### Interest Income

- 5.5% 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 +26%) by investing in an ETF such as ZST vs a GIC.*

**Note:** ZST is currently making monthly cash payments of \$0.19, 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.

<sup>4</sup> Initial investment of \$1,000 – holding period 1 year (assumes that the investor sells the ZST at 1 year)

<sup>5</sup> YTM is calculated gross of fees.

<sup>6</sup> 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 is 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 5.00% and the coupon is 1.32%.<sup>7</sup>
- 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 \$92.14.
- Using a one year time horizon with an investment of \$100<sup>8</sup>, 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<sup>9</sup> and VSB<sup>10</sup>.

	Coupon	YTM <sup>11</sup>	Before Tax Return		After Tax Return		After Tax Return (\$)	After Tax Return (%)	Difference
			Interest Income (\$)	Capital Gains (\$)	Interest Income (\$)	Capital Gains (\$)			
ZSDB	1.32	5.00	\$1.32	\$3.68	\$0.61	\$2.70	\$3.31	3.31%	
GIC	5.50	5.50	\$5.50	\$0.00	\$2.56	\$0.00	\$2.56	2.56%	-0.75%
XSB	2.68	4.91	\$2.68	\$2.23	\$1.25	\$1.63	\$2.88	2.88%	-0.43%

### Tax Calculation

#### ZSDB

##### Interest Income

- 1.32% Coupon x \$100 Initial Investment = **\$1.32 Pre Tax Interest Income**
- \$1.32 Income Before Tax x (1 - Marginal Tax Rate<sup>12</sup>) = **\$0.61 After Tax Interest Income**

##### Capital Gain

- (5% YTM - 1.32% Coupon) x \$100 Initial Investment  
= **\$3.68 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) ]  
= **\$2.70 After Tax Capital Gains**

##### Total Return

- \$1.32 Interest Income + \$3.68 Capital Gains = **\$5.00 Pre-Tax Return**
- \$0.61 Interest Income + \$2.70 Capital Gains = **\$3.31 After Tax Return**

<sup>7</sup> As of July 20, 2023

<sup>8</sup> Initial investment of \$1,000 – holding period 1 year (assumes that the investor sells the ZSDB at 1 year)

<sup>9</sup> ZSB – BMO Short-Term Bond Index ETF.

<sup>10</sup> VSB – Vanguard Canadian Short-Term Bond Index ETF

<sup>11</sup> YTM is calculated gross of fees.

<sup>12</sup> Assuming the tax rate is 53.53. Top marginal tax bracket will differ depending on province of residence

## GIC

### Interest Income

- 5.5% 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 +29%) 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.

### Disclaimer:

We are not tax specialists and each individual circumstance and tax situation may be different. Investors should consult their tax specialist before acting on the information provided above.

This article is for information purposes. The information contained herein is not, and should not be construed as, investment, tax or legal advice to any party. Particular investments and/or trading strategies should be evaluated relative to the individual's investment objectives and professional advice should be obtained with respect to any circumstance.

Any statement that necessarily depends on future events may be a forward-looking statement. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Although such statements are based on assumptions that are believed to be reasonable, there can be no assurance that actual results will not differ materially from expectations. Investors are cautioned not to rely unduly on any forward-looking statements. In connection with any forward-looking statements, investors should carefully consider the areas of risk described in the most recent simplified prospectus.

The viewpoints expressed by the Portfolio Manager represents their assessment of the markets at the time of publication. Those views are subject to change without notice at any time. The information provided herein does not constitute a solicitation of an offer to buy, or an offer to sell securities nor should the information be relied upon as investment advice. Past performance is no guarantee of future results. This communication is intended for informational purposes only.

BMO ETFs are managed by BMO Asset Management Inc., which is an investment fund manager and a portfolio manager, and a separate legal entity from Bank of Montreal.

Commissions, management fees and expenses all may be associated with investments in exchange traded funds. Please read the ETF Facts or prospectus of the BMO ETFs before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all dividends or distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Exchange traded funds are not guaranteed, their values change frequently and past performance may not be repeated.

For a summary of the risks of an investment in the BMO ETFs, please see the specific risks set out in the BMO ETF's prospectus. BMO ETFs trade like stocks, fluctuate in market value and may trade at a discount to their net asset value, which may increase the risk of loss. Distributions are not guaranteed and are subject to change and/or elimination.

®/™Registered trademarks/trademark of Bank of Montreal, used under licence.