Stop! What You Must Know Before Investing in These Funds

Description

With so many baby boomers nearing retirement, Canada's fund companies are doing everything they can to draw clients from that demographic. But one product in particular is worth looking into: the **CI Financial** (TSX: CIX) G5|20 fund series, which guarantees a 5% return on your money for 20 years.

A 5% return for 20 years? That doesn't sound like much of a guarantee. After all, you can get the same guarantee simply by sticking your money under a mattress. If you withdraw 5% of the money every year, the money will last for 20 years – pretty simple math.

Of course this is not what CI Investments is doing. But it does raise a larger question: how do these guarantee-based funds work? And should you put your money in them?

How they work

Guarantee-based products start out by investing the bulk of your money in equity funds. If the funds do well, covering the guarantee is no problem. If the funds do poorly, that of course creates a shortfall. And there's only one way to guarantee that the shortfall will be overcome — switch into bonds.

Another reason can crop up for switching into bonds: lower interest rates. This is because when interest rates are low, you must own them for a longer period of time to cover a shortfall. And that forces the guarantee-based products to own bonds earlier.

So over time, these products gradually shift from stocks into bonds. If equity prices or interest rates fall, that process is accelerated.

The problem

Imagine an investor who likes to invest in stocks, but sells his holdings if they don't do well. This is of course a terrible strategy, because it involves selling stocks when they are cheap.

But that is exactly what these products do. Even worse, the products are forced to buy bonds after interest rates have already fallen. In effect, the products tend to sell cheap stocks and buy expensive bonds.

A case study

Back in 2008, **Bank of Montreal** (TSX: BMO)(NYSE: BMO) launched its LifeStage Plus funds. These funds promised to pay investors all their money back as long as the funds were held until the maturity date. And investors would get to keep any and all of the upside!

Unfortunately the financial crisis followed, and the funds got crushed. And that meant switching all the holdings into bonds. Fast forward to today, and the fund's investors are still waiting for their maturity dates. Worst of all, they have all been investing in bonds for the past five years, and missed out on the market rebound. The funds have dramatically underperformed both stocks and bonds over their lifespan.

BMO closed those funds, but started a fresh set of LifeStage funds in 2011. Fortunately the newer funds have not had the same bad luck.

Foolish bottom line

In investing, just like anything else in life, there is no such thing as a free lunch. Likewise, a guaranteed return doesn't mean a fund company is willing to pay you from its own pocket. These products are not a good way to invest your retirement money, and are not suitable for anyone else either. You should put your money elsewhere.

CATEGORY

1. Investing

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1. NYSE:BMO (Bank of Montreal)
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3. TSX:CIX (CI Financial)

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Date
2025/07/06
Date Created
2014/04/18
Author
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