How Investing in Stocks Differs From Investing in GICs

Description

Guaranteed Investment Certificates (GICs) allow you to earn interest, and you're guaranteed to get your initial investment back at maturity. The interest rate of a GIC is around 2%. Usually, the longer the term, the higher the interest rate. However, there's a hidden risk in investing in GICs: inflation.

Risk and return

The long-term inflation rate has been 3-4%. In this case, your purchasing power from a GIC investment decreases. To counter inflation, you can include equities in your diversified portfolio. I prefer to invest in stocks for the equity portion of my portfolio.

Stocks are viewed as risky because of their volatile prices. Further, the business behind a stock could go bankrupt, in which case shareholders likely won't get their investments back. However, if you stick with quality businesses, such as **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), you shouldn't have to worry about bankruptcy.

Instead, for the business risk that you're taking, you should get higher returns than you would investing in GICs. For example, Canadian Imperial Bank of Commerce yields 5.3% at February 9th's closing. That's already more than double the interest rate for GICs. Additionally, you should also expect price appreciation from your stock investments if you buy at the right price.

It's obvious that the lower the price you pay for a quality business, the higher your expected returns should be. It's not so obvious that when you buy stocks at lower prices that you're also taking on less risk than if you invested at higher prices, because you're paying less for more.

Unfortunately, when a stock's price dips, there are some macro factors or company-specific issues. For example, the Canadian economy has weakened due to lower commodity prices, and the banks are expected to experience slower growth in the near term. As a result, Canadian Imperial Bank of Commerce's multiple has contracted and its stock price has declined.

Since 2009 Canadian Imperial Bank of Commerce has normally traded at 10.6 times its earnings. Because of the price decline, at $86.20, it's priced just a little over nine times its earnings. So, the shares are discounted by about 15%, assuming that the bank will eventually trade at the higher historical multiple in the future.

Lower prices also imply higher yields as long as the company maintains its dividend.

Should your money be working for you all the time?

You can always get your money invested in GICs without worrying about the principal. However, you might use a laddered GIC approach, in which you set up your GIC investments so they mature in different years. In doing so, you get an average interest rate instead of potentially being stuck with low interest rates.

For your stock portfolio, you probably don't want your money to work for you all the time because you want to lower risk and buy low to maximize returns. If you're not sure what prices to buy the stocks on your watch list at, you can opt for the dollar-cost averaging approach, in which you buy small positions over time. In the long term, you get an average cost. With the same purchase amount you buy more shares when prices are low and fewer shares when prices are high.

Alternatively, if you already have some stock investments, you can always save up some cash and wait for a market dip of 15-20% before starting to buy more.

Conclusion

GICs and stocks can be a part of a diversified portfolio. GICs protect your initial investment while you earn interest at maturity. On the other hand, investing in quality stocks such as Canadian Imperial Bank of Commerce should give you a higher return because you're taking on higher risk. However, you can reduce the risk by buying on dips.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
3. Investing

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1. Editor's Choice

TICKERS GLOBAL

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