Investors should take a pass on this market-linked GIC



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SPECIAL TO THE GLOBE AND MAIL

PUBLISHED AUGUST 7, 2014

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A prospective client recently brought an index-linked guaranteed investment certificate (GIC) to our attention – an investment that he found very attractive. He asked for our thoughts on this product. This GIC that pays interest linked to the S&P/TSX 60 Index performance over 3– or 5– year terms.

While it uses an averaging formula to compute returns, it has no maximum participation in index returns. On the surface it even sounded good to your humble and skeptical blogger – i.e. 100 per cent participation, capital guarantee and potentially some minimum interest kicker if the index lost money. But after subjecting this deposit product to some simple modelling it was clear that this was just another linked note with odds tilted in favour of its issuer.

While the issuer – [Alterna Bank](https://www.alternabank.ca/Personal/Investments/TermDeposits/) – doesn't make an offering document available on its website, it provides a [fact sheet](https://www.alterna.ca/SharedContent/documents/Alterna_MarketTracer_rev-E.pdf) and [other information](https://www.alternabank.ca/Personal/Investments/MarketTracer/) with sufficient details to test the product using actual historical data. Using the formulas contained in the fact sheet, I was able to model the S&P/TSX 60 Index to see how often and by how much the GIC would have beaten the pure index investment over both 3 and 5 year terms. The S&P/TSX 60 Index has existed since the summer of 1999. My analysis, which uses a September 30, 1999 start date, yielded insightful results.

**Three-year terms**

From September 1999 through June 2014 there were 141 rolling 3-year periods based on monthly data.

* In 108 of those rolling three year periods – or 77 per cent of the time – the Market Tracer GIC would have underperformed by a median 5 per cent per year.
* In the 33 rolling three-year periods – 23 per cent of the time – during which Market Tracer would have done better, it would have outpaced the index by 3.6 per cent per year.
* In other words, 77 per cent of the time Market Tracer loses. During the little time during which Market Tracer would have done better, its margin of outperformance would have been much smaller than the margin of underperformance.

**Five-year terms**.

From September 1999 through June 2014 there were 123 rolling 5 year periods based on monthly data.

* In 119 of those rolling five year periods – or 97 per cent of the time – the Market Tracer GIC would have underperformed by a median 4.7 per cent per year.
* In the 4 rolling five-year periods – 3 per cent of the time – during which Market Tracer would have done better, it would have outpaced the index by just 0.8 per cent per year.
* In other words, the time Market Tracer would have lost during virtually every five year period by a large margin. And in the few instances where it was successful, it just squeaked by the index.

**Other Factors**

The above analysis assumes that the Market Tracer GIC's formula uses the total return – not the price-only return – of the S&P/TSX 60 Index. Details I found online did not specify whether the index tracked is a "total return index" (i.e. price + reinvested dividends) or purely a "price index" (i.e. change in price only, excluding the benefits of dividends and compounding benefits of reinvesting those dividends). A key question that the offering document should answer: is interest paid based on the total return index or does the issuer keep the dividend to reduce its cost of capital?

If it tracks price only, the above figures would go from bad to ugly for Market Tracer. Keep in mind that financial institutions have designed these products and have deemed them attractive enough to want to sell a lot of them. In other words, they will tend to offer products when they are confident that the odds will be tilted in their favour – which may be at odds with what's best for end investors. Interested investors should review the offering document prior to making any decision. My initial analysis, however, suggests that investors should take a pass.