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# Time to get real about returns

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Interest rates in developed countries have plummeted as the global recovery and employment growth has slowed. Long-term Government of Canada bond yields are languishing at levels not seen since the 1950s.

For retirees, the mathematics is daunting. An investor today holding a 10-year Canadian government bond faces the unhappy prospect of earning about a 2.75% yield to maturity. As a result, an affluent investor with a million dollars in this bond will earn $27,500 per annum for each of the next 10 years.

As discouraging as these numbers are, this example only scratches the surface of the problem. Canadian government bond yields compensate investors for two factors. One is a "real return" component that recompenses an investor for deferring consumption; in essence, this is a payment for the time value of their money. The second is a return to cover expected inflation.

Retirees who face the prospect of rising prices year after year are vitally concerned with the real return on their investment. This is what funds their purchasing capability. The inflationary element buys them nothing.

Yet, thinking in real dollars is difficult. Numerous behavioural finance studies have documented that "money illusion" -- the tendency of individuals to think of money in nominal rather than real terms --is widespread and persistent. For example, experiments have shown that most people who think that a 2% cut in nominal income is unfair also believe that a 2% income increase in a world of 4% inflation is fair -- despite the equivalent purchasing power.

Hence, while most people are aware that inflation has trended downwards over the past decade, they are not aware that real interest rates have also headed south. In 2000, a real return bond -- a government bond that pays you a real rate of interest as well as a separate amount that adjusts your principal upwards for inflation -- yielded as much as 4% annually. In contrast, this past September it yielded a diminutive 1.17%.

For many people heading into retirement, this is ruinous. That million-dollar investment in Canadian government bonds is only paying about $12,000 in inflation-adjusted dollars. Hardly the stuff of the lifestyles of the rich and famous.

As the economy recovers, real interest rates are likely to increase. However, many economists believe that surplus savings globally in combination with slower growth will keep real interest rates low for years to come. And even if real interest rates recover to their long-term norm, nobody is going to have a party. Since 1870, the real interest rate on U.S. Treasuries has only been 2.1%.

There is another possible fly in the ointment. Today's rates incorporate an expected annual inflation rate in the order of 1.5%. If actual inflation ends up higher, the real interest return will be further diminished, and may even go negative.

There is no cure-all to the challenge of lower real interest rates. People need to save more for retirement while retirees have the unpleasant task of chopping their budgets.

Diversification, always important, is now vital. Provincial, corporate and high-yield bonds deserve consideration. For taxable investors, Canadian preferred shares are a worthwhile option. Real estate investment trusts and infrastructure investments are also possibilities. Stocks, due to their higher return potential, are particularly critical for long-term investors.

Today's low rates mean investors need to get real about their planning.

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