

Tax-Efficient Discount Bond ETFs

Justin Bender, CFA, CFP®, TEP *Portfolio Manager* PWL Capital Inc.

Toronto, Ontario November 2024



BENDER, BENDER AND BORTOLOTTI



This report was written by Justin Bender. The ideas, opinions, and recommendations contained in this document are those of the author and do not necessarily represent the views of PWL Capital Inc.

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PWL Capital Inc., "Tax-Efficient Discount Bond ETFs"

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Table of Content

Introduction	4
What is a Bond?	5
Understanding Bond Market Prices	5
The Relationship Between Interest Rates and Bond Prices	6
Beyond the Coupon Rate: Total Return	7
Calculating Total Return	8
How Discount Bonds Can Boost After-Tax Returns	8
Introducing the BMO Discount Bond Index ETF (ZDB)	10
A Tale of Two Indices	11
Sector Weightings: ZDB vs. ZAG	12
Understanding Modified Duration in Discount Bond ETFs	12
Evaluating BMO's Discount Bond Strategy	14
Capital Gains and Total Returns	15
Historical After-Tax Returns: ZDB vs. ZAG	16
Disadvantages of Discount Bond ETFs	18
Conclusion	20

Introduction

Passive investing continues to capture the attention of Canadian investors, who have collectively funneled over \$30 billion into the country's largest broad market bond ETFs. While a significant portion of these funds are likely held in registered or tax-free accounts—where taxes aren't a concern—investors with holdings in non-registered accounts face more substantial tax implications.

For those navigating this landscape, only two tax-efficient options stand out for non-registered accounts: the <u>Global X Canadian Select Universe Bond Index Corporate Class ETF (HBB)</u> and the <u>BMO Discount Bond Index</u> <u>ETF (ZDB)</u>. HBB boasts an impressive \$3 billion+ in assets, accounting for over 10% of the total assets listed in the table below. However, its more <u>complex corporate class structure</u> might leave some investors feeling a bit uneasy.

This brings us to ZDB, a reliable choice for traditional investors. While its structure is less tax efficient than HBB's, ZDB competes effectively with other conventional bond options. Despite this, it has only captured about 2%-3% of investor dollars from the ETF list below. It seems that many taxable investors may still be leaning towards less tax-efficient bond options in their non-registered accounts—and perhaps they just need a gentle nudge to optimize their tax savings.

In this article, we aim to provide that nudge. We'll begin with a straightforward introduction to bonds, then explore ZDB's tax-efficient structure and assess whether it has delivered higher after-tax returns compared to plain vanilla bond ETFs, like the <u>BMO Aggregate Bond Index ETF (ZAG)</u>.

Security	Symbol	Assets Under Management	Weight %
BMO Aggregate Bond Index ETF	ZAG	\$10.04 billion	32.03%
iShares Core Canadian Universe Bond Index ETF	XBB	\$7.65 billion	24.40%
Vanguard Canadian Aggregate Bond Index ETF	VAB	\$5.05 billion	16.11%
Global X Canadian Select Universe Bond Index Corporate Class ETF	HBB	\$3.38 billion	10.78%
TD Canadian Aggregate Bond Index ETF	TDB	\$1.77 billion	5.65%
Mackenzie Canadian Aggregate Bond Index ETF	QBB	\$775.65 million	2.47%
BMO Discount Bond Index ETF	ZDB	\$734.49 million	2.34%
Desjardins Canadian Universe Bond Index ETF	DCU	\$674.73 million	2.15%
CI Canadian Aggregate Bond Index ETF	CAGG	\$478.93 million	1.53%
Scotia Canadian Bond Index Tracker ETF	SITB	\$391.70 million	1.25%
iShares High Quality Canadian Bond Index ETF	XQB	\$338.54 million	1.08%
CIBC Canadian Bond Index ETF	CCBI	\$66.33 million	0.21%
Total		\$31.35 billion	100.00%

Table 1: Largest broad market Canadian bond ETFs

Source: ETF Market Canada ETF Screener as of October 10, 2024



What is a Bond?

A bond is essentially a loan that an investor provides to an entity, such as a corporation or government. In return for this loan, the borrower pays periodic interest, known as the coupon, until the bond matures. At maturity, the borrower repays the principal, which is the bond's face value or par value. For many investors, bonds are appealing because they offer predictable income and a relatively safe way to preserve capital.



For a deeper dive into bonds, be sure to check out <u>A Guide to Fixed-Income</u> <u>Investing</u>, written by PWL's Head of Shared Services Research, Raymond Kerzérho, MBA, CFA.

Understanding Bond Market Prices

Bond prices are typically quoted as a percentage of the bond's face value (also known as its par value or maturity value). This percentage reflects how much investors are willing to pay for the bond in the market compared to its value at maturity.

For example, let's consider a bond with a face value of \$100:

- If the bond is quoted at 98: Investors are willing to pay 98% of its face value, or \$98. Here, the bond is trading at a discount to par.
- If the bond is quoted at 100: Investors pay exactly 100% of its face value, or \$100, indicating that the bond is trading at par.
- If the bond is quoted at 102: Investors are willing to pay 102% of the face value, resulting in a market value of \$102. This indicates that the bond is trading at a premium to par.

Face Value	Bond Quote	Market Value	The Bond is Trading At
\$100	98	\$98	A discount to par
\$100	100	\$100	Par
\$100	102	\$102	A premium to Par



The Relationship Between Interest Rates and Bond Prices

Governments and companies generally issue bonds close to their par or face value. After issuance, bonds can be traded on the secondary market. As market interest rates change, the price of a bond will also change. Bond prices move in the opposite direction to interest rates: as interest rates rise, bond prices fall, and as interest rates fall, bond prices rise.



As the bond's time to maturity changes, its price will also change. For a bond trading at a discount, its price will be pulled upward toward par as its maturity date approaches. Conversely, a bond trading at a premium will see its price pulled downward toward par.





Beyond the Coupon Rate: Total Return

The coupon rate of a bond is the fixed annual interest payment made to the bondholder, based on its face value. For instance, a bond with a face value of \$100 and a 4% coupon rate pays the holder \$4 annually. Many investors mistakenly view the coupon rate as their only source of return. If a bond pays a 4% coupon, they might expect a 4% annual return.

However, the price paid to purchase a bond can also influence the total return of a bond held to maturity. As bonds mature at their par or face value, purchasing a bond at a discount or premium can lead to a capital gain or loss at maturity. For example, if you buy a bond at \$98 and it matures at \$100, you gain an additional \$2, enhancing your total return. Conversely, buying a bond at a premium can result in a capital loss at maturity. If you buy a bond at \$100, you lose \$2, reducing your total return.

Thus, while the coupon rate indicates annual income, total return is a more comprehensive measure of a bond's performance, accounting for potential capital gains or losses.





Yield to maturity (YTM) is a key measure that helps investors estimate the total return they can expect from holding a bond until it matures. This includes not just the regular coupon payments but also any potential capital gain or loss. For our discussions, we'll treat 'Yield to Maturity' and 'Total Return' as interchangeable terms.



Calculating Total Return

You can think of a bond's total return as the sum of the income and capital appreciation or depreciation over your holding period. Here's a straightforward example:

Imagine you purchase a bond for \$98, which has a 4% annual coupon and matures in one year for \$100. Here's how the total return is calculated:

- Coupon Payment: 4% coupon rate × \$100 face value = \$4
- Capital Gain at Maturity: \$100 face value \$98 purchase price = \$2

At the end of the year, your total return amounts to **\$6**, which is a return of **6.12%** on your initial investment of \$98 (calculated as \$6 divided by \$98). This clearly exceeds the implied 4% return from the coupon alone.

How Discount Bonds Can Boost After-Tax Returns

Let's say you're an investor looking to buy a bond maturing in one year with a face value (or par value) of \$100, and you have three options to choose from:

- 1. Discount Bond: Trading at \$98.06, with a yield to maturity of 4% and a coupon rate of 2%.
- 2. Par Value Bond: Trading at \$100.00, with a yield to maturity of 4% and a coupon rate of 4%.
- 3. Premium Bond: Trading at \$101.94, with a yield to maturity of 4% and a coupon rate of 6%.

While all three options offer the same before-tax yield to maturity, their after-tax returns differ significantly, especially for a taxable investor with a marginal tax rate of **50%**. Let's break down each option to see which is the most tax-efficient choice.

Option 1: Purchase the Discount Bond

When you buy the discount bond, you're purchasing it for **\$98.06**. As it approaches maturity, its price will rise to par, resulting in a **capital gain** of **\$1.94** (\$100 maturity value - \$98.06 purchase price).

Only half of this gain is taxable, thanks to the capital gains inclusion rate. So, the after-tax capital gain income amounts to:

$$1.94 \times (1 - 0.50 \times (1 - 0.50)) = 1.46$$

On top of that, with a **2% coupon**, you'll receive **\$2** in fully taxable interest income. After taxes, this is:

$$2.00 \times (1 - 0.50) = 1.00$$



Adding the after-tax capital gain income and the after-tax interest income gives you a total of **\$2.46**. Dividing this by your original purchase price of **\$98.06** yields an after-tax yield to maturity of:

$$\frac{2.46}{98.06} = 2.51\%$$

Option 2: Purchase the Par Value Bond

With the par value bond, you buy it for **\$100** and it matures at the same value, meaning there's no capital gain or loss involved. **The 4% coupon** results in **\$4** of fully taxable interest income. After taxes, this income is:

$$4.00 \times (1 - 0.50) = 2.00$$

Dividing your total after-tax income of **\$2.00** by your purchase price of \$100 gives an after-tax yield to maturity of:

$$\frac{2.00}{100.00} = 2.00\%$$

Option 3: Purchase the Premium Bond

For the premium bond, you purchase it at **\$101.94**, which will decline to \$100 at maturity. This leads to a **capital loss** of **\$1.94** (\$100 maturity value - \$101.94 purchase price). However, you can use this capital loss to offset gains elsewhere in your portfolio. The adjusted loss after tax effects is:

$$-1.94 \times (1 - 0.50 \times (1 - 0.50)) = -1.46$$

With a **6% coupon**, you'll earn **\$6** in fully taxable interest income. After tax, this is:

$$6.00 \times (1 - 0.50) = 3.00$$

Therefore, your total after-tax income from this bond is:

$$3.00 - 1.46 = 1.54$$

Dividing this by your purchase price of **\$101.94** gives an after-tax yield to maturity of:

$$\frac{1.54}{101.94} = 1.51\%$$



In a tax-deferred or tax-free account, all three options yield an identical pre-tax yield to maturity of **4%**. However, in a taxable non-registered account, the analysis clearly favours the discount bond, making it the most tax-efficient choice for maximizing after-tax returns.

Example: Before-tax and after-tax yield to maturity (total return)

	Discount Bond	Par value bond	Premium bond
Face value	\$100	\$100	\$100
Price paid	\$98.06	\$100.00	\$101.94
Coupon rate	2.00%	4.00%	6.00%
Before-tax yield to maturity (total return)	4.00%	4.00%	4.00%

	Interest income	Capital gain	Interest income	Interest income	Capital loss
Income/gain/loss	\$2.00	\$1.94	\$4.00	\$6.00	-\$1.94
Taxes (50% marginal rate)	-\$1.00	-\$0.49	-\$2.00	-\$3.00	\$0.49
After-tax income	\$1.00	\$1.46	\$2.00	\$3.00	-\$1.46
Total after-tax income	\$2.	46	\$2.00	\$1.	54
After-tax yield to maturity (total return)	2.5	1%	2.00%	1.5	1%

In the above examples, interest income is taxed at a 50% marginal tax rate. Taxable capital gains (i.e., 50% of capital gains) are taxed at a 50% marginal tax rate. Capital losses are assumed to be used to offset other realized capital gains in the investor's portfolio.

Introducing the BMO Discount Bond Index ETF (ZDB)

In February 2014, BMO launched the <u>BMO Discount Bond Index ETF (ZDB)</u> as a compelling lower-coupon alternative to its well-known Canadian bond fund, the <u>BMO Aggregate Bond Index ETF (ZAG)</u>. For investors holding ZAG or similar traditional bond ETFs in non-registered accounts, ZDB offered a more tax-efficient way to achieve a comparable risk and return profile for their fixed income investments.



ZDB was conceived by **Kevin Prins**, Managing Director and Head of Distribution for ETFs and Digital Distribution at BMO Global Asset Management. His eureka moment came while listening to frustrated investors who were searching for a more tax-efficient bond solution.



A Tale of Two Indices

The FTSE Canada **Universe** Bond Index ("Universe Bond Index") is one of the most recognizable benchmarks for Canadian bonds. It encompasses short-, mid-, and long-term government and corporate investment-grade bonds. Both the <u>BMO Aggregate Bond Index ETF (ZAG)</u> and the <u>iShares Core Canadian Universe Bond Index</u> <u>ETF (XBB)</u> track this index, making either ETF a suitable representative of it. For simplicity, we'll use ZAG as a proxy for the Universe Bond Index in our discussions.



The BMO Aggregate Bond Index ETF (ZAG) tracks the performance of the FTSE Canada **Universe** Bond Index. So ZAG is a reasonable proxy for the **Universe** Bond Index, and we will use the two interchangeably in our discussions.

ZDB, on the other hand, tracks the FTSE Canada Universe **Discount** Bond Index ("Discount Bond Index"). This index aims to mirror the risk and return profile of the Universe Bond Index but with a focus on bonds that offer lower coupon rates. The Discount Bond Index is rebalanced quarterly, adjusting its bond holdings and weights to align closely with the sector allocations and duration of the Universe Bond Index.

The Discount Bond Index selects bonds from the Universe Bond Index based on their coupon rates relative to their yields to maturity (YTM). To be included in the Discount Bond Index, a bond's coupon rate must be **1.2** times its YTM or less. For instance, a Province of Quebec bond with a 4.25% coupon rate and a 4.18% YTM qualifies because the ratio (calculated as 4.25% divided by 4.18%) is 1.02, which is below the 1.2 threshold.

Conversely, bonds in the Discount Bond Index are reviewed for potential removal if their coupon rate exceeds **1.4** times their YTM. For example, if the Discount Bond Index holds a Province of Ontario bond with a 6.20% coupon rate and a 4.19% YTM, the ratio of 1.48 (calculated as 6.20% divided by 4.19%) is above the 1.4 threshold. As a result, this bond would be dropped from the Discount Bond Index.

While ZDB's fund managers strive to maintain a portfolio exclusively consisting of bonds found in the Discount Bond Index, there are times, especially during sharp declines in interest rates, when it may be challenging to find sufficient qualifying bonds. In such cases, BMO's managers might include higher coupon bonds to ensure that ZDB continues to track the risk and return characteristics of the Universe Bond Index effectively. Essentially, they use their discretion to select bonds from either index to maintain alignment with the Universe Bond Index.

Sector Weightings: ZDB vs. ZAG

The Discount Bond Index adjusts its bond weights quarterly to ensure that government (federal, provincial, municipal) and corporate sectors remain within +/- 1% of their weights in the Universe Bond Index. Between rebalancing periods, weights may vary slightly. In contrast, ZDB's managers aim to keep these sector weights within +/- 1% of the Universe Bond Index on a daily basis, not just quarterly.

As of the July 2024 rebalance, the sector weighting differences between ZDB and ZAG are all within +/- 1%.

Table 2: Sector weightings - ZDB vs. ZAG

Security	Federal	Provincial	Municipal	Corporate
BMO Discount Bond Index ETF (ZDB)	40.1%	33.7%	2.0%	24.2%
BMO Aggregate Bond Index ETF (ZAG)	40.1%	33.3%	1.7%	24.8%
Difference	0.0%	0.4%	0.3%	-0.6%

Source: BMO Global Asset Management as of July 31, 2024

Understanding Modified Duration in Discount Bond ETFs

Modified duration is a crucial concept for investors looking to understand how bond prices react to changes in interest rates. Essentially, it measures the sensitivity of a bond's price to interest rate fluctuations. A higher modified duration indicates greater price volatility: if interest rates rise or fall, the bond's price is likely to experience more significant changes.

Modified duration is expressed as the percentage change in price for each 1% change in interest rates. For example, if a bond has a modified duration of 7, we expect its price to increase by about 7% for every 1% decrease in interest rates. Conversely, if interest rates rise by 1%, the bond's price would likely decrease by approximately 7%.

One important factor that influences modified duration is the bond's coupon rate. Generally, the lower the coupon rate, the higher the duration. Let's consider three bonds that all mature in 30 years with the same yield to maturity of 4%, but with different coupon rates: 2%, 4%, and 6%. The bond with the lowest coupon rate of 2% has the highest modified duration of 20.19, making it more sensitive to changes in interest rates. This heightened sensitivity carries important risk implications for bond ETFs, such as the BMO Discount Bond Index ETF (ZDB), which targets bonds with lower coupon rates.



Term to Maturity	Yield to Maturity	Coupon Rate	Modified Duration
30 Years	4.00%	2.00%	20.19
30 Years	4.00%	4.00%	17.38
30 Years	4.00%	6.00%	16.02

Example: Modified duration of a 30-year bond with different coupon rates

Sources: Justin Bender, MDURATION function in Microsoft Excel

To manage volatility, both the Discount Bond Index and ZDB implement duration thresholds. The Discount Bond Index constrains its overall modified duration to within **±0.05** of the Universe Bond Index at each quarterly rebalance. In contrast, ZDB allows for a slightly broader range, permitting a modified duration deviation of **±0.5**. This flexibility gives BMO's fund managers more room to navigate risk and return dynamics.

Historically, ZDB's duration has mostly stayed within ±0.5 of ZAG's duration (our Universe Bond Index proxy) but often strayed outside the tighter ±0.05 thresholds set by the Discount Bond Index.



Sources: Justin Bender, BMO Global Asset Management, FTSE Russell Indices

Evaluating BMO's Discount Bond Strategy

BMO's approach has proven effective over time. Historical data shows that the average yield to maturity of ZDB and ZAG has been nearly identical. Moreover, since ZDB's launch, its pre-tax performance and risk, as measured by its standard deviation, have closely mirrored those of ZAG, validating BMO's goal of reflecting the Universe Bond Index's risk/return profile.



Tax Efficiency and Coupon Rates

When comparing ZAG's average coupon rate to its yield to maturity, it becomes evident that until recently, ZAG's bonds typically traded at a premium, making it less tax efficient in non-registered accounts. For instance, in July 2020, ZAG's average coupon rate divided by its yield to maturity was **2.56**, significantly higher than the Discount Bond Index's thresholds of 1.2 and 1.4.



Sources: Justin Bender, BMO Global Asset Management as of July 31, 2024

Sources: Justin Bender, BMO Global Asset Management as of July 31, 2024





The **dark red** area above the **dark green** area in the charts indicate that, on average, the underlying bonds are trading at a **premium** to their par value.

The height of the **dark red** area represents the expected capital loss "contribution" to the ETF's total return at that time.

In contrast, ZDB consistently maintained a lower average coupon rate compared to ZAG, even during periods when ZDB's bonds were trading at a slight premium. In July 2020, despite lower tax efficiency, ZDB's average coupon rate divided by its average yield to maturity was **1.61**, still lower than ZAG's ratio of 2.56. This lower ratio indicates greater tax efficiency for ZDB, even with adjustments to better align with the Universe Bond Index.





Capital Gains and Total Returns

Currently, ZDB is expected to generate a higher proportion of its total return from capital gains compared to ZAG. This trend underscores ZDB's enhanced tax efficiency, even when the average underlying bonds in both ETFs are trading at a discount to their par value.



The **light green** area above the **dark green** area in the charts indicates that, on average, the underlying bonds are trading at a **discount** to their par value.

The height of the **light green** area represents the expected capital gain contribution to the ETF's total return at that time.



Historical After-Tax Returns: ZDB vs. ZAG

We've already covered why discount bond ETFs are generally more tax efficient than traditional bond ETFs, especially in non-registered accounts. Now, let's see how this theory plays out in practice.

Comparing ZDB and ZAG

Since ZDB launched in February 2014, its before-tax returns have closely mirrored those of ZAG. Given ZDB's tax-efficient design, we'd expect it to deliver superior after-tax returns compared to ZAG.

Table 4: Before-tax performance - ZDB vs. ZAG (as of December 29, 2023)

Security	Symbol	1 Year	3 Years	5 Years	Since February 10, 2014
BMO Discount Bond Index ETF	ZDB	6.59%	-2.97%	1.33%	2.09%
BMO Aggregate Bond Index ETF	ZAG	6.65%	-2.88%	1.21%	2.06%
Difference		-0.06%	-0.09%	0.12%	0.03%

Sources: Justin Bender, BMO Global Asset Management

Data Sources

To analyze the after-tax returns of ZDB and ZAG, we used daily net asset value and cash distribution data from BMO's website, covering February 10, 2014, to December 29, 2023. We manually verified before-tax returns to ensure consistency with BMO's published figures.

For tax breakdown information—such as the portion of each distribution that is interest income, return of capital, or capital gains—we referred to the <u>Tax Breakdown Services</u> data available on the <u>cds.ca</u> website for the 2014-2023 tax years.

Methodology

In calculating before-tax total returns (including distributions), ETF companies assume cash distributions are reinvested back into the fund on the ex-dividend date, rather than the distribution date. This approach was maintained for our after-tax return calculations.

We used the tax rate applicable to a top Ontario taxpayer for this analysis. Taxes on interest and capital gains distributions were first deducted from the distribution amount, with the net cash then reinvested on the exdividend date. Distributions classified as return of capital were fully reinvested and adjusted the ETF's book value, affecting future capital gains or losses.

At the end of each daily measurement period, we assume that all units of the ETF are sold. We then deduct any applicable taxes on capital gains from the total value. If there's a capital loss upon liquidation, we add the tax benefit from that loss to the sale proceeds.

Handling Non-Cash (Phantom) Distributions

ETFs sometimes distribute non-cash items at year-end. Although investors don't receive cash, they still face a tax bill. This typically happens when the fund realizes significant capital gains from selling securities, reinvesting the proceeds, and leaving no cash to distribute to unitholders. This creates a challenge for calculating after-tax returns, as these transactions result in negative cash flow.

To address this, we assumed that enough ETF units were sold before year-end to cover the taxes on these non-cash distributions. We adjusted the number of units sold to ensure that the taxes due on both the non-cash distributions and the additional gains from the unit sales were fully covered by the proceeds from the sales.

The Results

During the measurement period, ZDB achieved an annualized after-tax return of 1.02%, surpassing ZAG's return of 0.76%. While it's important to keep in mind that bond ETFs overall faced challenges during this time, the key takeaway is the **0.26%** annualized difference between their after-tax returns.

At first glance, a 0.26% difference might not seem substantial. However, considering that ZDB and ZAG share similar risk profiles, this outperformance can be seen as a significant advantage for taxable investors. For high-income earners in Ontario, ZAG would have needed to generate an additional 0.56% in interest each year (calculated as $[0.26\% \div (1 - 53.53\%)]$ to match the after-tax returns of ZDB.

To put it another way, if you're a top rate Ontario taxpayer holding traditional bond ETFs like ZAG in your nonregistered account, it's as if you've been paying an extra 0.56% in management expense ratio (MER) each year compared to what's advertised. Most investors wouldn't choose a passively managed Canadian bond ETF with such a high MER, but this is effectively what they've been doing for nearly a decade.



After-Tax Returns: ZDB vs. ZAG

Sources: Justin Bender, BMO Asset Management Inc., CDS.ca Canadian Tax Breakdown Reporting Service, Taxtips.ca. Results assume a top rate Ontario taxpayer.

Growth of \$100,000 (post-liquidation, after-tax): February 10, 2014 – December 31, 2023



Disadvantages of Discount Bond ETFs

Discount bond ETFs generally hold bonds that trade at a discount to their par value or have lower average coupon rates than conventional bond ETFs. This can provide investors with not only regular interest payments but also capital gains as the underlying bonds mature or are sold at a profit (which in Canada are usually taxed at half the rate of interest income). However, as with any investment strategy, there are certain disadvantages to consider:

Tracking Error to ZAG

While BMO has to date effectively managed ZDB to align closely with ZAG's performance—offering greater tax efficiency—there remains a risk that ZDB's returns may lag those of ZAG going forward. This discrepancy could partially or entirely offset the tax benefits associated with their strategy.

Lower Monthly Income Distributions

Although it may seem irrational, some investors prefer higher taxable income to support their lifestyle expenses. While a more tax-efficient approach would involve selling additional units of their ETF when extra income is needed, the concept of 'total return' is not widely understood or accepted by many investors.

Larger Capital Gains Distributions

ZDB's strategy focuses on purchasing lower coupon bonds and those trading at a discount, which typically leads to larger capital gains distributions compared to a conventional bond ETF like ZAG. This is particularly pronounced during periods of declining interest rates, as ZDB's fund managers may sell bonds that have appreciated in value to reinvest in lower coupon options, realizing capital gains in the process.

For example, in 2020, ZDB's yield to maturity fell to a low of 1.20%. If you had invested \$100,000 in ZDB at its inception and reinvested the after-tax distributions, you would have received a T3 slip reflecting **\$4,662** in capital gains. Although receiving a greater portion of your total return as capital gains can be advantageous, a larger distribution may inadvertently push you into a higher tax bracket in that year, potentially negating some of the strategy's tax benefits.

Tax Year	BMO Discount Bond Index ETF (ZDB)	BMO Aggregate Bond Index ETF (ZAG)
2014	\$1,175	-
2015	\$240	-
2016	\$35	-
2017	-	\$107
2018	-	-
2019	\$1,255	-
2020	\$4,662	-
2021	\$76	-
2022	-	-
2023	-	-
Total	\$7,443	\$107

Table 5: Historical capital gains distributions - ZDB vs. ZAG

Sources: Justin Bender, BMO Asset Management, cds.ca

Potential for Capital Gains to Exceed \$250,000 Threshold

Although this was not an issue between 2014 and 2023, starting June 25, 2024 (if enacted), any capital gains realized above \$250,000 in a single tax year may be subject to a higher inclusion rate of 66 2/3% (up from the usual 50%). If you've already reached your \$250,000 threshold during the tax year (possibly through the realization of capital gains on the sale of another security), ZDB's unexpected capital gains distributions could push you over the limit, potentially undermining the tax advantages of the strategy.

Complexities of Tax-Loss Selling

Transitioning from a broad market Canadian bond ETF like ZAG to a similar ETF like VAB for tax loss harvesting is straightforward; there's often no need to switch back after 30 days, as the replacement ETF is quite similar. However, if you realize a capital loss on ZDB and switch to VAB, you'll likely want to revert to ZDB after 30 days to maintain your tax-efficient bond strategy. This adds yet another step in an already complex process.

More ETFs to Manage

Many DIY investors have turned to one-fund solutions for their portfolios, and it's easy to understand why. With just a click, anyone can create a low-cost, diversified portfolio. However, to enhance tax efficiency, investors may need to complicate these straightforward portfolios by adding additional holdings, such as ZDB. This also means taking on the responsibility of rebalancing. Given this added complexity, most investors might be better off sticking with a single asset allocation ETF rather than stressing over modest tax savings.



Conclusion

Investors seeking tax-efficient exposure to bonds in non-registered accounts would do well to consider the <u>BMO Discount Bond Index ETF (ZDB)</u>. Its unique structure not only provides comparable returns to traditional bond ETFs like ZAG but does so in a more tax-efficient manner, potentially enhancing after-tax returns.

For many Canadian investors, integrating ZDB into their portfolios could represent a savvy move towards optimizing their fixed-income investments.



BENDER, BENDER AND BORTOLOTTI

www.benderbenderbortolotti.com

PWL Toronto

8 Wellington Street East 3rd Floor Toronto, Ontario M5E 1C5

T 416.203-0067 1-866.242-0203 F 416.203-0544 **PWL Ottawa** 265 Carling Avenue, 8th Floor, Ottawa, Ontario K1S 2E1

T 613.237.5544 1-800.230.5544 F 613.237.5949 **PWL Montreal**

3400 de Maisonneuve O. Suite 1501 Montreal, Quebec H3Z 3B8

T 514.875.7566 1-800.875.7566 F 514.875.9611

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