The Short-Term Route to Long-Term Failure

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Fear of an impending rise in interest rates has many recommending short-term bonds. Such fears are misplaced, however, and investors can better position their portfolios by constructing a ladder of high-quality individual bonds, rather than moving assets into only short maturities.

"It is too risky to go long-term," the fearmongers assert. "What happens if inflation soars?" That word "soar" probably makes your heart flutter. But should it? After all, birds soar and that is okay, but inflation just increases and decreases – and the parts of the Consumer Price Index that are increasing might not even affect you. For example, if you own your own home, rent increases do not affect you meaningfully.

Soaring is an overstatement.

But it lays a foundation for more fear. What will "soaring inflation" do to the value of your bonds and your retirement plans? To protect you from inflation, the fearmongers recommend certificates of deposit (CDs), short-term bonds, short-term bond funds or step-up bonds.

Certificates of deposit versus Treasury bonds

Retirees frequently opt for certificates of deposit. Their bank is familiar, and CDs are FDIC insured (up to $250,000 per bank), giving comfort that Uncle Sam stands ready to protect them.

The problem is that a 3-month CD yields approximately 0.27%, and a 6-month CD 0.41%.

Instead, whatever kind of investor you are – whether you have $45,000 or $400,000 to invest – you can easily purchase Treasury bonds through www.TreasuryDirect.org and get the backing of the Federal Government directly instead of putting your money in the bank and relying on the FDIC. Using this approach, you can purchase longer-maturity Treasury bonds that currently yield more than shorter-term CDs.

Short-term bonds

There is nothing wrong with purchasing short-term bonds, except that in the current environment they do not yield very much. A two-year Treasury bond yields less than 1%.

The yield curve is currently very steep. You get a lot more return from a long-term bond than from a short-term bond.

Money market funds and an alternative

When thinking short-term, investors often turn to a money market fund offered by a broker or a bank. These two investment alternatives were an appropriate place to stash cash when short-term interest rates were much higher than they are now. Money market funds were able to protect their one-dollar-per-share value. Most investors preferred so-called "prime" money market funds because they yielded more than the Treasury and government agency money market funds. Prime funds had a higher yield from investing in instruments such as "taxable short-term obligations issued by corporations and banks, as well as repurchase agreements and asset backed commercial paper secured by pools of assets."[i] Those assets are riskier than those held by Treasury and government agency money market funds.[ii]

The term "prime" refers to the prime rate, which is the approximate rate at which banks lend to their most favored customers. It does not imply that the underlying collateral for these funds was of high quality, as many unfortunate investors discovered in the financial crisis of 2008 and 2009.

The Reserve Fund, a prime money market fund, "broke the buck" in 2008, creating a run on money market funds. The federal government created the Temporary Guarantee Program for money market funds to temporarily insure those that chose to participate. This calmed the market and stopped the run on those funds.

To make sure that money market funds would maintain their $1 per share value and the government would not have to rescue the money market funds again, the government modified Rule 2a-7 of the Investment Company Act of 1940 in 2009. To this end, they required that the money market funds hold assets that are more readily converted to cash, reduce the weighted average of the portfolio to 60 days from 90 days and acquire only the best-quality securities.

As a result of very low short-term interest rates and the new regulations, money market funds now pay as little as 0.01%, which means that on an investment of $100,000 you can earn $10/year tax-exempt, and 0.02% or $20/year on a taxable investment! Prime money market funds invest in commercial paper that is riskier than straight money market investments. That might increase the yield range to 0.07% to 0.12%. You pay for the liquidity; in the event of a surge in redemptions, the yields on these funds would decline.

Something always fills a vacuum, and there are now very short-term bonds funds, like Fidelity's Conservative Bond Fund, that was created to provide more yield while still trying to approximate the liquidity of a money market fund. With a maturity of 270 days, 210 days more than a money market, there is no guarantee that this fund or funds like it will maintain the $1 per share value. Its current 30-day SEC yield is 0.28 (retail) and 0.37 (institutional).

Step-up bonds

Step-up bonds are supposed to increase their yield with inflation. They carry a current below-market coupon rate (and low rate-of-return) that increases over a period of time. As rates rise, your yield will rise as well. A provision in all step-up bonds, however, says that the issuer has the right to call the bonds, generally on short notice.

There are two possible outcomes:

1. If interest rates fall and the issuer is financially able, it will call the bonds and refinance at the lower rates. If the step-up bond is called you will not get the benefit of a higher coupon at some later date. If you anticipate rising rates, you may think that having your bonds called is a poor outcome, but that may be the best outcome if the company issuing the bonds is struggling financially. If the issuer cannot call the bonds in the face of rising rates, they may not be able to pay you at all, since they may have been counting on refinancing when lower rates became available.

2. If interest rates rise, then the bonds may not be called. If the issuing company is financially weak, however, then it may default because it cannot service its debt at higher rates.

So the best outcome you can hope for with a weak issuer is to follow the bouncing ball:

- You earn a relatively low short-term rate until the bonds are called when interest rates fall;
- At which time you get your money back; and
- You can pay another fee and spread for purchasing a replacement – probably another short-term bond if interest rates are rising.

The benefit of longer-maturity bonds

Investing in short-term bonds or CDs is a poor choice at the current time because of the low return you receive. Below is an alternative, based on *tax-exempt* rates. The numbers would be different for taxable bonds, but the outcome is essentially the same. The yield curves for both taxable and tax-free bonds are very steep, meaning that bonds with longer maturities pay much more than bonds with short maturities.

First, let's look at the cost of investing in short-term bonds. If you invest $100,000 per year in tax-free bonds for a total investment of $300,000, the annual interest (according to the Municipal Market Data Company) is as follows:

1 year rate = .32%= $320/year
2 year rate = .66%=$660/year
3 year rate – .98% =$980/year

Total: $1,960 in income for the first year, or an overall rate of 0.65%.

Assume instead that you were to create a ladder using bonds of 15 to 20 years in maturity, investing $100,000 in each of three years:

15-year rate is 4.17 =$4,170
17-year rate is 4.35=$4,350
20-year rate is 4.63=$4,630

Total: $13,150 for three years, per year, Federal tax-free, for an overall rate of 4.38%.

The difference between investing in 1-3 year bonds versus 15-20 year bonds is *$11,190 more per year* for a $300,000 investment. That's 6.7 times more return than for the 1-3 year option.

Now, if someone told you that you could increase your return by more than 600%, would you increase your holding period? Would you make the switch? After all, you invest in stocks for the long run, don't you?

What about inflation?

"Wait!" you say. What about inflation?

The media always discusses the impact of inflation on bonds, but it has a light touch when describing its equally significant impact on stock prices. With bonds at least you have significant cash flow to cushion the impact of inflation. If you are able to reinvest the coupon income in higher-yielding bonds, then inflation may be an additional benefit. The yield-to-maturity calculation assumes that you reinvest the income at the stated yield-to maturity, so if you can reinvest at a higher rate your actual return would be higher.

The specter of inflation sows fearsome uncertainty that often overrides realistic assessments. Is inflation galloping or only creeping? Remember, there is limited wage pressure because of high unemployment and competition for work from foreign countries through outsourcing. The risk of deflation has not yet been eliminated.

Furthermore, many assume that rates controlled by the Fed will remain the same. If the Fed does raise short-term interest rates, then longer-term rates might actually *fall* rather than rise, as inflation fears abate rather than increase.

Investing in short-term bonds makes sense if you anticipate a near-term need for your funds. Investing short-term is not advantageous, however, if you are trying to save for your retirement – it will just create a lot more transactions for the brokers. Instead, you should consider the alternative – a ladder of high-quality individual bonds – constructed to meet your individual needs.

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[i] Murphy, Elizabeth M. 2009. "Money Market Fund Reform" *Securities and Exchange Commission: Proposed Rules,* Securities and Exchange Commission 17 CFR Parts 270 and 274 RIN 3235-AK33. Pp. 19-20.
[ii] Murphy. 2009. During the financial meltdown of 2008, on three consecutive days in September, between and quarter and a third of prime institutional money market funds had outflows greater than 5 percent. p.58. Retail funds suffered the same run on assets but to a lesser degree. Overall the assets in prime money market funds shrank by 30 percent. p.20.