The Cost of Safety

Christopher J. McDonnell, CFP®

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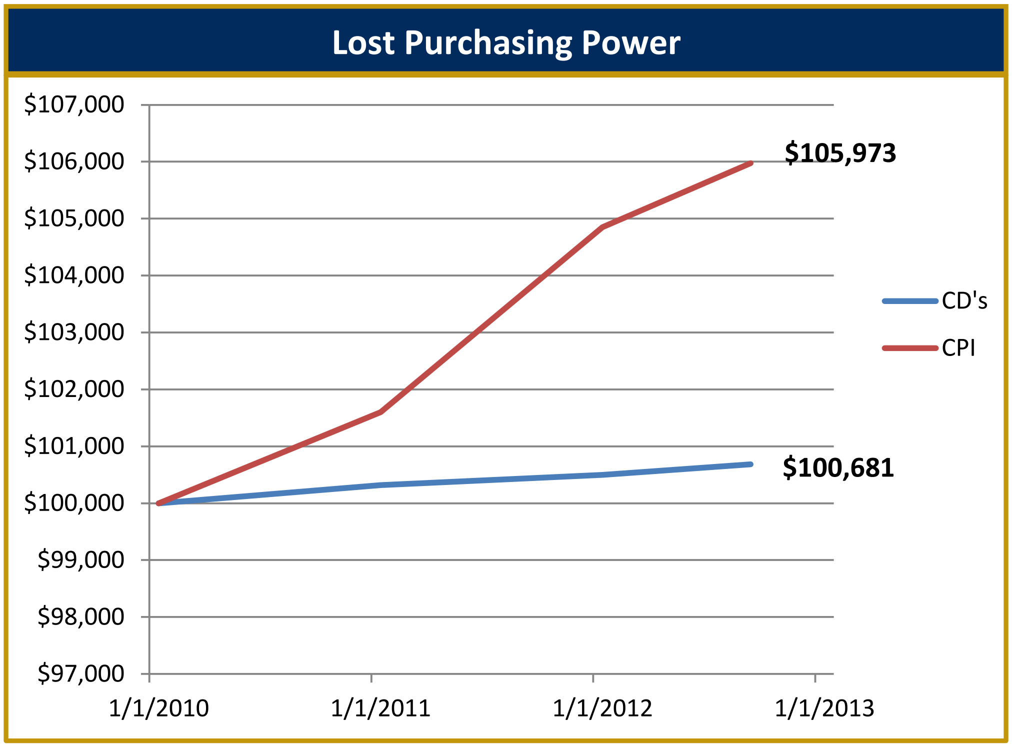
It is no surprise that yield is scarce everywhere you look. Money markets, CD's, Muncipals, Treasuries – many of those areas that investors historically look for a conservative income stream are bone-dry. Yet investors as a whole still are flooding the fixed income market with their dollars, choosing abysmal yields instead of anything to do with the equity markets and rationalizing their decisions with "my money might not be growing much, but at least it is not losing anything." Let's explore what is fundamentally flawed about that statement.

How investing in CD's and "safe" assets is costing you your purchasing power

The average yield on a current one year CD is 0.18%. The average yields in 2011 and 2010 for one year CD's were 0.18% and 0.32% respectively. Historically, the number one risk to choosing these safer assets classes over equities is what we refer to as the loss of purchasing power. This means that an investor is unable to purchase the same or similar goods at some point in the future for the same proportion of their assets. Essentially, your money is worth less than before. Purchasing power is best measured by using the Consumer Price Index (CPI) to study how the price of consumer goods have risen or fallen. The CPI has risen by 1.6% in 2010, 3.2% in 2011 and 1.07% to date in 2012. Do you think that because rates are low, "inflation" is close to zero? Clearly, the inflation measures consumers should care about are not even within an ear shot of nominal. These numbers matter.

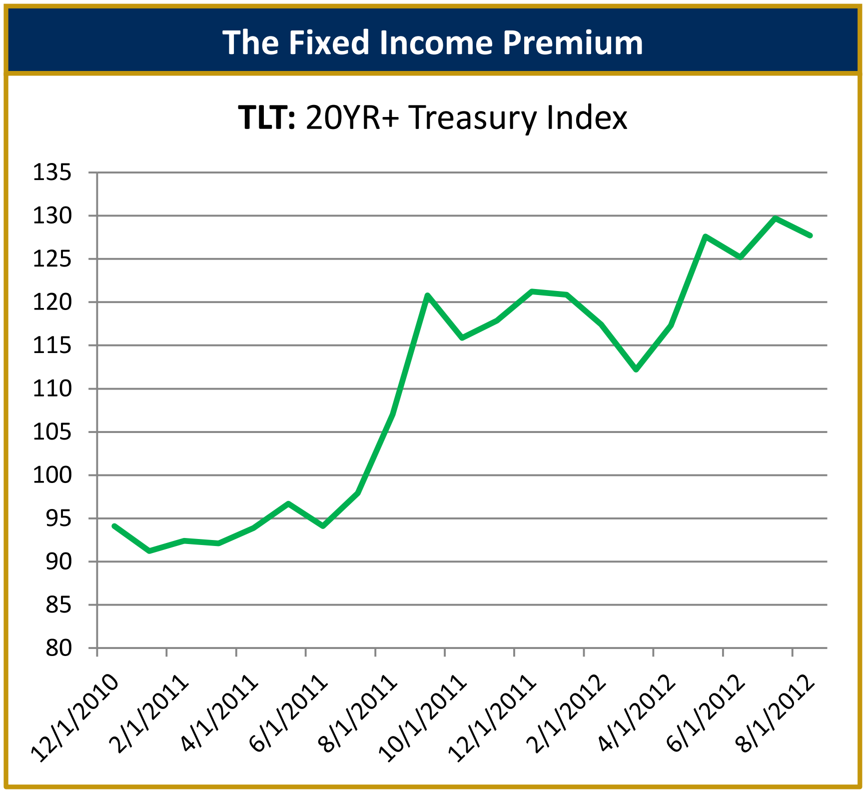
Hypothetically, if you had $100,000 at the start of 2010, that same $100K would have to be worth $105,973 today to purchase the same amount of consumer goods. If you had chosen to invest that same $100,000 in the average CD over the same time period, that $100K would only be worth $100,681. Granted we are in a unique period of historically low interest rates, but it is important to consider this type of analysis because CD investors have lost close to 5% of their purchasing power in just two years! Common sense tells us that goods will continue to become more expensive. If this low rate environment continues for some time, which we believe is likely, CD investors will continue to erode their purchasing power. Just because a CD statement shows an investor that their principal remained intact, clearly doesn't mean they haven't lost anything.



Are investors in store for a bloody lip in the bond market?

Historically, investors seek bonds and fixed income assets to provide a stream of income with small fluctuations in their principal value. This is achieved by investors lending their principal to an entity and, in return, receiving interest payments for a period of time until their principal is returned to them. This applies in effect whether investors use individual bonds or fixed income pools such as mutual funds or exchange traded funds. The relationship between the interest payments (yield) the investor receives and price paid, typically are affected by a number of factors, which primarily include length of time until the principal is returned (maturity), risk of the entity paying the principal and interest payments (credit rating), and how the current market is pricing similar investments.

The fixed income market today is in a strange place. Just last August, for the first time in the history of the United States Treasury, Standard & Poors removed U.S. debt from their risk-free investment list, removing their AAA credit rating. Ahead of the decision, Wall Street speculators everywhere shorted U.S. Treasuries waiting for their price to decline after the suspected downgrade. After the news broke, U.S. Treasury prices skyrocketed driven by continued investor demand for "safe" yield. Standard & Poors, the juggernaut independent rating agency, essentially stated that the Treasury is now less likely to repay their debt than before, and investors continued to flock to it – even at a higher premium than before. Only in America (as they say).



Since that date, the prices of 20+Year U.S. Treasuries have risen over 20 percent. It is that type of movement that causes concern. Fundamentally, bond prices and yields have an inverse relationship. If bond prices are high and yields are at historic lows, there is only one direction to get back to equilibrium. It is common sense. As rates rise, prices will fall. Investors holding bond investments with high sensitivity to price fluctuations will be left with a bit of a bloody lip as interest rates tick up, even slightly. We measure the price sensitivity of a fixed income portfolio to changes in rates using a statistic called duration. It works like this: if your duration statistic is 5, that means with every 1% increase in rates, the price will decrease by 5%. As an example, if you purchased the Barclays 20+ Year Treasury Bond Fund (Ticker: TLT) today, you could likely receive a yield of around 3%. The effective duration of TLT is currently around 16. That means if interest rates were to rise by 1 percent, the price of this pool of 20+ year treasuries could potentially decrease by around 16 percent. Is that risk worth the 3% yield? Typically, the longer the maturity, the higher the duration. We believe investors stretching for yield with long maturity and/or high duration bonds could be in for a fight with a big bully.

How to invest in fixed income today

Fixed income is still a critical asset class as a part of a well-diversified investment portfolio. Over a long period of time, it has played an important role in providing a steady stream of income and stability to portfolios, especially when equity markets fluctuate. Today, we favor credit risk over duration risk, short term over long term maturities, and corporate over sovereign issuers. *Credit risk vs. duration risk:* As illustrated, the current inherent duration risk in fixed income securities is our biggest concern. If you are stretching for yield, we favor taking credit risk with issuers who have strong balance sheets and cash reserves. We also recommend diversified fixed income portfolios with an effective duration of 7 or less. *Short term vs. long term maturities:* Short term issues typically have less sensitivity to changes in interest rates than longer term issues. They also can provide a higher yield than traditional CD's for nominal increases in risk, with similar or improved liquidity. *Corporate vs. Sovereign Issuers:* Both in the U.S. and globally, we favor searching out the cash-rich companies that have weathered the global recession and emerged leaner and strengthened. We do not favor the interest rate risk inherent in U.S. government fixed income. In addition, we do not favor the credit and repayment risk of non-U.S. sovereign debt, although it may provide a hedge to rising rates in the U.S.

Our Firm

McDonnell Wealth Management is an independent, registered investment advisor (RIA) that integrates the disciplines of financial planning, investment, tax, estate, and risk management. We provide competent, objective advice without hidden fees in an environment where our client's interests are our only interests.

We are committed to our craft. Both of our firm's principals have earned the Certified Financial Planner™ designation, taking the extra step to demonstrate professionalism by voluntarily submitting to the rigorous CFP® certification process that includes demanding education, examination, experience and ethical requirements. With a combined 30 plus years of experience advising clients, we have created a process called ***Goals Driven Wealth Management*** that ensures our client's unique needs, concerns and goals are incorporated into every aspect of their financial game plan. Too many advisors today forget that helping clients build, sustain and transfer wealth cannot be limited to picking investments. We invest the time to learn about who you are and what matters most to you, and use those goals and unique circumstances to *drive* how we professionally manage your wealth.

Our Integrated Wealth Management Services include:

- **Comprehensive Financial Planning**
- **Investment Advisory**
- **Portfolio Management**
- **Tax Advisory**
- **Estate Planning**
- **Risk Management**
- **Employee Benefit Plans for Business Owners**
- **Investment Policy Statement Administration**
- **Institutional Asset Management**

Meet Our Principals

Joseph J. McDonnell, CPA, CFP®, PFS®

Joe has spent over 25 years as a CPA, advising a myriad of clients including both individuals and entities. There are few professionals who can truly call themselves a personal Chief Financial Officer, having studied and practiced for years on the tax implications of investments, trusts and estates, and retirement. Joe is one of those few consummate financial planning professionals.

Christopher J. McDonnell, CFP®

Chris has extensive experience creating comprehensive financial plans for families and business owners. He has studied and been trained to use statistical analysis to design and manage multi-faceted investment portfolios and adhere to disciplines that help control and monitor risk. In addition, he has unique experience working with non-profits and company 401K plans.

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