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# Fixed-Income Dangers

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By Walid L Petiri | Posted: 06-19-12 | 04:02 PM | Email Article

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For decades, financial institutions have promoted certificates of deposit, savings accounts, money market funds, interest-bearing checking accounts and fixed annuities as riskless or low-risk investment options. This still remains generally sound advice regarding the risk of loss of principal.

However, with interest rates at all-time lows, the risk of inflation is growing. With a negligible federal funds interest rate, these conservative options stand little chance of keeping up with inflation. The price of debt has gone up, particularly U.S. and German sovereign debt. In mid-June, the 10-year Treasury yield was 1.59% after touching an all-time low of 1.44%. It has consistently been below 2% since April 26. Overseas, we see Germany's 10-year notes yielding around 1.4%.

America had 3% inflation in 2011. The annualized inflation rate was down (reportedly) to 2.7% in March 2012. Today, the yield on many CDs, money market funds and interest earning checking accounts can't even keep up with that. I say "reportedly" because the Consumer Price Index doesn't tell the whole story of inflation

About the Author

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**Most Active Stocks**

| Ticker | Price($) | Change(%) | Morningstar Rating | Morningstar Analyst Report |
|---|---|---|---|---|
| BAC | 8.30 | 4.28 | ★★★ | |
| NOK | 2.44 | 2.52 | ★★★ | |
| S | 4.96 | 0.2 | ★★★ | |
| C | 30.89 | 3.76 | ★★★★ | |
| FB | 18.98 | 2.15 | ★★★★★ | |
| MSFT | 31.16 | 2.5 | ★★★★ | |
| F | 9.82 | 2.61 | ★★★★★ | |
| JPM | 38.68 | 4.2 | ★★★★ | |
| GE | 21.19 | 2.62 | ★★★★ | |
| AIG | 34.32 | -1.41 | ★★★ | |

With Morningstar Analyst reports you can get our expert Buy/Sell opinions on over 3,900 Stock and Funds reality – retail gasoline prices rose 9.9% during 2011.

**Retirees are feeling the pain of low rates.**
With the federal funds rate at 0% to 0.25%, a short-term CD earns 0.5% interest today. On average, those who put money in long-term CDs at the end of 2007 (the start of the Great Recession) saw the income off those CDs dwindle by two-thirds by the end of 2011.

On paper, consumer price inflation is tame, personal incomes are modestly higher and measures of senior poverty are reassuringly low. But in the real world, prices for many consumer items are much higher, especially in poorer neighborhoods without Wal-Marts and other price-conscious retailers. Incomes for many seniors are not rising as their interest income continues to fall and they rightly fear the stock market. A lot of older households are experiencing what can best be called financial exhaustion.

Many older Americans have scrimped during their retirement years to make ends meet. While they make enough money to avoid poverty, they don't have much cushion. Now, with nest eggs depleted and home values still depressed, they are running out of painless financial sacrifices.

In the 1990s and 2000s, the common philosophy was to invest for growth in your thirties and forties and then focus on wealth preservation as you neared retirement. (Of course, back then it was also widely believed that you could count on stock market gains of 10% per year.)

The stock market collapse of the 2000s has, of course, permanently changed this belief in stocks. A generation of people in their fifties and sixties, who still need to accumulate wealth for retirement, also need to start withdrawing from savings for current income. This is truly a sandwich generation. Aside from having to help their children and their aged parents, this group also is caught between their own looming retirement and the need to make up for investment losses of the past decade.

**Who could live on the income earned in 1996 or even 2004?**
Essentially the dilemma of many retirees is: 1) their certificates of deposit and money market accounts yield almost nothing, 2) they are withdrawing more than they are earning, 3) their retirement fund is shrinking and 4) they must live on less or without.

Recently reported inflation in the U.S. has averaged between 2% and 4% annually. What if consumer prices rise 4% annually for the next 20 years? At 4% inflation for 20 years, today’s dollar will be worth 44 cents in 2032. Today’s $1,000 king or queen bed will cost about $2,200 then. Today’s $23,000 sedan will run more than $50,000.

Beyond prices for gasoline or durable goods, think of the cost for food and health care. Because of this reality, most retirees can’t completely refrain from growth investing. They need their portfolios to yield at least 3% and preferably much more. If their portfolios bring home an inadequate yield, they risk losing purchasing power as consumer prices increase at a faster rate than their incomes.

**What if you want or need to stay in bonds?**
Some bond market analysts believe now might be a time to exploit short-term bonds with different maturity dates. As each batch of bonds matures, it is reinvested, thus capturing the latest interest rates. You are less likely to be locked into low yields if current rates increase.

The trade-off is accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities when rates rise. (Bond rates and prices move in opposite directions.) If you are after higher rates of return from short-duration bonds, look at bonds that are investment-grade but without the top-tier ratings, AAA or AA.

If you too expect rates will rise in the near future, using short maturities could position you to get your principal back in the short term. That could give you cash that you could reinvest in response to climbing rates. Still, if you think bond owners are in for pain in the coming years, then you limit yourself to small positions in bonds.

**No appetite for risk.**
Why would people put their money into an investment offering a 1.5% return for 10 years? In a word, fear. The fear of volatility and a global downturn is so prevalent this spring that many investors are playing not to lose again. Yet when interest rates rise, owners of long-term bonds might find themselves losing out in terms of their portfolio's potential. This is especially worth remembering given the history of the CPI and how inflationary jumps come without much warning.

From 1900 to 1970, inflation averaged about 2.5% in America. Starting in 1970, the annualized inflation rate hit 6%, and by 1979 it was at 13.3%; it didn't moderate until 1982, when it fell to 3.8%. U.S. consumer prices rose by an average of 7.4% annually in the 1970s and 5.1% annually in the 1980s, compared to 2.2% in the 1950s and 2.5% in the 1960s.

According to the Department of Labor and Axa Equitable, since 1950, there were 19 calendar years when the CPI was 2.0% or less. The Standard & Poor 500 stock index was up in 15 of the 19 years, gaining an average of 13.9% per year in total return (stock appreciation plus interest).

All this should tell you one thing: you can't hide in fixed income. Inflation has a powerful cumulative affect no matter how conservatively or aggressively you invest – so you had better seek to at least keep pace with it or better yet seek to beat it.

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