Conservative Investment Strategies and Financial Instruments

Last update: May 14, 2014

Summary

Most retirees should hold a significant portion ó in many cases, 100% ó of their savings in conservative financial instruments such as bank accounts, money market mutual funds, bonds, annuities, and certain kinds of stocks.

Conservative investments have varying characteristics, related to safety (risk), liquidity (free access to your money), return (interest or other earnings), inflation adjustments, and taxation.

This paper describes the main types of such investments, the characteristics of each, and strategies for both selecting among these types and making the most of those that you do select.

Main Types of Conservative Financial Instruments

Financial Instrument	Safety	Liquidity	Rate of Return	Inflation Adjusted?	Taxation
Bank accounts:					
Checking accounts	Very High	Very High	Very Low	No	Full
Savings accounts	Very High	High	Low	No	Full
Certificates of deposit	Very High	Medium	Medium	No	Full
Money market funds	High	Very High	Low	Partially	Full
Conservative bonds:					
Savings bonds	Very High	High	Medium	Partially	Deferred
I-Bonds	Very High	High	Low	Yes	Deferred
U.S. Treasury bonds	Very High	High	Medium	Partially	Yes
U.S. Treasury %TIPS+	Very High	High	Low	Yes	Yes
Municipal bonds	Varies	High	Varies	Partially	No
AAA Corporate bonds	High	High	Varies	Partially	Yes
Annuities:					
Fixed annuities	High	Low	High	Some-times	Partly Deferred
Variable annuities	Medium	Low	Varies	Partially	Partly Deferred
Conservative stocks:					
Preferred stocks	Medium	High	Varies	Partially	Partly Deferred
Income stock funds	Medium	High	Varies	Partially	Partly Deferred

A Conservative Investment Strategy

Think of your savings and investments as being divided into four categories:

1. Your õcash reserve.ö This is money that is immediately available to you without penalty and without market fluctuations. It should represent at least six monthsø worth of expenses, and preferably more like 12-18 months ó and even more when interest rates are low and you donøt want to lock them in for the longer term.
2. Your õincomeö sources. Social Security and traditional pension plans are basic income sources: you do not own any asset, but you have something else of tremendous value,

namely, a right to receive income for life. You can buy more of this kind of arrangement by purchasing annuities. An annuity, in its basic form, is simply the right to receive a regular income for life. In general, annuities will pay you a much higher return than other conservative investments, but you give up some or all access to the money (or you can get a lower return if you choose to keep some degree of access to the money). You also are guaranteed income for life for as long as you (and your spouse, if you choose) live, no matter how long that is. If your savings are a bit on the short side, therefore, and if you can afford to give up some degree of access to some of your money, buying an annuity can be a great choice for you (though not so much so when interest rates are low).

3. Your õsafe investmentö money. Most retired people need to be conservative with most of the money over which they do retain control. But for amounts other than your cash reserve, you can afford to trade liquidity and perhaps a small degree of safety in exchange for higher rates of return. So the bulk of your õsafe investmentö money should go into certificates of deposit, bonds, and perhaps preferred stocks or mutual funds that target income.
4. Your õhigher riskö fund. Not everyone should have a higher-risk fund. In general, this is a good idea only if you could afford to lose some significant portion of it without having to sacrifice your standard of living more than you would be willing to, keeping in mind that you might live well into your nineties or even beyond. You should also have a higher risk fund only if you are something of risk-taker at heart, and will not find sudden drops in the financial markets to be too stressful for your health and happiness.

The next two sections will look at your options for your õcash reserveö fund and your õsafe investment fund,ö in that order. Since we are focusing here on conservative investment strategies, we will not be discussing how your õhigher riskö fund, if any, should be invested. The pros and cons of annuities in their various forms is also itself a complex subject worthy of an entire separate paper; we deal with them in õAnnuities: Basics You Need to Know.ö

Where to Put Your "Cash Reserve"

- Your checking account: At least once a month, make sure that your balance is large enough to support at least two months of normal expenses. This will keep you from being overdrawn, and will still give you enough to cover an emergency repair or an unexpected trip out of town. Checking accounts pay little or no interest, though, so donøt keep the balance too high.
- Your savings account: The rest of your cash reserve should go into a bank or credit union savings account and/or into a money market mutual fund. Bank and credit union accounts are better when interest rates are low, because their rates will generally be a little higher than money market accounts. Money market accounts can pay back close to zero, or occasionally below zero, when interest rates are very low, while a saving account might still pay 1% or more even in the worst of times. Savings accounts are federally insured, but not over $250,000 per bank. Savings accounts are very liquid: your full funds are available on demand. Bank and credit union account interest is taxable. Credit unions usually pay higher interest than banks.
- Money market mutual funds: These are sold by securities firms; your broker or financial advisor can usually offer you a selection of funds. They are generally quite safe (it is

very unusual to have any loss of principal), but they are not federally guaranteed. They pay current rates that can change daily, but they also charge you a fee, usually between one-fourth and one-half of a percentage point, automatically deducted from your earnings. Money market funds are very liquid; many funds will provide you with a checkbook you can use to withdraw funds any time you want them. Dividends from such funds are fully taxable. Money market mutual funds are especially advantageous when interest rates are high, because the funds will pay significantly more than savings accounts ó often more than any other kind of investment ó when rates are near their peak. If you are willing to accept a little less convenience (i.e., no check-writing privileges) in exchange for a usually somewhat higher yield, consider putting some of your cash reserve into short-term bond funds (small risk with higher yield) or short-term bond exchange-traded funds (even smaller risk, slightly smaller yield, usually). Either of these can be obtained through a stockbroker (full service or discount).

We recommend keeping both a savings account and a money market account, and to move the bulk of your cash reserve from one to the other as interest rates change.

Where to Put Your "Safe Investment" Money

In general, as with any investment, there is a trade-off between safety and rate of return. The more of one, the less of the other. But you can tip the balance in your favor by following certain simple rules.

Safe Money Investment Rule #1: Diversify

Diversifying means putting your eggs in different baskets in terms of:

- The institutions you do business with. Bank deposits are federally insured only up to $250,000 per customer per bank. If you have more than $250,000 in bank deposits, including certificates of deposit, you should have more than one bank.
- The types of savings/investments that you use. Some conservative investments have locked-in rates, some float, or increase. Some are more liquid than others, or give you the chance for a better return in exchange for a small increase in risk. For most people, it is best to use several different kinds of financial instrument so that if economic conditions strongly disfavor one of them, you are not stuck with almost all your money in the wrong place.
- When you purchase them. Interest rates can change dramatically from year to year, even month to month. If you lock in current rates in long-term bonds, for example, you will lose out if rates then go up.
- When they mature. Certificates of deposit and bonds that have fixed maturity dates (i.e., the date on which your principal is returned to you along with whatever interest you have not already been paid) should be varied, so that they come due at different times. This has two advantages: first, if you reinvest those funds at those times, you will get diversification of purchase times, as recommended above; and second, if you need to spend some of your money, you will then have amounts coming available to you at different times without penalties or market timing risks.

Safe Money Investment Rule #2: Watch interest rates (or have someone do it for you)

- Watch rate trends. You can lock up your money for longer or shorter periods of time with bonds and certificates of deposit, or not at all with bank accounts and money market funds. Although some of your money should always be readily available to you (your õcash reserveö), the rest can be locked up quite safely, if you do it smartly. Smartly means having locked-up funds mature at different times (as explained above), but it also means locking it up when rates are favorable. If you are paying attention to interest rates, where they have been over time, and in what direction they are going currently, you have a better chance of doing the smart thing:
    - *When rates are high*: this is the time to lock in rates for a longer period of time: longer-term certificates of deposit, or bonds that mature well into the future. This is also a good time to invest in corporate or other bonds that trade in the open market, because when interest rates are high, bond *prices* are low.[*] But donøt be afraid to lock in rates when they are high, thinking they might go higher. They probably will go higher, but donøt be greedy! If they do go higher, you may have some more money to invest later.
    - *When rates are low*: this is the time not to lock in rates. If you have certificates of deposit or bonds maturing, do not renew them for long terms. Instead, keep more money in your cash reserve (until rates go up). If your cash reserve equals more than 18-to-24 monthsø worth of household expenses, put some of the money into short-term (one- or two-year) certificates of deposit. If rates are higher when those CDs mature, at that point you can lock them into longer-term investments; if not, roll them into another one-to-two-year CD.
- Shop around for rates. U.S. Government bonds (savings bonds, I bonds, treasury bonds, etc.) will have the same rates wherever you go. But money market fund rates will vary from fund to fund, as will the expenses that such funds charge. Banks will offer different rates on bank accounts certificates of deposit, depending on whether they are trying extra hard to bring in new deposits or not.

Safe Money Investment Rule #3: Understand what you are %buying+

Even among conservative investment categories, not every kind is right for every person. Here are some basic things you need to know about the main types of õsafe moneyö investment. Try to identify two or three or maybe four that seem suitable to you, and put some of your õsafe investmentö money into each.

[*] This seems backwards, but it makes sense. If you paid $1000 for a bond that earns 4% a year, then current interest rates go up to 6% a year, you now have a bond that no one will buy at face value. Why would anyone pay $1000 for your bond that pays 4% if they can now buy one elsewhere that pays 6%? So in order to sell your bond, you would have to *lower* the price to the point where the buyer would get a rate of return comparable to the current rate. So as interest rates go *up*, bond prices go *down*, and *vice versa*.

- <u>Certificates of Deposit (CDs)</u>:
    - are issued by local banking institutions. Make sure that any one you use is insured by the Federal Deposit Insurance Corporation (FDIC), and that you do not have more than $250,000 with any one bank. Note that different branches of the same bank are considered to be the same bank for FDIC purposes. Also, guarantees may not apply if you do not buy directly from a bank; õdeposit brokersö and other non-banks may get you a higher rate, but with no guarantees.
    - commonly offer terms as short as one year (sometimes even less) and as long as five or more, though different banks will be more or less flexible.
    - have interest rates that are fixed for the full term of the CD; rates are higher than bank savings account rates (because CDs are less liquid), but usually lower than rates on long-term bonds. Note, however, that some banks are now offering õinflation-protected certificates of depositö (CDIPs), which start with a lower rate and increase with inflation ó which is probably not a good trade unless you need a CD with a relatively long maturity (over five years). Some banks are also offering market-adjusted CDs that participate to some extent in stock market increases, but still have a minimum guaranteed return and are federally insured; again, though, you get this at the cost of a lower initial rate. If you are comfortable using an on-line bank, you can often get a better rate that way, because such banks tend to have lower overhead.
    - cannot be cashed in early unless you pay a penalty.
    - do not pay any interest in cash until the CD matures, but you will still have to pay taxes each year on the interest you *earned*; the bank will send out a tax form each year to let you ó and the government ó know how much taxable interest you earned.
    - ***Are best for:*** funds you expect to spend (or re-invest) from 1-to-5 years from now.
- <u>U.S. Savings Bonds (EE Series)</u>:
    - are usually available from your local bank, or on-line.
    - are very safe, guaranteed by the U.S. Government.
    - generally pay higher interest rates than CDs, but the rate is not fixed. The interest rate that is paid floats over time in line with other interest rates (not necessarily in line with inflation), and you probably will not know until you cash it in how much it is worth.
    - are not transferable, but can be cashed in any time after one year from issue (not before!)
    - pay interest in cash only when you redeem the bond; all interest earned becomes taxable at that time (*not* year-by-year).
    - are taxed by the federal government only, and are not subject to state and local taxes.

- o ***Are best for:*** funds you expect to spend more than 5 years from now and that you want to keep absolutely safe.

- I-Bonds:
  - o are U.S. government savings bonds, just like EE Series bonds, except:
  - o start out with a lower initial interest rate than regular savings bonds.
  - o guarantee that the base rate is always paid, plus an adjustment for inflation over the life of the bond (up to 30 years).
  - o ***Are best for:*** funds you expect to spend 10 or more years from now, that you want to keep absolutely safe, and that you want to keep pace with inflation.

- U.S. Treasury bonds, notes, and õTIPSö:
  - o can be bought new directly from the U.S. Treasury with no transaction costs; or existing bonds can be bought in the securities market through a broker.
  - o are completely guaranteed to mature at their face value (which may be more or less than you pay for them in the securities market).
  - o are generally issued and held electronically; there is no physical paper as there is with savings bonds or I bonds.
  - o Usually have long maturities (up to ten years for new issues, with some maturing up to 30 years from issue), and therefore may have noticeably higher or lower rates of return than CDs or shorter-term securities. TIPS (Treasury Insurance-Protected Securities) are available in 5-, 10-, and 20-year maturities, though you can buy existing ones that mature at other times on the open market. Note that you can also purchase short-term õtreasury billsö if you like, but this is usually not worth the trouble for individual savers.
  - o can be sold at any time in the open securities market, but as with other bonds sold in the open market, you will not get all your money back if interest rates have gone up since you purchased the bond; so you are taking some risk with your principal unless you hold the bond or note until its maturity.
  - o pay interest at a fixed rate for the duration of the bond or note. Interest is paid twice a year, directly deposited to your bank account. Interest is federally taxable as paid, but is exempt from state and local taxes. TIPS pay a lower rate, but the principal amount adjusts for inflation, so it is worth more when you cash it in; however, if the Consumer Price index falls, you will received lower payments or even none at all during such deflationary periods.
  - o ***Are best for:*** funds where you want the principal to be guaranteed, and you do not need to have access to it before the maturity date, but you do want to receive cash interest payments in the meantime. May be most suitable for funds you want to save for later in your retirement, or that you want to make sure are available after your death. TIPS are best for people concerned about inflation.

- Municipal bonds:
  - are issued by state and local governments, but are usually purchased in the open securities markets through a broker. You can also buy municipal bond mutual *funds* easily through a broker. Bond funds invest in many different bond issues, and therefore provide you with some measure of diversification, and thus lower your risk.
  - vary in safety and rate of interest. Generally they are less safe than U.S. government bonds, in some cases much less safe. Terms vary, but in general they pay a fixed rate of interest, with payments made periodically (rather than accumulated until maturity). Inflation-adjusted municipal bonds exist, but are rare.
  - are relatively liquid, because they can almost always be sold in the open market; again, though, you can lose some of your principal when you sell them, if interest rates have gone up since you bought them.
  - are tax-free both for federal taxes and in the state in which they are issued (you generally will have to pay state taxes on municipal bonds from other states); for many states, you can buy shares in municipal bond funds dedicated to that state. Warning: watch out for the federal Alternative Minimum Tax (AMT). If you have a lot of tax-free income and/or a lot of tax deductions, you can get socked with the AMT and end up paying much more than you would by having regular taxable income!
  - are more attractive than other kinds of bonds, because of their mostly tax-free nature, and therefore actually pay lower rates than most other kinds of bonds. But if you are in a high tax bracket, the tax savings can more than compensate for the lower rate.
  - ***Are best for:*** people in high tax brackets. If, like the majority of retirees, you are *not* in a high tax bracket, you generally come out ahead putting your money into taxable investments instead. But remember to take state and local taxes into account here, too.
- Corporate bonds:
  - are issued by corporations of all kinds. Generally you buy and sell these through a broker. You can also invest in bond mutual funds, many of which are specialized by nation, industry, or risk category.
  - vary immensely in safety and rate of interest. They are less safe than U.S. government bonds, and generally less safe than the better municipal bonds. Safety is evaluated by several commercial rating agencies; AAA bonds are the safest, but anything in the A range is generally considered safe enough. When companies go bad, though, ratings can drop swiftly and without warning.
  - pay rates of return generally higher than other kinds of bonds; the worse the rating, the higher the rate of interest ó but again, be hesitant to invest in bonds with lower than an A rating.
  - pay a fixed rate of interest, usually. However, some corporations are offering Inflation-Protected Notes (IPNs), which are inflation-adjusted and offer a higher

rate of return than I Bonds. These are relatively new, however, and it remains to be seen how many companies can make good on them if inflation ever hits double digits again, as it did in the early 1980s.

  - are relatively liquid, because they can almost always be sold in the open market; again, though, you can lose some of your principal when you sell them, if interest rates have gone up since you bought them.
  - generally pay cash interest twice a year. Such interest is fully taxable.
  - ***Are best for:*** money that you do not need to spend in the next five years or so. Also, you can minimize the risk of market fluctuations by buying individual bonds that mature at different times, ideally at times when you expect to need to spend the money. Any bond that does not default will pay its full face value at maturity (or sometimes before that, if it is a õcallableö bond and the company that issues it decides to pay it off early). If you buy bond *mutual funds*, their value will float up and down inversely with interest rates, so you need to have the ability to hold on when interest rates go up, or else risk losing some of your principal. But bond funds pretty well insulate you from the risk of a particular bond going bad, and can usually get you a little bit better rate of return (though your return may be reduced by fund fees). So they can be an excellent choice, if you have the financial flexibility to ride out the times when values are depressed. Or, you can buy õstable valueö bond funds where the fund value does not float, or changes only minimally, but the yield will usually be a bit lower.

- Stocks and stock funds:
  - are mostly *not* sufficiently conservative, with two exceptions: (1) õpreferredö stocks, which are called that because their owners must be paid dividends and/or principal (when appropriate) before regular (õcommonö) stockholders; and (2) income-oriented stock mutual funds, which are mutual funds that mainly invest in relatively stodgy corporate stocks that pay consistent dividends to their shareholders. Either variety can be purchased through your broker.
  - are generally riskier than bonds, both in terms of the possibility of default, and in the fluctuations in their market values.
  - generally provide more õupsideö potential, paying you reasonable cash income in the form of dividends, with the long-term potential for gains in the underlying stock value.
  - provide current income that is taxable when received.
  - ***Are best for:*** funds that you do not expect to need for a very long time (say, more than 15 years) and, preferably, that you could afford to take some losses on. They might, for example, be a good investment for a portion of your assets that you expect to be used only for one of three purposes: (a) for your living expenses in the event that you live past age 95, (b) for emergency medical expenses if you come down with a fatal disease before age 95, or (c) as a legacy to your favorite heirs if you die before you use it yourself. Note: if you are moving money into stocks for the first time, it is important not to do it all at once, if the market is high. It is bet-

ter to spread your investment over at least 12 months, or perhaps even better, to wait until the market has taken a tumble (say, a 10% drop within a 12-month period). It is not important to buy at the lowest possible point, but it is important not to buy at or near the highest point.

- Retirement income mutual funds:
    - These are funds that bundle together a mixture of stock and bond fund investments, and are intended to reflect the needs of investors who are in retirement or thinking about retirement. They are not necessarily conservatively managed, and you need to look at the stated investment goals and the actual composition of these funds to determine if they are suitable for you. Their characteristics will be a blend of the characteristics of bond and stock mutual funds, as indicated above. Many of them, including the õtarget dateö funds, are riskier than are really suited for the average retiree.

For More Information

- ***Papers available from this same source:***
    - õCan You Afford to Take Investment Risks?ö
    - õAnnuities: Basics You Need to Knowö
- ***Web sites:***
    - For general information and points of view:
        - The Bond Market Association website: http://www.investinginbonds.com/
        - The American Bankers Association õConsumerö website section http://www.aba.com/Consumers/Pages/ConsumerInformation.aspx
        - Data on historic rates and trends, from the Federal Reserve Bank: http://research.stlouisfed.org/fred2/
    - For information on current interest rates:
        - http://www.money-rates.com or http://www.imoneynet.com
        - http://www.bankrate.com or http://www.banx.com
        - http://money.cnn.com/pf/loan_center/
    - For information on bond prices:
        - http://www.investinginbonds.com/marketataglance.asp?catid=31 provides links to current sources of bond prices
    - For information on U.S. Government securities you can buy, including EE savings bonds, I-bonds, and variations not discussed in this paper:
        - http://www.savingsbonds.gov/indiv/indiv.htm

- ***Publications:***
    - The U.S. Securities and Exchange Commission regulates money market and bond funds (among others). They offer a variety of publications from their web site: http://www.sec.gov/investor/pubs.shtml
    - Current prevailing interest rates, as well as current prices of bonds and bond funds, are reported daily in the *Wall Street Journal* and in most major metropolitan dailies.
- ***Government agencies:***
    - U.S. Federal Deposit Insurance Corporation: http://www.fdic.gov/
    - U.S. Securities and Exchange Commission: http://www.sec.gov/
    - U.S. Treasury Department: http://www.ustreas.gov/

Analysis provided by Still River Retirement Planning Software, Inc., 69 Lancaster County Rd., Harvard, MA 01451. The information provided in this document is reasonable and accurate to the best of our knowledge. However, information can become outdated, opinions can vary, and your circumstances may differ in significant ways. Consult with your financial and tax advisors before making decisions based on ideas contained here.