# A CONVERSATION ON RISK

**INTEREST RATES GOT YOU DOWN?**

**Read on for some possible solutions…..**

A lady recently came into my office and was inquiring about investments for her 74 year old father.

“What investments, other than CDs, are there that are completely risk free,” she asked.

“What’s the matter,” I replied. “CD rates got you down?”

“Yeah, my dad went to roll over his CD and discovered that rates were barely above zero.”

“Well to answer your question, there is no such thing as a riskless investment. All investments carry some type of risk.”

She looked at me like I was nuts. “Sure there is,” she says, “CDs don’t carry any risk.”

“CDs may be the closest thing to a riskless investment because they carry no investment risk. But they do carry purchasing power risk.”

“What’s that?”

“Money itself has no value – or at least very little value. Money has value only because it can be used to purchase stuff. So money is important only because it has purchasing power and you really want your money to maintain its purchasing power. But every time prices go up, your purchasing power goes down. You can’t purchase as much stuff when prices of everything continually go up.”

“True,” she replies, “you’re talking about inflation, right? But inflation hasn’t been much of an issue lately, at least that’s what I’ve read.”

“Inflation has been under much better control the last 10 years as opposed to what it was like in the 70’s for example. But inflation still exists and even a small amount of inflation will have an impact. Let me ask you a question, what do you think inflation has averaged over the last 5 years?”

“Well I really don’t know, but I thought it was pretty low.”

“Comparatively speaking, it has been low. Inflation for the last 5 years, from 1997 through 2002, has only averaged 2.5% a year. Let’s just assume that that will continue over the next five years. If your father had $100,000 – this means he could purchase $100,000 worth of goods today – how much would he be able to purchase in 5 years.”

I quickly got out my financial calculator and punched in some numbers. “In 5 years, your dad would only be able to purchase $88,385 worth of today’s goods. What kind of rates did your father get quoted for his CD renewal?”

“The bank (I won’t name the bank) told him a one year CD would pay 0.20% and a 5 year CD would pay 2.9%.”

“Is this a taxable account or is the money invested in an IRA?”

“No, he has to pay taxes on the interest.”

“What tax bracket is he in?”

“Well it used to be the 28% bracket, didn’t these just change recently?”

“Yes, they did so he is probably in the 27% bracket now.”

Again, I got my calculator out and punched in some more numbers. “Well if he went ahead and purchased the 5 year CD, in 5 years he would be able to purchase $90,055 worth of today’s goods. So buying a CD is still better than doing nothing, but can you see the risk he is taking? Given the numbers you just provided, in 5 years he is going to lose almost $10,000 of purchasing power. And if inflation is higher than the 2.5% we guessed at he will lose even more, if it is less, he won’t lose quite so much.”

She looked at me gravely. “Well I don’t really know what inflation will be, but it looks like he is going to lose purchasing power no matter what? What are his alternatives?”

“Well he is going to have to take on a different type of risk if he wants to eliminate the loss of purchasing power risk. There are three other types of risk to consider – liquidity risk, credit risk, or investment risk.”

“What’s liquidity risk?”

“Liquidity risk is the risk you take for being able to get to your money quickly and easily. For example, when you purchase a CD, there is a penalty for if you take your money out.”

“Yes, the bank called it a substantial penalty for early withdrawal.”

“Right, so you’ve heard of it. If you purchase a 5 year CD, but have to take your money out at the end of three years, then the rate on the CD drops to only 1.9%. You have to pay the bank back 1% of the earnings for the first three years. They take this money out before they distribute the money. This is liquidity risk. In order to get the higher rate you have to tie your money up for a specified period of time. If your father is willing to take some liquidity risk, then fixed annuities would be a superior investment.”

“What’s a fixed annuity,” she wanted to know.

“A fixed annuity is a life insurance product, issued by a life insurance company. Most fixed annuities will pay a higher rate of return than CDs but you must leave your money in there or be subject to even greater penalties for early withdrawal. Insurance companies call these penalties surrender charges and they usually charge them as a percentage of the investment. So if you bought a 5 year annuity and took your money out at the end of 3 years, you might have to pay a surrender charge of as much as 7%. While the rate of return will be higher, probably in the 4.5% range, you would still lose a substantial amount of your profits should you have to take the money out early. That is your liquidity risk. However, the good news is that he won’t have to pay taxes on the interest earned until he actually takes the money out. This will allow the account to accumulate at a much faster rate if he doesn’t actually use it.”

“Well he really doesn’t plan on using this money, so I guess he could take the chance that he won’t need it in order to get a better return. Is it possible to get an even better return?”

“Of course,” I replied. “But he might need to take some credit risk. Credit risk is what you find when you purchase something like a bond. A bond is when you loan money to a corporation or a municipality. Then in turn they pay you interest on that loan. The risk you take is that the corporation or municipality will not be able to repay the loan.”

“Are there any bonds out there that are safe,” she wanted to know.

“Well do you consider General Electric safe,” I asked.

“Well, I’ve always heard they were safe. I can’t imagine them ever going out of business.”

“Me neither, but there is always that possibility. Your CD is guaranteed by the FDIC, but you always run the risk that the U.S. government could go bankrupt as well. That isn’t very likely either so they are much safer than a bond. But still there are some very big companies out there that are not likely to go bankrupt. Plus you probably should buy several companies so that if one did go bankrupt, you wouldn’t lose all of your money.

And interest rates on bonds are going to be higher than interest rates on fixed annuities since credit risk is considered to be a bigger risk than liquidity risk.”

“Well is there any liquidity risk on bonds?”

“Yes there is. When you buy a $1000 face value bond, what you pay for the bond will actually be higher or lower than the $1000 figure. This is because the price changes as interest rates change. Therefore if you bought a bond today and cashed it in 3 years from now, you would get either more or less than what you paid for. Unlike the CD, you could actually end up making money on cashing in early – or you could end up losing even more.”

“Well it would seem to me that if cashing in the bond early would cause you to lose money, then I would try to find money from someplace else.”

“Exactly,” I responded. “We rarely recommend that bonds be 100% of your investment portfolio for exactly that reason. What if you put half of the $100,000 in a CD and half in bonds. On the average you would still do better than if you put the entire amount in a CD – even if you had to take some of the money out. The only way you would come out worse would be if you had to take all or almost all of the money out in a lump sum. Most people are never faced with a scenario quite that bad. Instead they can take a little bit out a time to meet whatever emergency they are facing.”

“Well, given that scenario, perhaps he could take an even greater amount of risk and get an even higher rate of return. What did you say the other type of risk was?”

“Investment risk.”

She immediately gave me a frown. “I think I know this risk,” she said. “That’s where you buy stocks, right.”

“Correct, although you can also have investment risk with longer term bonds. Investment risk exists any time the amount of the investment could decline in value. But because you are willing to take this risk, then you normally get a higher rate of return. The longer you are able to hold your investment, the more likely you are to make money on it. For most retired people, stocks and long-term bonds can represent a substantial risk.”

“Tell me about it,” she said. “I think we’ve already been through this scenario.”

“So you’ve invested in the stock market and lost money, I take it.”

“Well my father did. Many years ago and now he isn’t much interested in stocks. He finds them way to risky.”

“Well stocks can be very risky and this is not the type of investment you want to be in without professional help.”

“Oh, but he had professional help. He went to XXXXXX (I’m not going to name the investment firm here but suffice it to say it was one of the big ones). They put him in some mutual funds that immediately lost money. We found out later that the person who sold them these funds had very little experience in the financial world but had previously sold cars for a living.”

“Unfortunately that is usually the case. The big boys in the financial brokerage world are mostly interested in sales, so they hire people that are good at sales and not necessarily well trained in managing risk. It is important that you find the right person to help you. Stocks can be very profitable, but in order to reduce your risk it is important that you find someone knowledgeable in the methods for achieving the higher rates of return and at the same time protecting yourself from undue risk. Unfortunately, I don’t think there are a lot of us out there.”

“Well you have been very helpful. I’m thinking that maybe my dad needs a little bit of money in all of these investments, but maybe with most of it in the fixed annuity. Can you help me determine how much should go in each one?”

“Yes, but I probably should take a look at his entire financial picture. The only way I can really tell how much should be in CDs and how much should be in annuities and how much should be in bonds or stocks, is to see the entire portfolio. From there I will be able to determine if the money is invested properly to offset all potential risks – purchasing power risk, credit risk, liquidity risk, and investment risk. Remember that the reason to invest is to offset risk – it is not about getting higher returns.”

“Another thing to remember is that what is a good investment changes over time. For example, in the late 1970s, my father bought a CD paying 12.5%. He kept it for the next 10 years while interest rates began a rapid decline. But when he had to renew it, the interest rate dropped substantially. Right now you may have heard the phrase, ‘Cash is trash?’”

“Actually I have heard that, but I didn’t really know what it meant.”

“What it means is that cash investments, such as CDs, fixed annuities, etc. are not good investments right now because their rates of return are so low. At one point in time ‘Cash was King.’ That meant that owning cash investments was the right place to be. In the investment world, it is never good to get locked into a single investment as they all go through time periods where they are good and where they are bad. Being flexible is the key.”

She finally gave me a big smile. We then went on to set an appointment for her to come back in – with her father this time – and look over his portfolio.