

The Sound Investor Series #43

It's Time to Get the Cash Out of the Mattress!

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Two days ago, the Federal Reserve raised short-term interest rates again. For the 15th meeting in a row, the Fed Funds target rate was increased 0.25 of a percentage point and now stands at 4.75%. The Fed's next meeting is May 10 and we are likely to see a 16th increase.

Less than two years ago, the Fed Funds rate was 1% and investors had very few good opportunities for safely investing cash reserves. Now with overnight rates close to 5% it is time to get the money out of the mattress and invest it.

Individual investors with moderate cash balances have many choices for safely investing cash reserves. Savings accounts, money market funds, certificates of deposit (CDs) and U.S. Government bills are common examples. Depending on the market, their relative attractiveness shifts over time and investors should not automatically assume one method is always the best.

Saving accounts are the most convenient. Money can be added and removed from the account on demand and there are no penalties for withdrawals. The downside is that most banks pay very low interest rates on savings account balances so this is seldom your best choice. Many saving accounts are currently paying less than 2% and some less than 1%.

Money market funds offer investors higher interest rates with very few restrictions. Brokerage firms commonly use these funds for holding their customer's cash. Many of these funds currently have yields of 3.5% to 3.75%. Money market funds are considered very safe but unlike bank deposits or CDs, your money is not FDIC insured.

Some brokerage firms offer customers the opportunity to hold their cash in affiliated bank accounts where up to \$100,000 is FDIC insured. The rates on these accounts are often in the same range as the money markets. For the extra protection, you would expect the interest rates to be lower, but that is not always the case for competitive reasons.

Certificates of Deposit (CDs) are popular products that many investors have used at one time or another. CDs often pay attractive interest rates and like other bank deposits, are FDIC insured up to \$100,000.

Each bank individually determines the interest rates on the CDs they offer. For instance, banks needing to attract deposits might offer higher rates than other banks. Most 3-month CDs currently yield around 4.5% although some are higher.

CDs come in a variety of maturities ranging from 1 month to over 5 years and almost all CDs impose penalties for withdrawing your money prior to maturity. This is one major drawback, although if you need your money in an emergency, you can still get it.

Some CDs offered by brokerage firms are tradable and you can sell them in the open market without a penalty. However, investors should be slightly wary of this provision. If interest rates are higher, the price you receive will be lower than expected. A more significant issue is that trading small notional amounts of CDs, let's say \$5,000, is very inefficient in the fixed income markets and the price will reflect that fact.

Other short-term alternatives for investors are U.S. Treasury Bills (T-Bills) and Notes. T-bills are currently issued with maturities of 3 and 6 months. Investors looking for a longer maturity, let's say one-year, should consider 2-year Treasury notes that are one year from maturity. Yesterday 3 and 6-month T-bill rates were about 4.63% and 4.82% respectively.

T-bills offer investors additional flexibility since unlike CDs, there is no penalty for selling early. Nevertheless selling a small sum of T-bills, as with CDs, is not very efficient. While investors can buy and sell T-bills in denominations as low as \$1,000, to get decent pricing, if possible trades should be for \$10,000 or more.

Investors can purchase T-bills and other U.S. Treasury issues directly from the government at www.treasurydirect.gov or through their broker.

Let's go back to the market, where many professional investors think the Fed will raise rates for the 16th time come May 10. Should individuals invest their cash now or wait? Don't wait - buy 3-month T-bills or CDs and earn an annualized interest rate of around 4.5%. If rates go up at the next meeting you can roll your investment in 3 months into a higher yielding investment.

At some point down the road, when you feel the Fed has finished raising rates, you might want to extend your maturities by buying longer dated T-bills or CDs.

In summary, short-term interest rates are significantly higher than they have been in years and investors should make sure their cash reserves are earning their keep!

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