# Fixed-Income Investing

**No stocks?** Fixed income investments include securities like bonds but not stocks. Bill Bernstein, one of the most respected people in the finance world (efficientfrontier.com.) is now advocating that once a person has saved enough for retirement, they should go to Savings I Bonds, TIPS or lifetime payments from annuities or even short term bonds. **He now calls stocks "nuclear-level toxic" for retirees.** (*Money* magazine, 9/12, p. 97 ff.)

That's further than I would go, but he might be right because the long-term prospects look pretty dismal considering the huge debts our nation has, the meager savings people have accumulated over the last three decades and the aging of our population. This is a complete turnaround for Bernstein who was a promoter of portfolios holding the optimum percentage of various stock and bond sectors in his popular financial books for all ages.

I still adhere to an allocation policy that has served me well over 40 years and forced me to sell stocks when they were high and buy them when low. My allocation rule is that stocks (including stock funds, stock ETFs and REITS) should be a percentage of my investments equal to 105 minus my age, plus or minus 5%. So at age 65, my target was 105 – 65 = 40 percent stocks, and I would sell stocks and buy fixed-income investments if my stocks got over 45% of my investments and buy stocks if my stocks got lower than 35%. Now at age 79, my stock target is 26% which is lower than professional planners generally like but closer to Bernstein's current position.

**What is a fixed income security?** A fixed-income investment is an investment in debt while a stock represents ownership in a company. Buying stock is like buying a rental house or a precious metal. Your return is quite uncertain because you don't know what the value will be when you sell it. If you buy a government bond, for example, you are buying part of the government's debt. The government owes you interest until it pays the debt to you in the form of a return of your original investment, usually paid when the bond "matures." Before it matures, you can sell that debt to someone else, but the value of a premature sale is uncertain as well. There is more certainty in the on-going interest from a debt than the dividends from a stock, but both are dependent on their own credit worthiness. When either type is invested in a mutual fund, both the ongoing income and what you will get when sold are uncertain.

**Lesson 101 on fixed-income securities:** Bonds, like many fixed-income investments, are worth less after inflation of several years because the value of money is less when cashed. You can buy some fixed-income investments that compensate for inflation such as Savings I Bonds and TIPS. The same is true of fixed payments from an immediate annuity. A sparse offering of immediate annuities will pay either a fixed percentage increase each year or the actual inflation rate that may be capped at 10% a year.

**Inflation** has been a boon to the government and killer for retirees living on fixed income investments. The government has depended on inflation to make previous debts look smaller and to be able to pay the interest and principal with cheaper dollars and greater tax revenues. Our country's high debt makes high inflation desirable from this aspect, but the higher the inflation, the more interest the government has to offer on new issues--and it can't afford to pay higher interest without major sacrifices in entitlements and defense. Much of the government debt is held in 3 month treasury bills, so the effects would be felt quickly as the debts are rolled over. **Inflation has averaged about 4% since the Great Depression or 3% if included.** It has gone over 13% during the Carter administration and was negative in the Great Depression. 4% inflation over twenty years reduces the value of a $100 bond to $46.

**Lesson 102 on bonds:** If you do not hold a bond to maturity, its value is determined by the ongoing market interest rate for similar or competitive securities and its proximity to its maturity date. The value is inversely proportional to an interest rate change so that if interest rates go up, the amount you can get for a bond before maturity goes down. If market interest rates go down, it's worth more. For the past few years, the government has been forcing interest rates down, so mutual bond funds values have gone up because almost all of their bonds are not near maturity.  Short-term bond funds values change little compared to long-term bond funds.

**Lesson 103 on laddering**:  The most common form of "laddering" is to buy bonds so that they mature in different years of the future thereby providing steadier future income or opportunities to reinvest in more bonds of longer maturity or a different security at the time.  The longer the maturity, the higher the interest.  An initial ladder of five year CDs (Certificates of Deposit) would consist of one CD maturing in each of the next five years.  After the first year, the cash from the one year CD would be invested in a new five year CD.  At the end of the second year, the cash from the two year CD would be invested in a new five year bonds as well.  Etc. After five years, the entire CD portfolio would be in five year CDs, one of which will mature each year, and the interest rate will be substantially higher than the initial ladder.

Another form of laddering is with immediate annuities where you would spread the purchases out over a number of years thereby benefiting from the higher payments that come with lower life-expectancies that come with age and perhaps benefit from higher payment rates than available now.

**Here is some information on fixed-income securities that may help with your investment decisions:**

**Savings I Bonds** are really good for any savings you can make above what you can put into an employer's savings plan. They pay a fixed coupon rate plus inflation rate every six months.  After 30 years they pay no interest. The value compounds unlike bonds that pay a fixed coupon on the original amount.  The taxes are deferred until cashed, so they have properties similar to an IRA financed with after-tax income.

You can cash them in after one year with the only penalty being the last quarter's interest gain.  After five years you can cash them without any loss of interest. They will never be less than the face value of the bond even if you cash them when market interest rates are very high.  Savings I Bonds are so good that the government has greatly restricted the amount you can buy each year to $10,000 max per person and stopped banks from selling them. So the most a couple can buy now is $20,000 a year.  The smallest amount is $25.

In the current environment, in order to discourage Saving I Bond investments, the government has reduced the fixed coupon to 0%, but I have many from past purchases paying a 3% coupon plus inflation.   The coupon values are fixed for 30 years once you buy the bonds.  When market interest rates increase, the government will likely increase the coupon offerings.

**Savings EE Bonds** pay a fixed interest rate for the life of the bond unlike a Savings I Bond.  They usually offer a larger interest rate initially than Savings I Bonds, so those who expect a low future inflation rate prefer Savings EE Bonds to Savings I Bonds.

By reducing the number of places to conveniently buy the Savings Bonds and setting a limit on the amount a citizen can buy, the government is trying to get people to look for other government bond sources which may cost the government less.  During World War II, it was considered patriotic to buy Savings Bonds.  The citizens held the country's debt, not China or other foreigners.

**TIPS are Treasury Inflation Protected Securities**.   Like Savings I Bonds, they pay a fixed coupon rate plus inflation.  Currently you pay more than the face value of the bond because market interest rates are lower than inflation, so new issues now have a negative yield of about 1.3% for a five year bond calculated on the basis that inflation will be 0%.  With inflation of only 2% (The Feds want it higher.), the net yield would be a 0.7% which is higher than banks or money markets now pay.  At the historic inflation rate of 4% since the Great Depression, they would yield 2.7%.   The higher inflation, the better looking TIPS get.

With current negative yields TIPS will not fully keep up with inflation. With the exception of Savings I Bonds they are one of the best bets for fixed-income in either hyper-inflation or a depression. In between, there may be better fixed-income investments. Longer-term CDs may pay higher interest rates in a relatively low inflation environment and are also FDIC insured up to $100,000. However, they are at a disadvantage in a high inflation environment--something that many economists project.

Even if the prevailing interest rates were to go up (See Lesson 101 above) thereby reducing the current value of TIPS you had already bought, you will get the face value plus all accumulated interest if held to maturity. If the prevailing interest rates go down, you may decide to sell some of the bonds before maturity and take the profit as I did last year. If bought at a premium, it's possible to lose money if no inflation.

There is no amount limit on purchases of these bonds, but you must buy them through TreasuryDirect.gov or a broker. Some mutual fund companies will not charge a fee to buy them if you get them on the auction dates. (See [www.treasurydirect.gov](http://www.treasurydirect.gov) for the next auction dates.) The earliest you can order original issue TIPS from a broker is 6 1/2 days before the auction.

I buy TIPS in a Roth in five and ten year maturities each year. That way I'm building a ladder where one will mature each year and I can then make a decision what to do with the money every year. At the end of five years, I will have a ten year ladder.

**CDs are Certificates of Deposit**. They are sold through brokers and banks. Web sites like BankRate.com show current rates from different sources. They currently pay higher interest rates than TIPS and should be laddered in most cases. They are FDIC insured up to $100,000 for each CD from a different source. That gives them some government protection almost as much as Savings I Bonds and TIPS. If not insured, they are dependent on the credit risk of the issuer. CDs can be sold before maturity but at the penalty rate specified in the contract.

**Bonds** can be bought individually from a broker, Treasury Direct or are in a mutual fund. They can be taxable, tax-deferred in qualified accounts, or tax-exempt as with those issued by municipalities. The value of an individual bond is dependent on current market rates until it is cashed at maturity. Individual bonds pay a fixed interest rate for the life of the bond. Interest rates as well as the principal in a bond fund change as the prevailing interest rates change. See Lesson 102. There is no maturity date or coupon for a bond fund. When buying individual bonds, you may also pay for accrued interest that's earned after the last interest payment date. You get this back on the next interest payment.

**Immediate Annuities** are an insurance product that starts making payments the month or year after making the investment. They provide these payments either for a lifetime or a specified number of years or even a combination of the alternatives. The majority offer fixed payment amounts, but some are available that help compensate for inflation either by specifying a certain percent increase each year or are subject to the consumer price index, CPI, sometimes with a cap on the maximum inflation adjustment. A pension from an employer is a form of immediate annuity. Immediate annuities and pensions offer survivor benefits, unlike Savings Bonds, TIPS or Savings I Bonds.

Immediate annuities are hard to place in an allocation analysis because, if considered, the value is the present value of all future payments at a discounted rate for the life-expectancy of the owner and survivor. Most people choose not to consider them in an allocation analysis just as they don't put pensions or Social Security in such a calculation. So once payments begin, they are then no longer an "investment" but a kind of pension.

**Money Markets and Bank Savings and Checking accounts** are fixed-income investments too, but usually pay lower interest rates than other fixed-income investments. They usually have checking privileges unlike other fixed-income investments and therefore considered the most liquid of investments. Bank savings and checking accounts are FDIC insured up to $100,000, but not money markets.

**Surviving a Depression:** FDIC insured savings accounts, CDs and money markets are great for a depression as are fixed-income investments bought from the federal government including federal bonds, Savings Bonds and TIPS. You can never get less than the face value for Savings Bonds, CDs and TIPS at maturity, but the same amount of dollars will be worth more in terms of purchasing power in a depression. In a depression, corporate or municipal bonds may default on their payments as well as part or all of the principal. Insurance on such bonds provides some protection providing the insurer stays solvent.

**High Inflation** literally destroys the value of most fixed-income investments over a period of time. My father's fixed income investments lost 80% of their value from 1965 to 1996 when he died. That's why Savings I Bonds, TIPS and inflation-adjusted immediate annuities may well be an attractive investment.

**Taxes on fixed-income securities**. If fixed-income investments are held in an employers' savings plan or IRA, there is no tax until money is withdrawn. I bonds are not taxed until you cash them in. At that time, you will owe income taxes on the interest earned. If the investments are not in such accounts, then the coupon interest on bonds, CDs and TIPS is taxed every year as is the interest from money markets and bank accounts. When you cash in TIPS that are not in an IRA, you pay tax on the gain of TIPS at ordinary income tax rates. The gain is considered the growth from inflation, not the coupon.

The taxes on immediate annuity payments are very strange if they are not bought using rollover money from an IRA. The IRS assumes that you are getting back the original investment in even payments spread over your life-expectancy at the time of the purchase, let's say 20 years. Therefore, only a small amount of the annuity payments is taxed for 20 years. But once the 20 years is over, the full amount of the payments are taxed.

**You can get more info on TIPS and Savings Bonds on www.treasurydirect.gov.** What's above is what I have learned from investing in all of these for the fixed-income portion of my portfolio. I may have sold my bond funds too early fearing interest rates hikes, but I'll always remember the quote from Bernard Baruch when asked how he made so much money: "I always sold too soon." Meantime, I can rest more comfortably knowing I have some inflation and depression insurance from my Savings I Bonds and TIPS.

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