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WHAT DOES ONE DO WHEN INTEREST RATES COME DOWN?

Whenever the interest rates paid on cash and cash equivalents, such as bank certificates of deposit, Treasury bills, and money market funds come down precipitously, the question arises as to what one can do to mitigate the effects of the problem.

In spite of the proliferation of advice that I hear and see dispensed on this subject at such times, my own personal advice, though perhaps unconventional, is at least relatively simple: There is nothing one can do except grin and bear it. Low interest rates must be endured; they cannot be overcome.

An action taken to recoup an interest rate shortfall in cash, in cash equivalents, or in any other fixed income securities must necessarily include an assumption of greater risk. There is no organization of which I am aware that subsidizes investors by offering instruments that pay more than the going market rate of interest.

If an investor is willing to take on added risk, there are two ways to increase the return on cash. First, one can subject his money to a greater likelihood of outright loss through default. This can be done by putting it in less creditworthy investments, such as junk bonds, or by shifting funds from FDIC insured banks to money market funds, none of which are insured. Second, he can increase the term-to-maturity of his investments. Neither is an acceptable alternative. This can be demonstrated with respect to the former by intuitive logic and with respect to the latter with some elementary financial mathematics.

As to the alternative of taking on greater credit risk, I believe the investor should first ask himself this question: "If I did not subject myself to that greater risk when interest rates were higher, when my income was therefore greater, and when consequently I had a greater tolerance for loss, why should I be willing to subject myself to such greater risk now when, by simple arithmetic, I can obviously less well afford it?"

What further compounds the folly of this approach is the matter of timing. Interest rates are usually high when the economy is strong and the issuers of debt are in relatively good health; and interest rates are lower when the economy is weak and the issuers of debt are less able than before to repay their obligations. Is it, then, not inherently imprudent to increase one's exposure to credit risk at the very time when one might otherwise be most tempted to do so?

The argument against lengthening maturities is a bit more esoteric but, for those of you with the patience, I should like to run through it.

An interest rate is the price of money. If interest rates are low, money is cheap. If interest rates are high, money is expensive. If one acquired a money asset when it was expensive (high interest rates), does it make sense to dispose of it just because it becomes cheap (low interest rates)? There is no investment philosophy that advocates buying high and selling low. It may seem counterintuitive but, if one adopts a policy of acquiring cash assets when the return on cash is high and getting out of cash when the return on cash is low, he is exposing himself to whiplash. That is because the opportunities for gain in investments other than cash are greater when rates are coming down, while the possibilities for loss in such other investments are greater when rates are going up.

The traditional measure of the rate of return on a fixed income security is its yield-to-maturity - a mathematical combination of the fixed rate of interest the security pays, the length of time until it matures, and the difference between the price at which it will mature and its current price. At any given time, the interest payment and maturity factors are fixed, and the only factor that can vary is the current price.

Because only the price, and not the interest payment, of a fixed income security can vary, the price of such a security varies inversely with the prevailing level of interest rates. The prices of fixed income securities and interest rates behave like the opposite sides of a teeter board. When one side goes up, the other side comes down, and vice-versa - with mathematical certainty. Moreover, the magnitude of the impact of any given change in interest rates will be in approximate direct proportion to that security's term-to-maturity. That is, the impact of a change in interest rates on the price of a security with a two-year maturity will be about twice the impact of the same interest rate change on the price of a one-year security. Similarly, the impact on a four-year security will be nearly twice the impact on a two-year security and nearly four times that on the one-year security. The linearity of the relationship diminishes as the term-to-maturity lengthens, but the impact of an interest rate change on the price of a thirty-year security is still usually over ten times its impact on a one-year security.

Let us carry the teeter board analogy one step further, remembering that interest rates are on one side and the prices of fixed-income securities are on the other. Cash and other instruments of short maturity are located nearer the fulcrum, while instruments of longer maturities are nearer the end of the board. When the interest rate side of the board rises, those securities with the longer maturities, because they are nearer the end of the other side of the board, decline in value the most. Conversely, when the interest rate side declines, those instruments nearest the other end rise the most. If one prefers to rise more, or at least no less, than he falls, it is inherently illogical to move from the fulcrum toward the end of the board when that end is up and/or move from the end toward the fulcrum when that end is down.

The point to be made is that, if one does not think that fixed income investments with longer maturities are appropriate when interest rates are high, they sure as heck must be even less appropriate when interest rates are low. The investor who seeks to increase his rate of return by extending the maturities of his fixed income portfolio is somewhat akin to the businessman who seeks to enhance the profit of his business by borrowing more money and so leveraging his balance sheet. Both are decidedly exposing themselves to greater risk. If events develop to their liking, they both derive greater benefit. If events develop adversely, they both suffer greater loss.

Of course, my readers all know that I personally do not harbor much affection for cash or any other kind of fixed-income security at anytime because I prefer to see money enjoying the higher rates of total return that have historically been available in high-quality growth stocks. However, low interest rates on other types of investments alone are not a reason for redeploying such funds into common stocks. They may provide an occasion for doing so; and I personally will not discourage the decision, thinking it better to do so at anytime than never at all. However, one should not think of common stocks as a temporary haven for money when interest rates are low, only to be withdrawn and put back into cash instruments when interest rates are high again. Such a strategy, too, is a formula for whiplash.

In conclusion, then, the level of interest rates, in no way, should ever be a factor in determining how, when, or where one invests his money. When rates come down, one should tolerate the decline just as stoically as the prudent common stock investor knows he should tolerate declines in the stock market. DW2DWB0051

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