



Adviser Soapbox

Avoid The Yield Curve Trap

Bill Matthes, Westport Resources 01.26.07, 1:55 PM ET

Retirees could be making a terrible mistake keeping their savings in CDs and money markets, because the inverted yield curve is sending a powerful signal that interest rates are headed lower. That could leave retirees with a big hole in their wallets where their interest income used to be.

The trillions of dollars that represent the U.S. bond market are betting that interest rates will be going down for several years and won't be going up much after that. Otherwise, the yield curve wouldn't be shaped the way it is.

In Pictures: Six Stocks For Yield And Growth

In financial markets, nothing is more dangerous than assuming that recent performance will continue. For the past few years, short-term interest rates have been increasing, but longer-term rates have hardly budged. That has led to the unusual situation where short-term interest rates are higher than long-term rates. The yield curve, which normally slopes upward to reward long-term investors with yield, is now tipping down for the first five years of maturities, and flat from five to 10 years.

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How bad could it get for investors who ignore the clear signal the bond market is sending? Retirees who are enjoying short-term yields of 5% or better today could see their income cut by 40% if short-term interest rates go back down to 3%. Faced with a decline in income of that magnitude, they could either adjust their budgets or continue to spend at the 5% level and watch their assets decline by 2% a year. Depleting savings not only renders it less likely that their nest egg will ever be able to provide the income they once enjoyed; it also means retirees could outlive their assets.

It is absolutely rational for retirees, who need as much income as possible, to gravitate to the highest yields and the least risk. But in all likelihood, it is the exact wrong thing to do when the yield curve is inverted. An inverted yield curve is a rare but unequivocal signal that interest rates are headed lower, and if that is true, money markets and CDs are yield traps that give investors a temporary yield advantage, which will disappear before long.

Here is how to avoid the yield curve trap:

- 1. Assume that short-term interest rates are going significantly lower and that long-term interest rates are headed modestly lower.**

Calculate the effect a one- or two-percentage-point drop in interest rates will have on your portfolio and plan accordingly.

Warning: Waiting for short-term interest rates to go down before you buy longer bonds is not a plan. In all likelihood, longer yields will fall with short-term rates, and if you wait you'll just be locking in lower yields

2. Don't put all your eggs in one interest rate basket.

The worst thing you can do in a declining interest rate environment is to concentrate your portfolio in short-term investments. Now, more than ever, you should have a fixed-income portfolio that has a variety of maturities, ranging from money markets to longer-term bonds. With a laddered portfolio, any change in interest rates will have a gradual effect on your income.

Warning: Bond mutual funds and variable-rate fixed annuities are not effective substitutes for bonds in a declining interest rate environment. Their yields will adjust down rather quickly, compared with owning a bond with a fixed coupon and a known maturity.

3. Protect your portfolio with stocks.

It is counterintuitive enough to recommend that investors protect their income by moving from short-term investments to lower-yielding, longer-term bonds. We are recommending that investors protect their principal by buying stocks that everyone knows are riskier than fixed-income investments.

Warning: Don't confuse volatility with risk. The risk of putting your money in money markets is that they could yield so little that you are forced to spend your principal. The risk of stocks is that their returns are volatile.

Stocks offer portfolio protection for conservative investors because in a low interest rate environment, stocks offer one of the few opportunities for real growth. Without growth, retirees face declining incomes as interest rates fall. In addition, stocks also offer tax advantages because dividends and long-term capital gains currently are taxed at very low rates.

We believe that it is always important to have liquidity, income and growth in a retirement portfolio. Investors who fall into the yield curve trap have liquidity, but they do not have a predictable source of sustainable income and will experience little or no real growth as interest rates decline.

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Bill Matthes is senior portfolio manager at Westport Resources in Westport, Conn. Clients of Westport Resources may be invested in stocks mentioned in the slide show. The information here is from sources believed to be reliable, but Matthes cannot guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results. The recommendations and opinions expressed in this report reflect the Matthes' personal views. [Click here for further disclosures.](#)

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