When 9% CDs Roamed the Earth

By Anthony Tanner, CFA
Scottsdale Wealth Planning Guest Contributor

June 2016

My first job on "the Street" was an unpaid internship at Dean Witter Reynolds during my senior year at St. Louis University. The year was 1983: The Dow had just crossed 1,200 points, the Prime Rate was 11.50%, and bank CD rates averaged 9%.

Just let that sink in for a minute.

9% CDs!

I remember it so well. It was my job to cold-call prospects for brokers with my script hawking 9% CDs:

"Good evening, Mr. or Mrs. John Q. Public. I hope you are enjoying your pot roast tonight. Would you be interested in learning more about getting NINE PERCENT *on safe CDs?!"*

That's right, 9%. Although the Prime Rate would briefly move to 13% the next year and other money market/bank rates would edge up accordingly, this was the beginning of the end for easy income investing. From that point on, interest rates and savings/income yields started their long march towards today's parched fixed income landscape.

THE DEMISE OF AN INCOME STAPLE

Out of school and on "the Street" as a bond trader and underwriter, I spent the next several years watching the perfect storm develop that falling borrowing costs and easier Fed policy create for savers. CD rates dropped from the 9s to 5s, and the financial press highlighted the increasing pain it brought to savers and income investors.

"Only 5%? But I used to get 9%! How am I going to maintain my spending? Pay for my living costs? I can't make up the difference!"

Yes, there was a time when 9% CDs roamed the earth. But today, that income and retirement staple is extinct. One can argue over what led to its demise (the decline of unions and wage bargaining power, the Fed's successful battle against inflation, or [insert-your-'90s-or-2000s-financial-crisis-meteor-here]). But make no mistake: "Traditional" bank CD rates (and many of its high quality, simple US and Municipal Government bond yields) are indeed extinct.

THE ASSAULT ON SAVERS

The chart below displays the long downward march of CD rates over the past 45 years.

Source: Board of Governors of the Federal Reserve System (US), 6-Month Certificate of Deposit: Secondary Market Rate (DISCONTINUED) [WCD6M], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/WCD6M, June 2, 2016.

What was once a fairly cyclical pattern–Rates go up, Rates go down–has flatlined. And while low borrowing costs have been a boon to many borrowers, it has become the bane of savers and retirees.

MAIN STREET, WE HAVE AN INCOME PROBLEM

The table below illustrated short/intermediate CD and US Treasury yields the past 30 years:

	July 1986	July 1996	July 2006	May 2016
1 Year CD	7.05%	5.00%	3.84%	0.28%
5 Year CD	7.85%	5.61%	4.20%	0.83%
7 Year UST	7.22%	6.95%	5.19%	1.51%
10 Year UST	7.31%	7.06%	5.23%	1.81%
Average Yield	**7.36%**	**6.16%**	**4.62%**	**1.10%**
Fed Funds Rate	**6.375%**	**5.25%**	**5.25%**	**0.50%**

The degree of income loss in vehicles that for decades were a lynchpin of retirement and balanced objectives has been devastating. It began gradually in the mid-80s and 90s. It picked up steam after the terror attacks of September 11, 2001. And following the housing bubble burst of 2008 and resulting financial crisis, it ran right off of a cliff. In real life terms, a basket of investments that once provided consistent 4%-5% yields (or, around $4,000 of income a month on a $1 million portfolio,) now requires *four times* as much principal (over $4 million!) to attain the same level of income.

In 2009, at the height of the financial crisis, average 6-month CD rates dipped below 1% for the first time, anchoring savings rates well below 1% for these past seven years. In the meantime, if you have been following the advice to "stay short and wait for rates to go up" (aka, *interest rate forecasting* and *timing the Fed,*) you have lost both time and money, foregoing income from utilizing broad diversification to manage interest rate risk.

LOWER FOR LONGER

Today, according to the financial press, those years of "preparing for higher rates" are being replaced by a new "lower for longer" mantra. Vanguard provided an investment and economic outlook to its advisors at the end of 2015 that indicates the expected ten-year median return of the global fixed income market is centered in the 2.0%–2.5% range.[1] This result is near current benchmark yields and thus most closely resembles the historical bond returns of the 1950s and 1960s, lower than return expectations just five years ago.

As they (accurately) point out, the most influential determinant the long run outcome for bonds and fixed income investing is <u>the starting point</u>. If you are starting at yields of 2% (or realistically, even less,) instead of 5%, you should have diminished expectations for success as well. The next 10 years could be characterized by pervasively low rates, and as long as these conditions persist, investors with income and retirement needs just can't bank on CDs and "plain vanilla" market yields to get the job done.

For those approaching or in retirement, the task at hand is to find solutions that provide a level of income that:

1) Sustains your living standards;
2) Does not lead to the rapid depletion of investment assets; and
3) Balances risks to minimize principal fluctuation.

CHICKEN EQUITY: MORE THOUGHT, HIGHER INCOME

For thoughtful investors, there are a variety of strategies and asset classes they and their advisors can engage to counteract this ongoing *assault on savers*. These include being invested broadly across the yield curve, utilizing defensive bond structures such as high-coupon callable bonds, and gaining exposure to a diversified mix of higher income/cash flow asset classes.

[1]David, J., Aliaga-Diaz, R., Westaway, P., Wang, Q., Patterson, A., & Ahluwalia, H. (2015, December), "Vanguard's economic and investment outlook", 18.

These include "chicken equity" asset classes such as convertible bonds, high yield bonds, floating rate and bank loan securities, asset backed securities, and real assets including REITs (Real Estate Investment Trusts). (I reference these as "chicken equity" because these high cash flow assets enable investors to retain some exposure to an improving economy without the same degree of stock market volatility, and with less interest rate risk than traditional plain vanilla bonds.)

The key in investing and owning many of these asset classes is gaining genuine diversification, holding smaller amounts of a wider variety of risks. This is not the same as taking *more* risk. What it provides is the increased likelihood that you will own asset classes when they are cheap, and, when owned collectively in a portfolio, they will respond in varying directions and degrees to changes in both interest rates and the equity market. This reduces volatility and portfolio risk.

Yields exceeding 4% and approaching 7%-8% can now be found in several of these less homogenous fixed income asset classes. Significantly diversified exposure can be easily attained through liquid mutual fund and ETF vehicles.

The key is to find an advisor to partner with who is both adept at navigating the waters of these asset classes and discerning true value in each, and who has a depth of experience through several interest rate cycles and the necessary perspective needed to assemble genuinely diverse portfolios and achieve real risk reduction.

"PREDICTIONS" FOR THE FUTURE

Are you ready? After completing my MBA and then spending more than 20 years on "the Street", I can consistently predict that 4% will remain greater than 1%. Furthermore, I feel confident predicting that earning 4%/year for 5 years will remain higher than 1%/year for 5 years. It's just that straightforward.

Sometimes we can outsmart ourselves in trying to time and outsmart the markets (and the Federal Reserve.) Yes, the current environment of generational lows in interest rates creates some problematic interest rate risk *management* concerns. In my years of managing fixed income portfolios for mutual funds, institutions, and individual investors I have found the best antidote to this risk has been a bigger coupon and a longer horizon. Together, they tend to better overcome the volatility created by interest rate risk than does timing the market. It's the difference between a thoughtful risk management approach and risk avoidance.

But you aren't going to find them posted on the wall of your local bank now … or any time soon.

---

those projected. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Please note that nothing in this content should be construed as an offer to sell or the solicitation of an offer to purchase an interest in any security or separate account. Nothing is intended to be, and you should not consider anything to be direct investment, accounting, tax or legal advice to any one investor. Consult with an accountant or attorney regarding individual accounting, tax or legal advice. No advice may be rendered, unless a client service agreement is in place.

All information has been obtained from the following sources: Board of Governors of the Federal Reserve System, Vanguard. Each source is believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.