Where to Invest Today

Before sinking the investment money you have set aside into the next hot IPO, here are several options to help you make the wisest investment for your particular needs.

BY MICHAEL P. HATCH, CFP, JD

Many people are faced with the dilemma of what to do with excess cash. You get an unexpected bonus, you've had a significant lump sum added to your retirement account, or you're been living well below your means. You realize that suddenly you have $50,000 or more to invest and are unsure about what to do with the money. Consequently, it languishes in your checking or money market account. Given the rising interest rate environment that has already begun, and the uncertainty surrounding the financial markets these days, I am routinely asked, "Where would you put $50,000 today?"

Without a doubt, my answer to this question is never quite satisfying to those who ask. My first question back to them is "What is the money truly for?" This question should be asked and answered before making any new investments. The taxability of the funds, your investment time horizon, your long- and short-term financial goals and objectives, your needs for the ability to access the money, your overall cash flow and debt usage, as well as how these funds fit in with the rest of your investments, should be addressed before making a random addition to your portfolio. As financial advisors and investment managers, we come into contact with bright, talented, and wealthy entrepreneurs, professionals, or executives who have a collection of mismatched, incongruent, and inefficient financial assets. We recently began working with an executive who had 27 different financial accounts! Imagine keeping track of all the paperwork, let alone the monitoring of the investments.

WHERE TO START

One obvious answer, of course, is paying down debt. Paying down debt can and should be the first place to start. Whether it is a car loan at 6.9%, or a home equity loan, this is typically the best move people can make. There are very few, if any, guaranteed, after-tax investments that will yield you more than 4% to 5%. If you are paying this type of interest or higher on any debt, starting an aggressive pay-off plan is a terrific idea. I would go so far as to say that making at least one extra principal payment on your mortgage each year should be a required element of every financial plan. Think about it this way: If your mortgage payment is $2,500 per month, you could simply pay $5,000 directly to your mortgage every year, and have the utmost confidence that as long as you keep this up, your brand new 30-year mortgage will be paid off in 20 years or less. You've paid an extra $100,000 over the first 20 years, to avoid paying an additional $300,000 over the last 10 years—maybe the exact time you are trying to retire.

Another answer, of course, is to spend the money now. You would be surprised the number of times we make that recommendation. This is a general reminder that life is short. Making the transition from saving to spending is a big change. If you are not sure you'll have enough funds for retirement, by all means get a second opinion. If, however, this additional $50,000 is an extra buffer, you will remember that Mediterranean cruise for the whole family 10 years from now more than any investment you'll make.

OPTIONS

There are various options that may prompt you to tinker with your cash position and help you decide how to invest some funds that you have been sitting on.

Option No. 1: Fixed-Rate Investments

Invest in fixed-rate investment options such as CDs. The Federal Reserve recently raised short-term interest rates for the second time this year. Because interest rates are expected to continue rising, many investors often choose to wait for that increase before they lock

TABLE 1. HYPOTHETICAL INVESTMENT OPTIONS COMPARISON								
	INVESTOR A				INVESTOR B			
	Start of Year Balance	Hypothetical Rate	Earnings	End of Year Balance	Start of Year Balance	Hypothetical Rate	Earnings	End of Year Balance
Year 1	$50,000	1.00%	$500	$50,500	$50,000	4.50%	$2,250	$52,250
Year 2	$50,500	1.50%	$758	$51,258	$52,250	4.50%	$2,351	$54,601
Year 3	$51,258	6.00%	$3,083	$54,333	$54,601	4.50%	$2,457	$57,058
Year 4	$54,333	6.00%	$3,268	$57,593	$57,058	4.50%	$2,567	$59,626
Year 5	$57,593	6.00%	$3,464	$61,048	$59,626	4.50%	$2,683	$62,308
Year 6	$61,048	6.00%	$3,663	$64,711	$62,308	5.00%	$3,115	$65,423
Year 7	$64,711	6.00%	$3,883	$68,593	$65,423	5.00%	$3,271	$68,695

This hypothetical example is not intended to illustrate any specific investment and is intended for informational purposes only.

in their funds. While this sounds like the logical and prudent thing to do, sitting on a 1% or 2% investment while waiting for rates to rise may not prove to be the best strategy.

Table 1 shows hypothetical Investors A and B; in this scenario, short-term money market investments are earning 1%, and within 1 year they are up to 1.5%, whereas 5-year CDs currently pay 4.5%. These rates are not atypical of what you might in the marketplace today.

Investor A didn't like the low yield on 5-year CDs (4.5%) and chose to wait for rates to rise before locking in the interest rate. Thus, he left his $50,000 in a 1% money market account, and in this hypothetical example, interest rates did rise. By the end of year 1, the money market rate was up to 1.5% and by the end of year 2, money market rates had risen to 2.5%, and 5-year CDs were paying 6%. At this point in time, Investor A locked his funds in a 5-year CD, perfectly content. Investor B chose instead to lock his funds at the best available rate at that time, when 5-year CDs were paying 4.5% per year. Who has more money at the end of 5 years? Investor A has a total of $61,048, but Investor B has $62,308. Assuming Investor B can only reinvest his proceeds at 5% after year 5, he would still have more money available at the end of 7 years. Thus, if this investor's goal was to have the money he could in 5 or 7 years, simply waiting for interest rates to rise was not the wisest strategy. For the 5-year goal, Investor A had significantly more risk (he could have been wrong and interest rates could have been flat, or even in decline).

This widely held view of predicting when and how much interest rates will rise, and thus "waiting for the right time" to invest money, may not prove to be the best strategy. We typically recommend that people continue to invest through all cycles, placing their fixed income assets in the best available investment at the time, for the term or maturity that they are willing to tie their money up, and move on.

Option No. 2: Buying Bonds

I would be very careful buying bonds because the principal on long-term bonds will suffer due to the likely increase in interest rates. However, if you have confidence in your issuer, and you are not worried about default or credit risk, why not buy and hold? Although bonds will decrease in value temporarily, as long as you are not paying a big premium, who cares? Currently, 18-year AAA rated municipal bonds (federally tax-free, and potentially state tax-free) yield close to 4.5%, whereas A-rated corporate bonds of similar maturity yield 6%.

In Table 1, had interest rates not risen from the 4.5% level to 6%, Investor A would have done even worse. Predicting how and when the Federal Reserve will change short-term interest rates, and the effects on long-term interest rates, has proven very difficult, even for professional money managers with multimillion-dollar research budgets. During the last 49 years, the Federal Funds Rates, less the Consumer Price Index, otherwise known as the "Real Return," has averaged +1.86%, while we are currently somewhere around -1%. And, excluding those periods when inflation reared its ugly head above 4%, that Real Return Figure averages closer to 2.11%. Therefore, I certainly think interest rates are on the rise. Put simply, a Federal Funds Rate less than the rate of inflation will not stand long-term in a growing economy. How fast and for how long interest rates will increase is a guessing game. Of course, there ance, we view economic prospects better in the US than in either Japan (heavy China exposure) or Europe (still stuck with antigrowth economic policies). Finally, we continue to worry about the financial position of Japan. Rampant deflation continues, consumer income is weak, balance sheets look highly leveraged, and demographic trends are poised to drain their pension system.

Option No. 6: Futures, Real Asset, and Other Hedge Investments

Most client portfolios we review are substantially underrepresented, or not represented at all, in the futures, real asset, or hedge fund sectors. While this is an investment category that does have a high element of risk, there are several futures programs and real asset investment pools that investors may wish to consider. These asset classes have little correlation to the traditional financial markets and can provide a necessary element of diversification to one's portfolio. Commodity prices are at their highest level in years (just ask your builder about the cost of lumber, or even trying to use steel instead of timber for construction). This is often an underrepresented asset class in typical portfolios that we see.

CONCLUSION

As with all of the investment ideas presented herein, I am not talking about making a $50,000 investment for the next 6 months, but rather making a strategic asset allocation decision for the next several years. Any doubts about the wisdom of diversification were hopefully laid to rest by the performance of the financial markets in the last 5 years.

Having an overall balanced allocation between fixed-income investments, real estate, equities, as well as some alternative investments, is still a good strategy. When looking at where to invest your own $50,000, look to see where your portfolio may be underallocated, and add to that first. For your physical health, as well as your financial well-being, balance may provide you with the best results. ■

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