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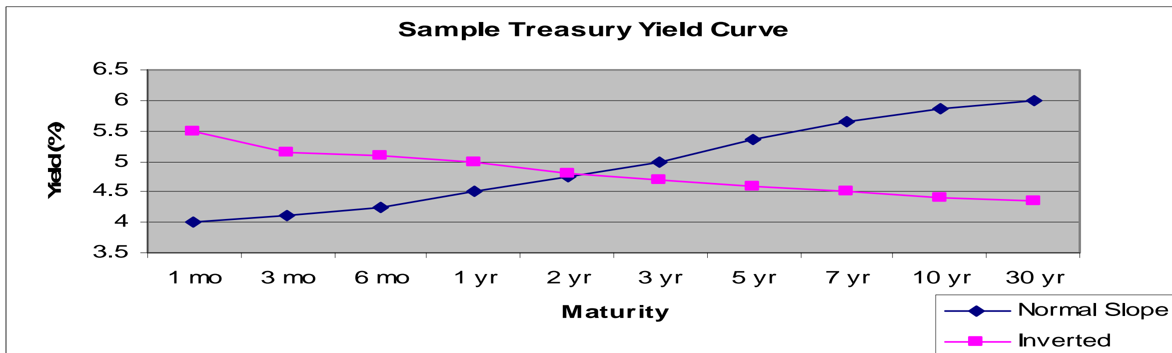
THE INVERTED YIELD CURVE

Does a Laddered CD Portfolio Make Sense?

What's wrong with this picture? The three month treasury bill is yielding about 5.10 percent. Or you can tie up those investment dollars longer in a 10-year treasury note and earn 4.85 percent. Similarly, a one year certificate of deposit pays approximately 5.05% annual percentage yield, while a five year CD will yield 5.05% as well. How can that be? Shouldn't investors be rewarded for extending the maturity dates on fixed income securities? Why would anyone in their right mind ever choose to invest in the longer-term security when they can earn a comparable (or higher) return in shorter maturing investments? Well, since July 2006, economists and investors have been pondering these exact questions.

The phenomenon known as the *inverted yield curve* occurs when longer-term fixed income securities pay lower rates of interest than shorter securities of the same credit quality. In a normal interest rate environment, the longer the maturity, the higher the yield. The investor then decides whether the additional return is worth the risk of tying dollars up for a longer time frame. Such decisions in the inverted curve environment of today would seem to be no-brainers…stay "short and sweet" and do not extend maturities at all. Or not.



What's the Curve Saying?

Many economists believe that an inverted yield curve implies that the economy will weaken in the near future. In fact, *Wall Street Journal* (January 8, 2007) pointed out that six of the last seven inversions have been followed by recessions. Sluggish economic environments normally are associated with declining interest rates as the Fed attempts to stimulate growth by easing borrowing costs on businesses and consumers. Further, in challenging times many investors implement a "flight to quality" strategy and turn to the safe-haven of fixed income rather than equity securities. If investors believe that rates will fall over time, they often move to lock in long rates today rather than risk the lower rates in the days, weeks, months to come.

For example, an institution has excess funds today that are earmarked for use in 10 years. Management perceives a slower economic environment ahead. Though it will only earn 4.85% over that 10 year time frame (as opposed to 5.10% over three months), they risk a decline in rates during the next 90 days. When that treasury bill matures, the 10-year may only be paying 4.75%, 4.50%, or lower. While the decision to earn a lower rate on a longer security may seem illogical, the institution chooses to forgo the additional 25 basis points for 90 days rather than risk a lower rate for 10 years.

Other Considerations

Supply and demand issues can also come into play and contribute to the inverted yield curve. Some institutions are concerned with "gap management" or matching their assets with liabilities. Pension fund managers and insurance companies have liabilities that will come due many years in the future. Regardless of the rate environment, they purchase longer-term securities to match their future funding needs. Additionally foreign investors (particularly in Asia) have been big buyers of fixed income securities over the past few years. They wish to earn greater income over comparable maturing securities in their markets and domestic long-term rates look very attractive. Both factors (gap management, foreign demand) may contribute to an artificial cap on long rates.

So what are the chances that a recession is drawing near? According to a recent *Wall Street Journal* survey of top economists, not very likely. Only 27% of them believe a recession will rear its ugly head within 12 months. Though housing remains weak, corporate earnings continue to grow quarter after quarter and consumer confidence in January hit its highest level in five years. Further, the GDP in 2006 grew at its fastest pace in two years. While a recession does not appear imminent, some economists do expect a slowdown in the months ahead. The Fed raised rates 17 times before ceasing that cycle last summer 2006; many believe the next Fed movement will be lower. Given the foreign demand for domestic securities, the long-term funding needs of certain institutions, and the expectations for future Fed actions, investors are locking in longer rates today. And suddenly, that inverted curve doesn't seem quite so illogical.

Laddered Portfolios

While fixed income investors may be tempted to hold only short-term (higher yielding) securities in the current rate environment, structuring laddered portfolios still makes a great deal of sense. By purchasing fixed income securities like CDs of varied (increasingly longer) maturities, investors are able to better manage their future cashflow needs and reduce the reinvestment risk that comes with timing their purchases and attempting to predict the direction of rates.

Here's how it works. The investor determines a maximum investment time horizon and spreads out CDs to mature at regular intervals between now and then. When each CD comes due, a new one is purchased at the back end of the schedule. If the investment horizon is five years, for example, the investor may own five CDs that mature every 12 months. After year one when the proceeds from the first CD are returned (with interest), they are reinvested for another five years regardless of the interest rate environment at that time. If rates have increased, the investor reaps the benefit of higher yields on the newly purchased CD. If rates have declined, they will be reinvested lower; however, the CDs that remain within the laddered portfolio continue to pay a higher rate of interest than new ones of similar maturities at that time. The investor who implements such a strategy effectively manages cashflow needs, always earns a market yield, and never has to worry about what the future holds for rates. And there's nothing wrong with that picture.

A Call to Action

So quit reading the business press and trying to predict the future direction of interest rates. Quit studying the slope of the yield curve and over-analyzing exactly what that means for the economy. For a certain percentage of your investment dollars, considering structuring a portfolio of laddered CDs and rest easier at night.