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The Dilemma of Our Current Interest Rate Environment

Many of you are wondering where to put cash these days. We are used to getting paid when we park our cash in a financial institution, but since the great recession, interest is hard to come by. Of course, the bright side of this is that credit is cheap, assuming you are able to access it.

So, what are your options in our current environment to earn money on your cash? Well first, you have to make a decision, and for some, that decision is a tough one: are you willing to take a loss on your principal? If the answer is a resounding NO, then your FDIC bank account is still your best option, because these accounts are guaranteed from loss of principal by the Federal Government (up to certain limits). This is where you should be parking funds you may be needing for those unexpected expenses, which fall above and beyond your normal cash flow, or living expenses in case of a job layoff or reduction of hours. Money market mutual funds, which pay roughly the same amount of interest income, do not come with these guarantees. In addition, if the fund “breaks the buck” you may even lose principal. Granted, this would be a black swan type of occurrence, but in these times it is nice to have something we can count on.

If you want the potential of higher interest, and are willing to take a little more risk, there are some options out there, but you must be comfortable with the idea of a potential loss of principal before taking the plunge. The safest vehicles out there are US government securities backed by the full faith and credit of the US government, followed by agency bonds issued by Government Sponsored Entities, such as Freddie Mac and Fannie Mae. However, if you own Treasuries, and interest rates rise, you will lose money unless you hold it to maturity.

~ Continued on page 2.

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Interest Rate Environment (*continued*)

One of the fastest growing areas attracting those seeking higher yields are bank loan or floating rate mutual funds. These are mutual funds that hold adjustable debt from lower rated companies. Unlike bonds and bond funds, whose values fall when interest rates rise, these funds react positively to rising interest rates because their coupons usually reset quarterly. The threat of default of the underlying companies is the biggest threat to the fund, due to the fact that many of these funds hold loans of very highly leveraged companies with low credit ratings in their attempt to provide the highest yield. Taking a look under the hood before investing at the underlying investment strategy, as well as the current holdings will give you an idea of the riskiness of the fund.

Morningstar lists 153 bank loan funds*. While most of these funds post year-to-date returns somewhere in the 2% range, a few are as high as 7%. It is interesting to note that many of them experienced losses of 20% or more in 2008; some significantly more. If you are considering investing your cash in this market segment, ask yourself, could you stomach a loss like that if another severe correction were to occur?

Although it is hard to accept a return of almost zero, in this very volatile market it is not worth taking on additional risk for the extra income, especially when the income earned may not be a substantial amount. Remember, this is a temporary situation, and rates will eventually rise again. Until that time let your investment portfolio do the heavy lifting for you, but keep your cash safe. You will be happy you did.

*This is neither an offer to sell nor solicitation of an offer to buy any security. Such an offer can be made only by the prospectus for the specific security. Of course, any investment decision should be made after careful review of your individual financial situation, risk tolerance, investment objective and time horizon.

Have a great month! Feel free to pass this newsletter forward. And, as always, thank you for your referrals.

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