Investing in a Flat Rate Environment

By Kris Muller, CFA, Senior Portfolio Manager, Balance Sheet Solutions, LLC

"With age, comes wisdom" is how the saying goes, or in the financial markets, "Haven't we been through this before?"

For some of us, the current flattening yield curve is reminiscent of 2007 before the financial crisis. While we hope to not fall into the economic hardships caused by that crisis, we can learn some important lessons from that time frame that may help us over the next few years.

Diversification is the first concept taught in portfolio management. For credit unions, that means both investment sectors and maturities. However, at the current time, many investors do not feel adequately compensated for locking up investments in longer terms. Let's look at a current CD offering *(to the right)*.

ABC Bank*
1 Year: 2.70%
2 Year: 3.05%
3 Year: 3.20%
4 Year: 3.35%
5 Year: 3.50%

The investor would only pick up 80 basis points for going from a one year CD to a five year CD. There is not too much incentive for someone to lock up their funds for that extended time frame; therefore, the investor would likely stay below the three year mark.

Remember: The investment is part of the entire portfolio and should be viewed in relationship to your other investments. Have you been investing heavily in short-term investments lately? While short-term investments provide an important liquidity source for credit unions, they will not help if many investments mature in a lower rate environment. This happened to several credit unions in the years following the financial crisis.

Let's look at investment rates from March of 2007 versus rates just two years later.

2007	2009
1 Year: 5.17%	1 Year: 1.22%
2 Year: 4.93%	2 Year: 1.48%
3 Year: 4.89%	3 Year: 1.82%
4 Year: 4.91%	4 Year: 2.11%
5 Year: 4.96%	5 Year: 2.36%

The curve was inverted during 2007 and many investors saw no need to go beyond a one year investment. However, as we know in hindsight, investors would have been smart to lock in a few four and five year investments.

Had investors placed a few longer term investments back in 2007, they still would have had coupons above 4.9% in their portfolio in a time when investors were barely getting 2.00%. This is a great example of the importance of diversification in your portfolio.

No one is making a call on interest rates through this strategy. By staying diversified in your maturities, you create a well-balanced portfolio made of short- and long-term investments that can weather various interest rate environments. An ample short-term portfolio can provide a source of liquidity should interest rates rise, while longer term investments help to add yields that will be in your portfolio for an extended period.

While it can be painful to lock in a less than desirable yield, maintaining a disciplined investment approach may help your portfolio in ways that you don’t always anticipate.

**SimpliCD rates as of 11/5/18*

For more information, including ALM Board Training, please contact your Balance Sheet Solutions representative or email Kristina Muller at kristina.muller@balancesheetsolutions.org.