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I explore the investing world underbelly & challenge the status quo

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How Safe is Your 'Safe Money'?

With the equity markets setting record highs, many security conscious retirees and aspiring retirees are wisely repositioning a portion of their portfolios into “safer” types of investments in order to lock in some of their profits. It’s no secret that it’s difficult for these conservatively minded investors to find places to protect their principal while earning interest above money market funds. The choices are slim (there are only 3) and many may be wondering, *how safe is my safe money?*

Since “safe money” is only as safe as the company or entity backing their promise it’s worth examining exactly how does FDIC, insurance companies, and the Federal Government “guarantee” the safety of your money.

1) CDs & FDIC

Bank issued Certificates of Deposit (CDs) are ultimately principal protected under the Federal Deposit Insurance Corporation (FDIC) up to $250,000 per depositor. So, when you're stowing away money in a bank CD for safety's sake, you're counting on the fact that FDIC will be there to guarantee your principal should the bank become insolvent. In it's own words, "The FDIC is an independent agency of the United States government that protects you against the loss of your deposits if an FDIC-insured bank or savings association fails. FDIC insurance is backed by the full faith and credit of the United States government. Since the FDIC's creation in 1933, no depositor has ever lost even one penny of FDIC-insured deposits."

The "insurance" offered on FDIC insured bank deposits is funded through "premiums" paid by member banks, not taxpayer revenue. Of course, if FDIC reserves and bank failures were dramatic, the FDIC could tap their $100 billion credit line with the U.S. Treasury and the full faith and credit of the U.S. Government.

Intended Use of CDs: short-term savings of 1 year or less, perhaps for a near-term purchase.

(Photo credit: Wikipedia)

2) FAs & Insurance Companies

Fixed Annuities (FAs) meet two specific needs of retirees and aspiring retirees: the ability to create a “personal pension” and potential growth without risk of the markets. Like U.S. Treasuries, FAs come in a couple different flavors: Fixed Rate annuities (which offer a fixed interest rate much like a CD does) and Fixed Index annuities (which offer potentially higher interest than their fixed rate brethren because the interest you earn is based on stock index performance without any stock market risk). Because of the potential to earn significantly higher interest without added market risk many opt for Fixed Index annuities.

While many advisors and investors have varying strong opinions about fixed annuities, there's one element everyone can agree on and that's the "safety" of principal aspect of an FA. There are many moving parts to a fixed annuity, which can sometimes create a lot of confusion to even those in the know. The way your principal is protected by the insurance company who offers it can also be somewhat confusing because of all of the safety measures put into place to make good on the insurance company's promises to you. Ultimately, the guarantees offered by a fixed annuity are based on the financial ability of the insurance company to make good on them.

Instead of federal regulation each individual state has an insurance department who's responsible for enforcing strict regulations on insurance companies. One of the strictest, and most important requirements, is the "dollar for dollar reserve" requirement where the company must keep at least $1 in reserve for every $1 in guarantees they've made to contract owners. So, an insurance company must have in savings at least as much as it would take for every single fixed annuity owner to walk away with the current value *and* current value of future obligations of those contracts. (It's important to note that banks and the federal government are not required to keep such reserves. A large bank is required to have only 10% in reserves or .10 for every $1 deposited). On an annual basis, state regulators verify the solvency of insurance companies with an "asset adequacy test." Above and beyond the "dollar for dollar reserve," insurance companies maintain surplus capital as extra padding in case of a financial catastrophe. This means that instead of having \$1 in reserves for every \$1 of promised benefits to fixed annuity owners they will maintain \$1.05 or more in capital (.05 per dollar surplus, a solvency ratio of 105%).

Intended Use of FAs: Guaranteed income you cannot outlive and market-based potential growth without market risk.

3) U.S. Treasuries & Federal Government

The overwhelming advantage of owning U.S. government Treasury bills, notes, or bonds is safety. When you buy a U.S. Treasury security you are in effect buying debt of the U.S. government, in other words you're lending money to the federal government for a specific period of time. Treasury securities are considered super "safe" simply because of the promise by the federal government to pay you interest and your principal upon maturity. This promise isn't backed by any asset or contract, rather by the "full faith and credit power" of the U.S. government (aka *to raise taxes and print more currency*).

Because Treasury securities are believed to be one of the safest investments around they pay lower interest rates than other fixed income investments like corporate bonds and floating rate bonds. One small benefit of Treasuries is that the interest they pay are exempt from state and local income taxes (but of course not federal income taxes). Although Treasuries are considered to be super safe they are not without risk. The nemesis of Treasuries comes primarily from interest rate risk because as rates rise the underlying bond may fall in value. Generally, longer dated Treasuries will be affected more by movements in interest rates, perhaps considerably so.

Intended Use of U.S. Treasuries: extreme safety and dependable interest payments for longer term money.

Undoubtedly, anytime you ask for something in life you have to give up something in return. When you include principal protection in your portfolio be it CDs, FAs, or Treasuries you give up liquidity in return for certainty, but certainty is something many retirees and soon-to-be retirees are looking for in this potentially over inflated market.

Disclosure: Rob Russell offers advisory services through Centum Capital Advisors LLC, an independent RIA.