

Market linked CD not worth losing sleep

by Stephen J. Butler

As former President Ronald Reagan used to say, "There you go again." This time it's the re-emergence of complicated investment products by the financial services industry to assuage the fears of the investing public.

A re-packaged idea gaining traction in the aftermath of the recent crash is the market-linked certificate of deposit. It guarantees a CD rate of about 1.5 percent, while it also promises to pay half of whatever the gain in the S&P 500 index turns out to be over the next five years -- if the latter is greater than the CD's rate. Having your cake and eating it too? How do they do that? Simple. They take the invested funds and buy five-year, zero-coupon bonds and then purchase options on the S&P 500 Index for an amount that would generate enough gain to meet roughly half of the gain of the S&P 500. At the end of five years, they have enough money to meet whichever obligation would generate the most money for the investor.

In return, the investor enjoys five years of uninterrupted sleep knowing that they'll make at least 1 percent per year even if the world goes to hell in a hand basket. If the market does take off, they'll receive close to half of what would have been their full rate of return as direct investors in the S&P 500 Index. So, is this a good deal? That depends. The answer begins with breaking the investment into its component parts. We know what a CD paying about 1 percent per year is worth, and it's insured by the FDIC up to the usual limits. What happens when we combine it with an agreement to pay us half of what the S&P 500 generates?

To begin with, to say it is half is an over-simplification. It's not exactly half. It is the average increase in S&P 500 value over the five-year period. The average increase, of course, would be half of the total if there was a straight line of increasing values. If the S&P 500 went from 1,000 to 1,500, the average would be 1,250 and the profit would be \$250 on a \$1,000 investment. In reality, the increase is calculated each quarter and it's a cumulative collection of averages that gets added up. The index could get to the \$1,500 by the end of the period and generate more or less than the \$250 profit depending on what had been happening from quarter to quarter. Also, this program gives up whatever dividends might have been paid --- there is no credit for dividends reinvested. Finally, there is typically a 3% placement fee which means that out of a \$1,000 investment, only \$970 is actually invested.

Is not losing any money, even for a moment, worth giving up half of what could have been our gains from investing directly in an S&P 500 Index fund? Over any rolling, five-year period, the index has rarely lost money. In rolling 10-year periods, we were able to say, for many, many years, that it had never lost money except for one year back in the 1930's. Over the last five years, ending in August of this year, the loss was just 2.5 percent and that included the greatest market crash since 1929. Meanwhile, if we give up dividends, we're really getting less than half of what could have been earned by direct investment in the index assuming that dividends had been reinvested. From 1950 through 2009, the average price change of the S&P 500 was 7.2 percent and dividends averaged 3.6 percent for a total return of 11 percent. The investor during that time experienced a real roller coaster from year to year, but over almost all rolling five-year periods, they would have made money.

In a market-linked CD, by comparison, the same investor would have received half of the price change or 3.6 percent and no dividends. True enough, in some five-year periods, when the market had lost money, the rate on the CD could have been higher than the payout generated by the average gain of the index. However, assuming that this happened rarely, the advantage of the direct investment more than compensates. Why? The \$1,000 per year invested in the market-linked CD program (at 3.6 percent) would have accumulated to about \$200,000 over 60 years.

The same \$1,000 invested directly in the S&P 500 with dividends reinvested would have accumulated (at 11 percent) to almost \$5 million. Compressing this past history to a more meaningful time period, anyone with even just a 10-year horizon on an initial \$10,000 investment would be about \$12,000 ahead with the direct investment if the 3.6 percent versus 11 percent history repeats itself. I don't know about you, but I can afford to lose a little sleep for that kind of money.

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Reason for optimism in stock markets

by Stephen J. Butler

*W*alking through a packed mall, it's hard to believe that ATMs came within 24 hours of shutting down when the banking industry froze up. Or, that the fired manager of bond-trading who destroyed Merrill Lynch had \$10,000 in cash taped to the inside of his desk. He obviously was prepared for a scene out of Cormac McCarthy's "The Road."

Critics of the federal bailout program TARP can't appreciate how ugly things might have been if we taxpayers hadn't stepped up to the plate. Well, happy days may be here again. People are out spending money on cars, clothes, you name it. And companies like Honeywell are pre-funding their defined benefit retirement plan with more money than they are required to contribute -- \$500 million more in Honeywell's case. Companies, shaken by the banks' near failure and vowing to not be left vulnerable, have more cash right now than they know what to do with.

Jobs picture

Is the glass half empty or half full? While the jobs picture may continue to look bleak, it's worth noting that those with college educations are experiencing only 5 percent unemployment. Those still employed have typically received wage increases -- traditionally the norm during recessions. After all, how can corporate America be sitting on record amounts of cash and not consider some raises for what companies all claim are "our most important asset?"

Then, there's the stock market. We're getting back on track with Warren Buffett's 2005 prediction in Fortune that the market would "only" double over a 10-year period. This simply meant a 7.2 percent annual compound increase instead of the historic 10 percent average. We're five years into that prediction, and the overall market has remained flat up to now. For his original projection to reach fruition, we would have to experience about a 13 percent rise in values over the next five years. That may be happening as we read this. The average rate of return in the years following a major crash has been higher than the 10 percent historic average -- 13 percent as a matter of fact.

"Super boom"

What would contribute to a "super boom?" I'm reminded of the book that predicted with giddy excitement "Dow 36,000" written back in 1999. The Dow did make it to 14,000 in 2007, but nestles in at 11,000 today. Those who believe that we're in for strong stock market gains over the coming years cite, among other things, the possibility of higher inflation that would help to boost stock values. Of that historic 10 percent gain, 3 percent is simply inflation increasing the value of real assets in dollars as the dollars get cheaper. Since the market tends to beat inflation by 7 percent. Warren Buffett may have been thinking back in 2005 that inflation would be zero and that the market would do just 7 percent better.

According to "The Stock Traders' Almanac," the third year of a presidency tends to generate the best market results, so we have that possible tail wind working for us in the short term.

Add that to the \$9 trillion sitting in cash that is increasingly impatient earning zero interest and we have reason to hope for a rising stock market. Longer term, there's inflation around the corner, of course, because our government tends to pay debts with cheaper, inflated dollars when we think we can get away with it.

It's the political path of least resistance when compared with borrowing more, raising taxes or cutting spending. The market rises on a wall of worry. There are always reasons for why rosy predictions might not come true.

Not to worry.

There are investments like dividend paying stocks that offer some protection on the downside as well as some great balanced mutual funds with combinations of stocks and bonds that can insulate long-term investors from the vagaries of market forces. It gets back to the question of what appear to be "Happy Days" and whether or not they are real. If we can hedge our bets with some diversification, we can sleep at night even if our optimism is partially false.

