

The Cost of Waiting – Municipal Bonds

Among the many decisions facing investors, determining when to invest funds is one which frequently causes anxiety. While market timing is often attempted, it is a risky undertaking, particularly when it comes to the bond market.

Many investors delay their purchase of bonds because they think interest rates are going to rise. In the meantime, they keep funds in lower-yielding savings and money market accounts. What they don't realize is that even if interest rates do go up to a level where they are ready to purchase bonds, the higher yield may not make up for the lower return received while they were waiting. It is difficult to make up this penalty imposed by the "cost of waiting."

The cost of waiting can be best illustrated with an example. Let's compare Investor A, who buys a municipal bond that matures in five years and yields 3.70% tax-free, to Investor B, who will not buy the same bond now because he thinks that interest rates will go up. Investor B, therefore, keeps his money in a tax-free money market account currently earning a 2.90% yield. If interest rates do not change and he continues to wait in the money market the municipal bond investor will earn \$4,000 more over the course of five years. Furthermore, even if there is an annual 25 basis points increase in the money markets over those 5 years, the additional income would not be comparable to investing in the 5-year bond. The benefit of buying the 5-year bond, in both of these cases, is quite apparent.

PLAYING CATCH UP

If Investor B waits one to two years before investing, how high do rates have to rise for him to catch up by year five? After one year, yields on municipal bonds that mature in four years must rise to 3.90% for Investor B to catch up by the fifth year. If Investor B waits two years before investing, yields on municipal bonds that mature in three years must rise to 4.20% to catch up by the fifth year. See the chart on page 2 for these examples.

COUNT THE COST

Trying to time the market can be costly. If you are concerned that interest rates might rise, there are better strategies you can employ than to "wait-and-see." One strategy is to build a bond ladder where you diversify your portfolio across a maturity range. Another strategy is to build a barbell where you split your portfolio between long maturities and short maturities.

For more information on either of these bond portfolio strategies, please consult your RBC Wealth Management® Financial Advisor.

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