

"The Cambridge Safety Net: Laddered Treasury Strips

Bert Whitehead, M.B.A., J.D.

Capital preservation is a major concern of most people as they near retirement. Clients tell us that they want to make sure they don't run out of money. This is the main reason many people avoid investing in the stock market after they retire.

A key concept of the Cambridge System^ä is Functional Asset Allocation, discussed in our Fall 1997 issue of the Cambridge Commentary. According to this concept, the function of 'interest earning' investments in a portfolio is capital preservation. Interest earning investments protect the portfolio from deflation. The recommended proportion of assets in this category depends on where the client is in the Cambridge Financial Life Cycle, and increases in later stages of life.

One of the most popular investment approaches we use with clients approaching retirement is to build a ladder of Stripped Treasuries. This article will discuss how this strategy works, its advantages and disadvantages, and alternatives when this is not appropriate from a tax standpoint.

First, an explanation of what 'Laddered Stripped Treasuries' are. Treasuries are I.O.U.'s (i.e., bonds, notes and bills) issued by the U.S. Government. They are globally traded, and are considered to be the safest investment in the world which is why they carry a very low rate of interest relative to other bonds. They are available with maturities of one month to thirty years, and normally pay out interest every six months. Denominations generally are available in \$1,000 increments starting at \$10,000.

'Stripped Treasuries' are Treasury securities that pay out no interest, but are sold at a discount from their face value and at maturity can be cashed in at face value. This type of bond is sometimes called a 'zero-coupon bond.' In effect, the interest earned is reinvested instead of paid out. The advantage of this is that the interest doesn't have to be reinvested every six months, but automatically earns the rate of the original bond.

For example, at this time the 'Long Bond' (i.e. 30 year treasury bonds) are paying just over six percent interest per year. Shorter term bond usually pay a somewhat lower rate of interest. So for the sake of our example, say that 12 year bonds are paying exactly 6%. So, if you bought a regular Treasury bond for \$10,000, you would get \$300 interest paid to you every six months (or \$600 per year).

Since money invested at 6% doubles in 12 years, instead of buying a regular bond, you could buy a Stripped Treasury with a face value of \$20,000 due 12 years from now for the same \$10,000. Although no interest will be paid, the discount you get when you purchase the bond insures that you will earn a 6% compounded rate for the life of the bond.

A 'bond ladder' refers to a series of bonds which are bought with sequential maturities, so that a bond matures every year. Laddering stripped treasuries provides a cash flow that is guaranteed by the U.S. government.

In designing portfolios for clients approaching retirement, the most important thing is to make sure they will not run out of money. So we have to determine how much they need to live on per year, and how much of this will come from pensions and Social Security. The rest can be guaranteed by using strips as part of a diversified portfolio.

For example, if a client needs \$80,000 a year to live on, and pension and social security payments will contribute \$35,000, then we want to have a 15 year ladder built by the time they retire which provides \$35,000 per year. At current interest rates, if the ladder starts in 2-3 years, it

will take about \$350,000 to invest in the ladder today to provide this cash flow. This usually amounts to 50-60% of a client's investment portfolio, and the balance can be invested in the stock market.

This combination of super-safe bonds and a well diversified stock portfolio has averaged a combined return on average of about 8-9% over the past 70 years. The key is that now the client has locked in an assured investment horizon of 15 years. The ladder will be replenished during the period when the stock market is good. Since the bonds are guaranteeing 5-6%, as long as the stock market earns more than 5% over the fifteen year period, the client will never run out of money.

Each year we determine whether to take the funds provided from the bonds maturing in the ladder, or to take capital gains from the stock market. In good years, the funds coming from the ladder are reinvested at the top of the ladder where they will normally buy two years for every year that matures. When the stock market is weak, the funds provided from the ladder are used instead of selling stock. This assures the stocks in the portfolio are always bought low and sold high.

The critical part of this strategy is to make it tax efficient. The best way is to invest money which is in a qualified pension plan (e.g. I.R.A.) in the Stripped Treasury Ladder. This assures that the interest will be earned on a tax deferred basis, and also that there will be adequate funds for minimum withdrawals when required.

One of the key reasons to use Treasuries in the ladder is that they are non-callable. While municipal or corporate bonds may provide a higher yield to start with, they do not provide for long-term protection against deflation since the issuer can 'call' the bond back when interest rates drop.

If a client does not have adequate funds in qualified plans to build the total ladder, we can use insured municipal bonds up to 10 years out, since many non-callable bonds are available for that short a maturity. Likewise, we often recommend FDIC insured Certificates of Deposit for the first five years, rather than Treasuries because they carry the same government guarantee and are non-callable and pay a slightly higher yield because they are not negotiable.

We usually like to start building a client's ladder when they start planning for the Financial Independence stage, so that their marketable net worth is 7-10 times their annual living expenses. At this stage, we start with a ladder as small as 50% of their projected cash flow needs for as little as 5 years out starting with the year they plan to stop working full time. Each year we grow the ladder so that we have at least 7 years fully funded when the client may be dependent on it, and continue to grow the ladder so that there is 15 years funded when the client stops working entirely.

Over the years, this Cambridge Strategy has proved to protect our clients in the most financially vulnerable part of their lives, while giving them the peace of mind to really enjoy their golden years.

Copyright © 1998 Cambridge Advisors, LLC. All rights reserved.