

"Money Market or Short-Term Bond Funds?"

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

Money-market funds can be a good place to park cash temporarily or to salt away an amount equal to 10 percent of your income for use in emergencies. Your money can be withdrawn quickly -- usually as easily as writing a check.

Short-term bond funds are also attractive as a place to park surplus cash and generally offer higher returns but at higher risk. Here's what you should know about both types of investments and how to use them.

There are three basic types of money funds.

General purpose funds invest in short-term debt instruments (due in 270 days or less) such as certificates of deposit (CDs), U.S. Treasury securities, and corporate IOUs (commercial paper). Government funds put most of their money in U.S. treasuries.

Tax-exempt funds typically invest in short-term municipal bonds that are generally free of federal income tax and sometimes state income tax. Tax-exempt funds typically pay a lower yield than the other two types, but may be attractive to tax payers in higher tax brackets because the after-tax yield of the general purpose of government funds may be lower.

Money markets try to maintain their share price at \$1 per share. Interest earnings are paid as dividends, and there are no capital gains or losses (share-price increases or decreases). This makes them reasonably safe investments. It should be remembered, however, that these funds are not FDIC insured. The exception to this are bank money market deposit accounts. Historically, money market funds have been safe although some have run into trouble because of investment in risky derivatives.

When considering a money market fund, ask these questions:

What is the current yield? Compare this to yields offered by your local bank on CDs and bank money market accounts.

What is the fund's expense ratio? Higher expense ratios mean a lower return to investors. A reasonable money market fund expense ratio should be .6 percent or less.

Has the fund ever had a NAV (Net Asset Value) of less than \$1? Don't invest in any fund which has had this occur in the last 15 years.

While money market funds seek to maintain a stable NAV, short-term bond funds offer no such security. In 1994, for example, the increase in short term interest rates saw a drop of 4.75 percent on average in the NAV of short-term bond funds. For many individuals, this meant a loss of capital that they were not prepared to suffer. Over a longer term, however, the yield premium on short-term bond funds makes them better investments than money market funds. After expenses, you can expect a yield of 1-3 percent higher on short-term bond funds.

Another caveat to investing in short-term bond funds is that since the NAV fluctuates, you will recognize any gains experienced on liquidation.

Often, short-term bond funds are preferable to money market investments whenever you have a period of greater than one year before you require the use of capital. If this fits your investment situation, call for a fund recommendation from your advisor.

Cambridge Connection Inc., 26111 W. 14 Mile Rd Ste LL6 Franklin, MI 48025
Phone: (800) 224-1040 Fax: (248) 737-9528 web: www.cambridgeconnection.com

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