

CHASING YIELD

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For a variety of reasons, investors need to have a portion of their money in conservative, liquid investments throughout their lifetimes. It may be the need of establishing an emergency reserve fund for rainy day expenses or diversifying money from higher risk stock investments or allocating money to lower risk fixed income investments to generate income during later years of life. Whatever the circumstance, investors will always search for the highest rate of return possible for any given level of risk.

Unfortunately, many investors chase yield without understanding the potential risks and consequences. Whenever you are considering investing any portion of your money in lower risk investments, you should always keep in mind your reason for doing so – not to earn the highest rate of return, but to help protect your principal. When you select investments with lower risk, you should always expect to earn lower rates of return. But in many cases, investors are not willing to accept this tradeoff. They want lower risk investments, but want to maximize the potential rate of return. As a result, when considering options for where to invest their money, the current yield of an investment opportunity can quickly trump the safety of their principal.

For example, if you are considering investing money in what is described as a low risk investment with a high yield, the first step you should take is to compare that yield against an appropriate benchmark, such as the 2, 5, or 10-year Treasury bond. The interest rates on these bonds are considered the “risk-free” rate, and as such, provide a good measure of what you should expect to receive from other similar investments with a similar investment time period. At the time of this writing, the 5-year Treasury bond is yielding 2.5%. If you were to compare this yield against another similar five-year investment that is yielding 6%, you must ask yourself, ***“What is the embedded risk contained in this investment for it to offer me more than double the return of the risk-free Treasury bond?”*** Always remember that there is no such thing as a free lunch, so it is imperative to understand how the investment is able to pay out such a higher rate of return, if in fact, the risk to your principal is similar.

Over the past several years, interest rates have been lower than their long-term historical averages, and as a result, many investors are exposing themselves to higher levels of risk in search of higher yields. When searching for a conservative investment for your money, be cautious when chasing yield. The extra percent or two may initially appear attractive, but if you lose ***any*** portion of your principal, that extra yield may come at a great expense.

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