Our Perspectives: Consider Repositioning Your Short-Term Investments

Homestead Funds

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John helps shareholders with their financial goals by communicating the benefits and resources the Homestead Funds has to offer. He has FINRA securities licenses Series 6 (Investment Company and Variable Contracts Products Representative), Series 63 (Uniform Securities Agent State Law), Series 65 (Investment Adviser Representative) and Series 99 (Operations Professional).

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In this piece:

- How interest rates have changed in the COVID-19 era
- The impact of low rates on savings accounts and money market fund yields
- How cash loses value, even if inflation is low
- 5 reasons that conservative, short-term bonds are an alternative
- How to make the switch carefully

When markets undergo extreme volatility, as we have seen in the wake of the COVID-19 pandemic, we get a lot of questions from investors about "moving to cash." We are also hearing from many investors wondering about the impact of the Federal Reserve's interest rate cuts, in terms of the impact on savings accounts and money market funds.

We often remind investors that, in these low interest rate cycles, it's important not to overlook bonds for their short- to medium-term fixed-income positions within their portfolios. Here's a recap of the conversations we are having with shareholders now.

So many things have changed about the economy and the markets in the wake of the global pandemic. One change that we see from the investor's perspective: the market shock may have scared some savers out of their investments and into the arms of cash (or similarly conservative money market accounts).

But there are solid reasons not to sit in cash or money markets, from an investment viewpoint. So where could you stash it instead? We think short-term, high-quality bond investments offer an appealing and logical alternative for this environment.

In this piece, we will tick through the main reasons that short-term bonds could make more sense than cash and money markets for the medium term.

REASON 1: Near-zero money market rates to continue.

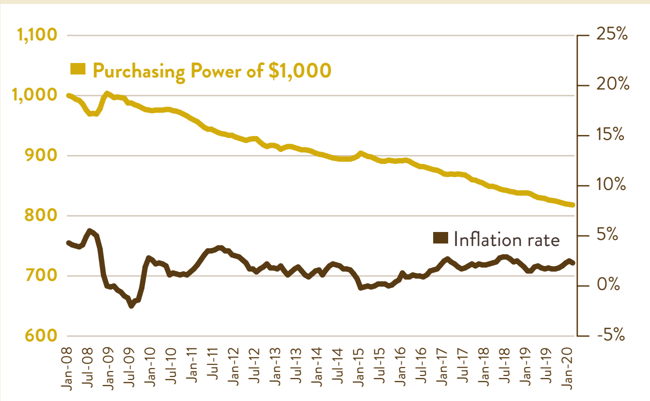
As soon as the full scope of the COVID-19 pandemic became clear, the Federal Reserve (Fed) slashed its target interest rate down to zero.

The Fed sets an overnight interest rate, which is the rate that commercial banks charge each other to lend and borrow excess reserves overnight to meet their reserve requirements — in other words, it's a rate only used directly by banks. However, the Fed's moves do affect all other interest rates in the marketplace — lower Fed targets also pressure bank-account interest rates down. All told, when the economy is hit with a shock or a cyclical slowdown, interest rates generally fall. Indeed, the interest rates paid on savings and money market accounts — which were already low — are now near zero percent.

So how long will rates be super low? Luckily, we have the benefit of a recent example of an interest-rate environment much like today's: after the financial crisis, the Fed held its target interest rate near zero from 2008-2016. It's too early to say if the post-pandemic economic recovery will need that kind of timeline for low rates. Still, it's quite possible that near-zero rates will go on for years.

Inflation, Even at Low Levels, Drains Purchasing Power of Cash

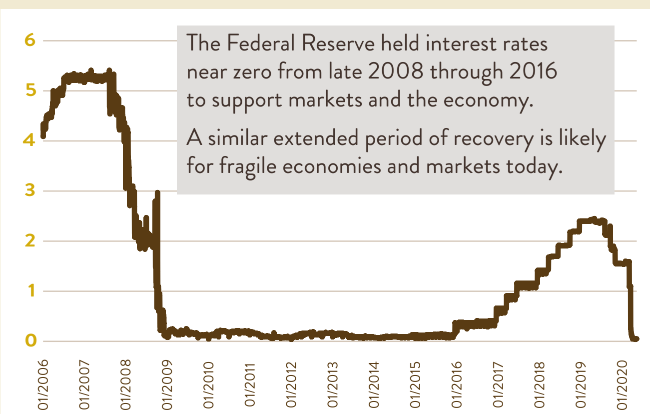
Inflation and the Purchasing Power of $1,000 (in 2008)



Source: Bureau of Labor Statistics, Homestead Funds' calculations

With Near-Zero Fed Rates, Money Markets Also Near Zero

Federal Funds (Overnight) Interest Rate (%)



Source: Federal Reserve Bank of St. Louis

Inflation has a problematic way of making your money worth less.

REASON 2: Inflation, even at historic lows, will reduce your purchasing power.

You should be considering the role of inflation in these interest rate dynamics. After all, inflation is a big factor in the overall level of interest rates. When investors expect future inflation to rise, longer-dated rates go up. When they think inflation will fall, long-dated rates tend to drop.

What does inflation have to do with your cash in savings accounts and money market funds? Inflation has a problematic way of making your money worth less, when deposits are not earning enough interest to offset it. $1,000 today will be worth less next year, in a world where there's even minimal inflation and near-zero interest rates on deposits.

In economic downturns, inflation often goes very low or sometimes even negative (deflation). As such, it might feel like inflation isn't a real threat to cash at the moment. But when we look back at the period immediately following the financial crisis, inflation was mostly positive in the years that followed. For an investor who had $1,000 in a no-interest bank account at the start of 2008, the so-called purchasing power of those dollars would have fallen to about $818 at the start of 2020. (See Figure 1.)

REASON 3: Bond funds can do their job in high-rate and low-rate environments.

It's important to understand the role that bond funds actually play in an investor's portfolio.

Whereas stocks are the go-to engine for potential long-term investment growth, they also come with periods of loss. Money market and savings accounts typically are used to hold investors' immediate cash needs.

In contrast to stocks and money markets, short- to intermediate-term investment-grade bonds funds are a more moderate alternative. Over long periods, bond funds typically provide some amount of steady interest income, but often more importantly, they could potentially help guard against losses compared to an all-stock portfolio, while potentially providing more in annual returns compared to savings or money market accounts.

When you think of short- to intermediate-term bond funds this way, as downside protectors and moderate-income providers, it's easier to see how they can do a valued job in a portfolio in varying interest rate environments.

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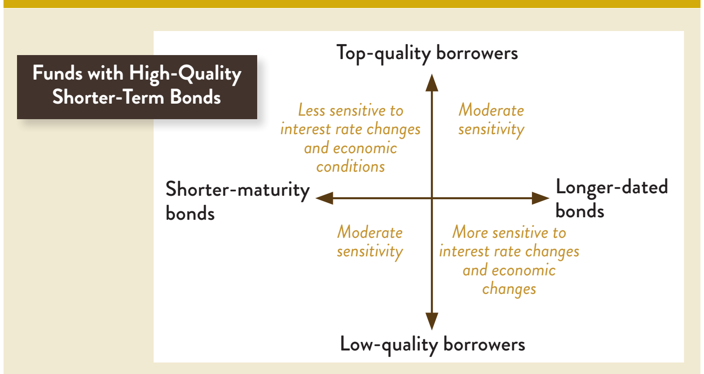
REASON 4: Careful positioning choices may minimize interest-rate risk.

The bond market is enormous in size and spans a huge range in terms of credit quality, from high-quality AAA-rated bonds to those with "junk" status, and in terms of bond maturities, from 1-month bonds to 30-year bonds. As you might guess, that also means bond funds owning various maturities and credits of bonds can span a huge range of risk levels, depending on what they hold. As such, you want to take a specific approach when considering how to reposition your portfolio to include bond funds instead of cash or money markets.

To assemble a conservative mix of bond funds, we think of three dimensions that, when combined, make for a conservative allocation. The first is picking short-term bond funds. Shorter-maturity bond funds often have less interest income, but they are also less sensitive to interest rate changes. Second, choosing high-quality bond portfolios is also a lower-risk option. Funds that hold U.S. Treasuries, U.S. agency or agency-backed issues, or the highest-quality corporate debt tend to be the least sensitive to changes in credit quality. Third, go for diversification in the form of a fund or mix of funds. A diversified portfolio reduces the risk that a single investment will determine your portfolio's overall performance.*

Bond Universe



REASON 5: The potential for more income!

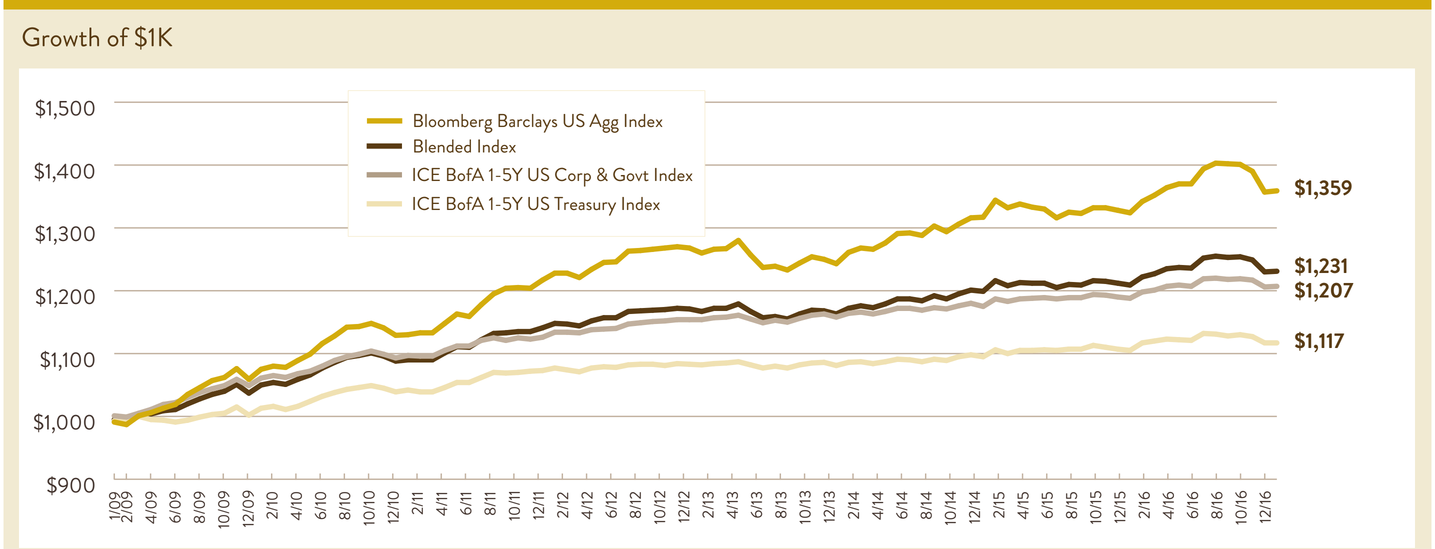
If you can get on board with the idea that a conservative mix of bond funds is a beneficial option versus sitting in cash, then you can enjoy another upside: the potential for more income!

It's one thing to embrace the idea, and another to see it. We looked at how a mix of conservative, shorter-term bonds performed in the last near-zero rate environment (2009-2016) to see just what kind of returns bonds posted then.

Sure enough, even in a low-rate world, a conservative mix of bond funds did have positive returns for investors. Specifically, we looked at the performance of three bond indexes representing three groups of bonds:

- **short-term government bonds** (represented by the ICE BofA 1-5Y Treasury Index)
- **short-term diversified bonds** including both government and corporate issues (represented by the ICE BofA 1-5Y U.S. Corp & Govt Index)
- **higher-quality intermediate-term bonds** (represented by the Bloomberg Barclays U.S. Aggregate Bond Index)

How a Conservative Mix Would Have Performed 2009-2016



Source: eVestment

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The blended index in the chart on the prior page is comprised of the other three indexes in equal proportion. For the 2009-2016 time period shown, $1,000 would have grown to about $1,200. While this example does not account for things like fund expense ratios that investors would pay in the real world, it is still a good approximation of how bonds performed over the period.

Making Logical Choices for Your Savings

In periods of volatility and uncertainty, the urge to retreat from risk is natural and commonplace. However, that doesn't make it the most logical or reasonable choice. Though we can't predict how the upcoming quarters and years will evolve in stock and bond markets, we can do a cool-headed assessment of where we are today: in a near-zero interest rate world. If history is a guide, this could be the new norm for years.

Near-zero is particularly unfavorable for cash and money market holdings. Inflation may be low at the moment, but any amount of inflation eats away at the purchasing power of cash. In the coming quarters and years, the economy could rally strongly (pushing inflation and long-dated interest rates higher), or we could see a protracted period of difficulty driving the credit quality of bond issuers downward (pushing the price of credit higher). With these opposing risks, investors looking for an alternative to cash have another, more conservative option: a diversified mix of short-term, high-quality bond holdings.*

Thinking beyond your conservative holdings, stocks probably deserve to keep a place in your portfolio. Stock prices tend to fluctuate more widely than bonds — as we certainly saw as the COVID-19 pandemic unfolded — but having a longer holding period has historically smoothed the ride as dips have historically been followed by recoveries.[1]

Homestead Funds client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.

[1]Historically, the risk of suffering a stock market loss has been reduced when you have a longer holding period. This point is illustrated in the chart, "Risk of Stock Market Loss Over Time (1926-2019)," TD Ameritrade.

Past performance does not guarantee future results.

*Neither asset allocation nor diversification guarantee a profit or protect against a loss in a declining market. They are methods used to help manage investment risk.

Investments in fixed-income funds are subject to interest rate, credit and inflation risk. Interest rate risk is risk that a change in rates will negatively affect the value of the securities in the Fund's portfolio.

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Index Definitions: The **ICE BofA Merrill Lynch 1-5 Year U.S. Treasury Index** measures the performance of short-term U.S. Treasury securities. The **ICE BofA Merrill Lynch 1-5 Year Corp./Gov. Index** measures the performance of U.S. government and investment-grade corporate debt. The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. Indices are unmanaged, and investors cannot invest directly in an index. Unless otherwise noted, index performance does not account for any fees, commissions or other expenses that would be incurred. Index returns do not include reinvested dividends.

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