Reinvestment and Purchasing Power Risk

Over the past two years, the Federal Reserve (Fed) has increased the Federal Funds interest rate significantly to try and reduce inflation. The Fed’s course of action has caused a corresponding increase in interest rates offered on deposit accounts such as savings, money market and certificates of deposits (CDs). This rise in interest rates has caused a resurgence in the interest in CDs. All investments carry some degree of risk and with CDs those risks include, but are not limited to, reinvestment risk and purchasing power risk. The purpose of this article is to highlight some of the often overlooked risks associated with CDs and offer options for investors to work to mitigate those risks.

Reinvestment risk is the uncertainty an investor faces when a fixed income investment (e.g. CD) matures and market conditions warrant a different interest rate upon renewal. An example of this was in late-2007 when 5% rates on CDs were common but then by early 2009 CDs rates had cratered to yield less than 1% with rates staying low for over a decade1.

After nearly two years of aggressively increasing interest rates, the Federal Reserve may be in the position to cut interest rates moving forward. The CME futures market2 is predicting a 1-1.5% decline in interest rates by year-end 2024 and the Federal Reserve’s own indication of long-term interest rates is 2.5%, over half of what rates are today. Regardless of interest rate conditions in the coming year, investors with CDs maturing will be faced with reinvestment risk and at the mercy of prevailing interest rate conditions at that time.

One option to mitigate reinvestment risk is to implement a ladder. This is the strategy where the investor staggers maturities of those fixed income investments over a period of time. An example of this is investing equal amounts in 1 year, 2 year, and 3 year CDs. Once the one year CD matures, reinvest the proceeds into a long-duration three year CD. After the first year, the original two year CD has one year to mature and the original three year CD has two years to mature. The benefit of a shorter-term certificate is that the investor has liquidity of those monies sooner than the longer duration CD. The drawback of the short-term certificate is that it is subject to reinvestment at a rate that may not be as favorable. The benefit of a longer-duration CD is the rate is locked in for a longer duration. However, the drawback of a longer-term CD is that the investor needs to wait longer for liquidity. By staggering when those certificates mature, the investor has hedged their reinvestment risk to some degree while also creating regular liquidity.

Purchasing power risk is the possibility that an investment return will not keep pace with the rate of inflation. A recent example1,3 of this was in 2022 when inflation averaged 6.5% while short-term CD rates averaged 2.2%.

Investment returns are a lot like gas mileage, in the short-term it doesn’t matter a whole lot, but it is a big deal long-term. For example, the difference between 4% and 7% returns on $10,000 over the course of one year is a $300 difference. However, over the course of a 20-year period, the difference in returns between 4% and 7% on the same $10,000 is over double, of course favoring the higher returning investment4. To combat purchasing power risk, investors should consider the appropriateness of CD investments over a longer-period of time for those longer-term financial goals.

CDs can be an appropriate investment in the right situation at the right time. There is no risk-free investment and investors should be aware of associated risks and work to mitigate those risks.

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*1 – St. Louis Federal Reserve. Interest Rates: 3-Month or 90-Day Rates and Yields: Certificates of Deposit: Total for United States.* [*https://fred.stlouisfed.org/graph/?g=16nMR*](https://fred.stlouisfed.org/graph/?g=16nMR)

*2 – CME Group: CMI FedWatch Tool. Data as of and accessed 11/29/2023. www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html*

*3 - US Bureau of Labor Statistics. Consumer Price Index: 2022 in Review.* [*https://www.bls.gov/opub/ted/2023/consumer-price-index-2022-in-review.htm*](https://www.bls.gov/opub/ted/2023/consumer-price-index-2022-in-review.htm)

*4 - Calculator math: $10,000 invested at a 4% rate over 20 years is $11,911 of returns while a 7% return over the same time-period is $28,696 of returns.*

*Certificates of Deposit are FDIC insured and offer a fixed rate of return if held to maturity. Brokered CDs sold prior to maturity in the secondary market may result in loss of principal due to fluctuations in the interest rate or lack of liquidity. Brokered CDs are registered with the Depository Trust Corp. (“DTC”). Brokered CDs with step-down and/or call provisions may be less favorable than traditional CDs without these features.*

*No strategy assures success or protects against loss.*