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Why I Like Long-Term Treasury Bonds Instead of CDs or Money Market Funds

Originally published in Muhlenkamp Memorandum *Issue 18, October 1990, this essay discusses the "callability" of Treasury bonds, CDs, and money markets and how that influences their value as investment options.*

As we noted in an earlier essay entitled "Defusing the Inflation Time Bomb," it is unlikely in the future that short-term interest rates will stay significantly above inflation rates. Therefore, to get a real return, investors must opt for long-term debt (bonds) or equity (stocks). Each of these has associated risks, some of which are well known. We want to point out some of the risks in long-term bonds that are not well known or understood.

Price volatility is obviously one risk, but so is the "risk" of the bonds being paid off or "called" early. Just as individuals borrow mortgage money to buy houses, companies borrow bond money to finance expansion. The government also borrows bond money to fund the deficit. Similarly, just as people who took out mortgages at 12% or more have since refinanced them at lower rates, companies that issued bonds at 12% or more have called those bonds when interest rates fell. The government has not called their bonds, because most U.S. Treasury bonds are noncallable by law.

The reason we recommend long-term Treasury bonds to investors seeking income for three years or more is because we want to lock in current interest rates for a long period of time. We also want the decision of when to cash in these bonds to be ours, not the issuer's. Treasury bonds are quite liquid. They can be bought and sold on any given day. Therefore, buying a 20-year Treasury bond does not lock you in for 20 years. It merely allows you to decide when to sell it. Of course, as interest rates change the price will fluctuate, but these fluctuations will decrease as time goes on and the time to maturity of the bond shortens.

A list of currently outstanding Treasury bonds appears in *The Wall Street Journal* every day under the heading "Treasury Bonds, Notes and Bills." [1] Items in this listing include:

- Rate: the nominal rate or coupon. The number of dollars paid out in interest per year per $100 of face value.
- Mo/Yr: the maturity date of the bond.
- Bid & Ask: currently quoted price.
- Ask/Yield: the compounded yield-to-maturity based on the asking price. Note that higher coupons have higher prices so that the yields-to-maturity are similar.

As an example, on Wednesday, April 17, 1991, the 8¾% bond maturing in 2008 was priced at 104 to return 8.18% compounded to maturity. These bonds can be bought and sold any day through any stockbroker. Many banks, including Mellon and Pittsburgh National, now also have this capability. They charge a fee for this service. Each quarter the U.S. Treasury also issues new bonds (borrows more money). Bonds of 3-, 10-, and 30-year maturities will be available at auction on May 7, 8, and 9, 1991, respectively. Check with your bank; sometimes they charge a lower fee on new issues.

[1] Due to a recent change in format, *The Wall Street Journal* no longer lists the table described above. However, it is printed weekly in *Barron's* under the heading "U.S. Notes & Bonds."

Editor's Note

So if you choose to invest in bonds, be sure you understand their callability. You want to be in control of when to cash them in. Bonds, like all financial products, are simply agreements written on paper. Read them—especially the fine print. Read them again and again, until you are sure you understand them. You want no surprises when it comes to your investments.