What’s the impact of investing in cash?

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Let’s say you have $1 million saved for retirement and need about $50,000 a year to supplant your Social Security funds. What are your investment choices?

One option is to leave your funds in a “safe” cash equivalent. You could choose money market funds backed by the US Treasury (or your bank checking account) and earn about 0.1-0.8 percent a year interest, or just put the cash in a “safe” box buried in your back yard. Each year you would take out your needed $50,000. The money should barely last up to or just over 20 years and then you will be finished.

Note though, that each year you do this, your money would buy less by the rate of inflation (and some taxes on any interest paid). For example, a first-class US postage stamp 10 years ago was 39 cents, and is 47 cents today. You can buy 20 percent less “stuff” with a dollar than you could 10 years ago. By the time your 20 years are up, your last 50K withdrawal will most likely only buy about two thirds of what it would today.

So, maybe take the option of Treasury bonds. Here the rate of interest is higher (taxable) but this may keep up with inflation better. If you bought a series of bonds that matured each year for the next 20 years, you would end up with a blended interest rate of about 2 percent. After taxes, you would still lose purchasing power each year due to inflation, and your funds are gone in less than 24 years. If you try to buy and sell bonds, you risk losing money if interest rates go up (as was the case in the 1970s).

TIPS (Treasury Inflation Protected Securities) take away the risk of inflation to a great degree. They offer almost no return above inflation, but your purchasing power would remain intact. So, you could buy a series of TIPS that mature regularly over the next 20 years and get a return of whatever it takes to buy about $50,000 of “stuff” today. Of the three options above, if you are strongly committed to absolutely safe fixed income, TIPS appear to be the best choice.

Accepting a steady erosion of purchasing power (bonds today, cash) is not palatable to most people. Even accepting the zero return (except inflation) over decades with TIPS is hard to accept. But you should realize that these are the choices outside of investing liquid capital in global stocks.

The day will probably come when you can buy a bank CD for 5 percent as we could do in 2006. Just remember that after taxes and inflation, even these returns are negative.

There is no “safe” and sure positive return. The best we can do being “safe” is to make a near zero real return (TIPS).

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