# Cash or bonds? Which one is right for you?

### We're in a new period of higher interest rates

Now that interest rates have risen significantly, you may be wondering whether it makes sense to invest in a bond fund when you can earn a relatively high rate of return in a money market, certificate of deposit, or other type of cash account.

These feelings are especially understandable after 2022, a rare year in which stocks and bonds lost money at the same time. History shows that most of the time, bonds can help shelter your portfolio against stock downturns.

When you're deciding between cash and bonds, it's important to weigh the risks of each. Generally, short-term instruments such as a money market are appropriate for short-term needs such as a rainy-day fund while longer-term goals like retirement call for bonds with longer terms to maturity.

### Cash has risks

You may be attracted to a certificate of deposit or other type of cash account because it won't decline in value, but cash comes with reinvestment risk. This is the risk that rates fall, which is what would happen if the Fed cuts rates in the face of a recession. In that situation, you would have to reinvest your money at a lower rate.

Here's an example using a hypothetical 5.09% rate on a 3-month Treasury bill as a proxy for any short-term investment such as a money market. It's important to remember that 5.09% is an annualized rate. You earn 1.25% every quarter, and interest compounds as it is reinvested at the end of each quarter.

Rates, however, change all the time, and if they fall, you could earn far less than 5.09% over the year. This is because you will have to reinvest the money when your Treasury bill expires. If rates are still at 5.09%, you're in luck. If they have fallen, you earn less.

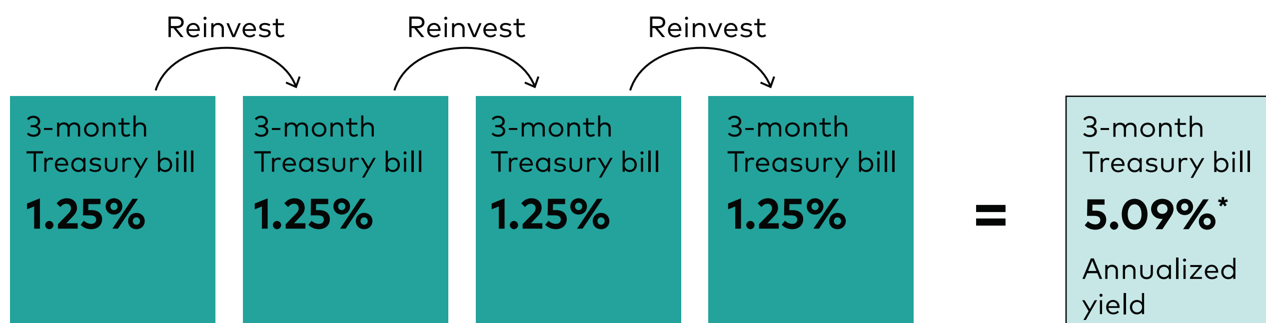
In this example, to earn 5.09% in a year, you would have to reinvest your principal at the end of the three months into a new 3-month Treasury bill at the same rate.

And do the same again. And again. Only then would you achieve 5.09%, as the illustration below shows. The assumption that rates will stay stable is a significant one behind the annualized yield calculation.

Every time you reinvest, you risk getting a lower rate. This risk is greater with short-term instruments, while longer-term instruments are more vulnerable to interest-rate and credit risk. Understanding different types of risks and matching short and longer-term investments to your goals' time horizon can increase your chances of investment success.

### How annualized returns work

**FIGURE 1: Reinvestment risk means you might not earn the annualized return unless rates stay at the same level**

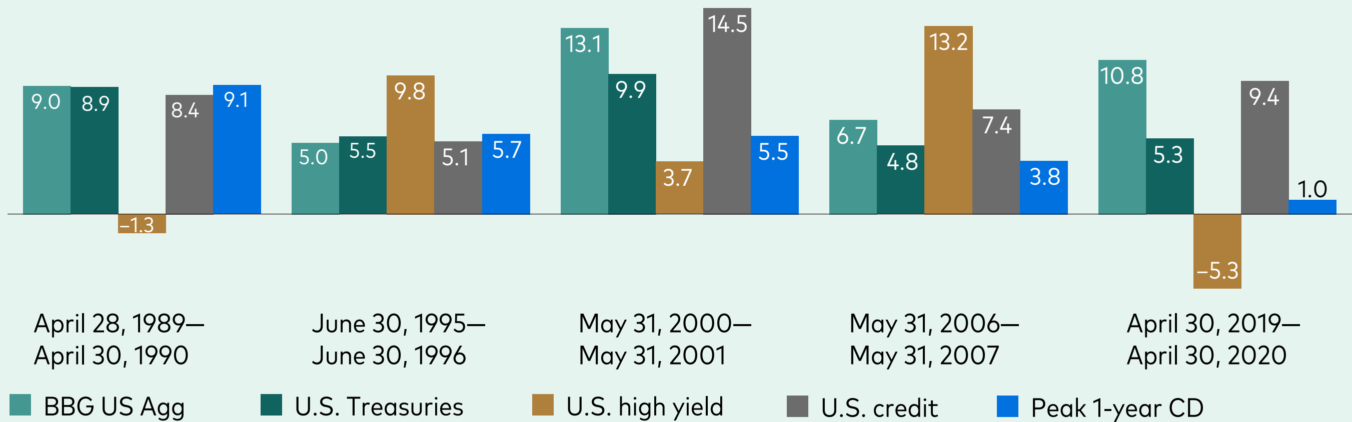



* Assumes interest is reinvested at the end of each term.

## CDs don't always earn more than bonds

It's tough to predict where interest rates will go, but we can look at what happened in similar periods. This chart compares returns on various types of bonds to those of CDs in the 12 months after the end of a Fed rate hiking cycle, starting in 1989. As you can see in this chart, CDs often earned less than bonds.

**FIGURE 2: Returns on bonds compared to CDs (%)**




**Sources:** CD rates are from Bankrate.com. Annualized return delivered by the Bloomberg US Aggregate Bond Index, U.S. Treasuries, U.S. high yield, and U.S. credit after the Federal Reserve stopping raising interest rates (we rounded dates to the nearest month-end). The blue bar shows the peak CD rate an investor could have locked in at the time the Fed was finishing its rate hiking cycle.

**Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.**

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Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income.

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