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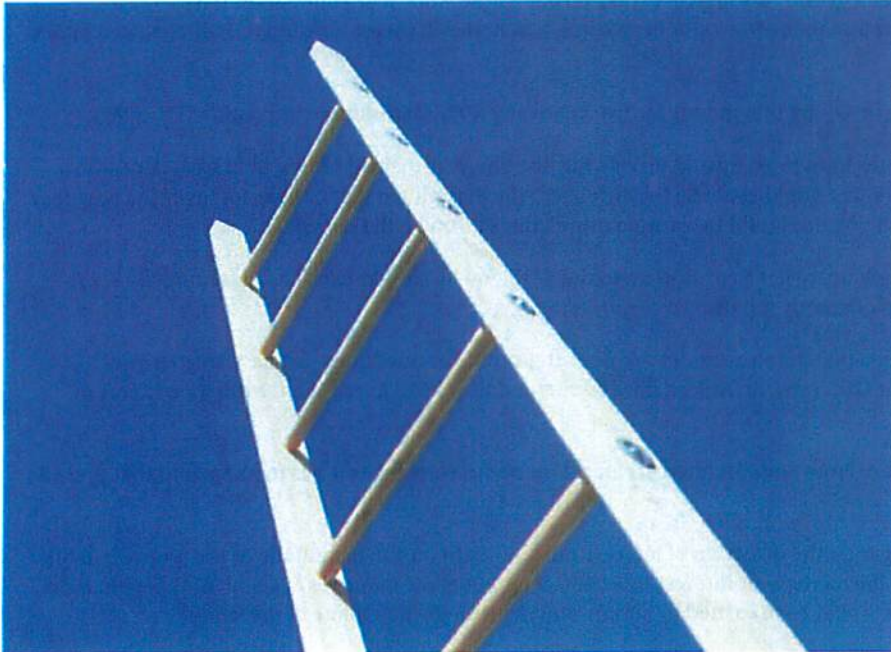
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Falling off fixed income ladder hurts



If people armed with the best information and most sophisticated systems have zero ability to see where rates are going, do you think it makes any sense for you to guess?

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It seems nobody likes today's interest rates. As I write this, rates paid by institutions on GICs are very near historic lows. Government bonds pay even less. If you ask the average person, they'll tell you interest rates just have to go up. That's what the "experts" are saying, too.

Of course, they've been saying the exact same thing for several years now and they've been dead wrong. Interest rates not only haven't gone up. They haven't even stayed level. Interest rates have actually declined. How can almost everyone be wrong? The simple answer is this: Nobody knows which way interest rates will go. Nor do they know when. Nobody. There are too many factors that can come into play, too many unknowns. Even those "experts" with the most experience, the most knowledge, the best information and the most powerful computer systems — even for them it's an outright guess, and they're wrong at least half the time.

If people armed with the best information and most sophisticated systems have zero ability to see where rates are going, do you think it makes any sense for you to guess, let alone invest your hard-earned money based on your guess? You're only fooling yourself if you answer "yes."

This, however isn't bad news. In fact, it's actually quite good since you're almost guaranteed to get the best returns by not trying to outthink, outsmart or guess — ever.

As I explained in my book *Investing on Autopilot*, a simple ladder approach, keeping an equal amount of money invested in one-through five-year maturities beats almost any other "strategy" 19 times out of 20. I'll show you statistically why this is absolutely and factually true. The ladder is how I always recommend people invest their fixed-income money because a) it's almost impossible to beat, b) it's simple and effective, c) it eliminates all guesswork, and d) you'll end up with more money in your pocket. Almost every single time, and I can prove it.

Recently, with such seemingly low interest rates, it's been more difficult to keep investors from "falling off their ladder." Let's revisit why the ladder makes sense, financially.

Interest rates offered on GICs in mid-2011 were:

1 year 1.80%

2 years 2.20%

3 years 2.60%

4 years 3.00%

5 years 3.50%

With a ladder already established, whenever money comes due, according to the discipline, this money is to be invested for five years. This keeps equal amounts always invested in each of one- through five-year terms. Those who “just know” rates have to rise sometimes decide they’ll invest for just one year and then after rates have surely risen, they’ll invest longer out. Bad idea, and here’s why.

Assume this investor had \$100,000 come due. Investing this money for five years at 3.50% earns him (compounded) \$18,769.

Now if he chooses to believe (guess) interest rates have to go up and invests for just one year instead of five, he’ll have \$101,800 a year from now. (He took the low 1.8% in hopes rates would rise.) So to catch up to the disciplined ladder investor, over the next four years he’ll have to earn \$16,969. (That’s the \$18,769 he should be earning minus the \$1,800 he did earn.)

If you do the math, you find that in order to catch up, to get \$101,800 up to the \$118,769 he should have had, guaranteed over the remaining four years, you have to earn a return of exactly 3.93%.

Looking back at our table of interest rates, we see that four-year rates are now at 3.00%. For our “rates just have to go higher” investor who chose to gamble with the one-year GIC, rates do indeed have to rise and they have to rise a lot, from 3.00% now to 3.93%, an increase of 31%!

And in the relatively remote chance that this very large jump in interest rates does occur, remember it has to happen in that first 12-month period.

The “fall off the ladder” investor has to be 1) right on the direction of interest rates, 2) right on the magnitude of the increase in the level of interest rates, 3) right on the timing of the increase in interest rates and if he somehow manages to get all of this right then ... he will actually simply break even with what he would have earned by simply staying with the discipline of the ladder.

If you’re at all wrong on any factor, you lose. You have to get everything right just to break even.

You be the judge as to whether the gamble was worth it. I fully realize some people will look at these facts and ignore them because they’re convinced rates have to go up and fixed opinions are hard to change no matter what the facts say.

Finally, what will this investor do a year from now if rates have not risen enough, not risen at all or actually drifted lower? He’ll have another \$100,000 coming due from his ladder and have a nearly impossible decision to make on over twice as much money. All because he took a gamble that statistically at least was a very poor one.

It’s only natural to think, “Rates are going up and so I’ll make more money if I wait.” On the surface, this seems to be a reasonable conclusion. But when you do the math and look at the actual facts, it’s exactly the opposite. You’re almost guaranteed to lose.

Think about this and the fact that you’re almost guaranteed to lose the next time you’re tempted to fall off your ladder.

-Robert S. Cable is an investment advisor and head of the Cable Group at ScotiaMcLeod in Toronto and author of Investing on Autopilot.

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