

Alan Unplugged



YIELD SIGNS

By now you are probably getting sick of hearing about the problems in the subprime mortgage market and the ensuing lock-up of the ABCP (asset-backed commercial paper) market. Well, I for one am happy to see that the emperor hath no clothes. Here is a “fictional” story to consider.

Client calls and asks for the best rate on short term paper. I quote Government T-bills at 4%. Client tells me that their “other” institution is paying 4.5%. I tell the client I could maybe recommend Bankers Acceptance commercial paper at 4.25%, but that is about as much risk as I am comfortable recommending. Client tells me thanks for my time and sends the money to the “other” institution. Fast-forward one year. Client requests their money but are informed that it turns out the money was backed by ABCP and once they figure out how to bail out of this little mess, client can have their money! Client was happy with the extra .5% (actually, after-tax, that was an extra .3%), but not happy now!

There is a moral to this story. There is one basic axiom in the world of investments – everything entails risk. A Government T-bill entails risk. You are lending money to the Government with the hope that they will repay you on maturity. In this country, that’s as good as it gets. We call this the risk-free rate. The risk in everything else can be measured against this rate. If a Government T-bill yields 4%, and bank commercial paper yields 4.25%, the bank is paying you the extra .25% to compensate for the “risk” that the bank won’t be able to pay you your money back on maturity. Let’s say Corporation X offers you 5%. You should know the extra yield over the banks commercial paper rate is to compensate you for the fact that Corporation X is riskier than the bank, which in turn is riskier than the Government. If you are willing to accept the extra risk which shows up in the form of yield, go for it, but know that it exists.

The moral to this story is that if you are investing short-term money for absolute safety, stick with Government T-bills. Why take a chance for an after-tax return that is marginally better for a risk which you can’t even measure, let alone know exists.

Alan

