In search of a safety net

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When the stock and bond markets look scary, cash seems like a safe bet. But is it?

Cold, hard cash would seem to be the ideal refuge for investors unwilling to put up with the uncertainty of today's stock and bond markets. But it may come as a surprise to many that cash has its own safety issues. Bank failures could imperil savings accounts in certain situations, and some money market accounts are being threatened by upheaval in the global credit markets.

Cash investors also face a third threat that may be less dramatic but is just as real: The likelihood that taxes and inflation will, over time, eat away not only the investment earnings of a cash savings account but a portion of the principal as well.

Careful investors can take steps, which we'll detail below, to minimize the possibility that bank failures or credit-market events will destroy their savings. Investors who just want to avoid catastrophic losses probably aren't too worried about inflation, at least in the short term.

"Right now, capital preservation is the name of the game," says Will Hepburn, president of Hepburn Capital Management in Prescott, Ariz., which manages $20 million for clients. But understanding how inflation affects your long-term savings is the first step toward taming its impact.

Banks practice safe saving

Sixteen U.S. banks have failed so far this year, compared with three in all of 2007, but thanks to the Federal Deposit Insurance Corp., depositors haven't lost a dime. The government agency, created during the Great Depression, has a $45 billion war chest to shield small savers from the impact of bank failures.

FDIC protection applies to any checking, savings or money market account or certificate of deposit held in an insured bank or savings association. Up to $100,000 in each account is insured, though in early October Congress temporarily raised the coverage limit to $250,000 through Dec. 31, 2009. This protection, however, does not cover non-deposit products -- for example stocks, mutual funds or annuities – even if they were sold by an FDIC-insured bank.

Savers with more than $250,000 in cash can split the accounts among multiple FDIC-insured banks or among multiple account holders to increase their protection. Spouses, for example, could have as much as $500,000 in protected savings in a joint account, or $250,000 each in separate individual accounts. The FDIC provides an online tool, the Electronic Deposit Insurance Estimator, http://www.fdic.gov/EDIE/, that can help you determine to what extent your existing accounts are covered.

In terms of safety, an FDIC-insured account is hard to beat, but the safety comes with a price. The average bank savings and money market account was recently yielding just 2.45% on an annual basis, according to Bankrate.com. Investors willing to shop around and invest in an out-of-town (but FDIC-insured) bank could find rates up to 3.75% with no minimum deposit. But be sure to ask about fees before investing.

Average FDIC-insured CD rates range from 3.06% for six months to 3.59% for 12 months, according to Bankrate.com. Savers looking for a little extra yield without having to lock up all of their money for six months or a year could "ladder" 3-, 6-, 9- and 12-month CDs, and roll over the proceeds of each CD into a new one as it expires.

Non-bank money market funds

Many mutual fund companies, such as Fidelity and Vanguard, offer money market mutual funds that typically offer a higher return than bank money market accounts. These money market mutual funds are not FDIC-insured, but historically they have been very safe.

These funds typically invest their assets in low-risk, short-term commercial loans, a market that, like many others, has seen turmoil lately. In September, however, one of the nation's oldest money market mutual funds, the Reserve Primary fund (Get Prospectus), hit by losses on its investments, "broke the buck" and fell below $1 a share. Some six weeks later, with investors unable to access their cash, the fund announced late Thursday that it would start mailing checks to shareholders on Friday -- for half their original investment. The fund also said in a statement on its Web site that it was "committed to making future distributions when more cash becomes available."

To help stem investor fears, the Treasury Department recently announced a temporary program that would guarantee for three months the safety of all money held in participating firms' money market mutual funds as of Sept. 19.

Fifteen of the largest mutual fund companies have signed on to the program, which could be extended when the three-month period expires. Any money deposited after Sept. 19 is not covered, though. Still, experts say investors will generally be safe if they stick to funds offered by large fund companies that are willing to cover any potential investment losses in these funds' portfolios.

Investors in money market mutual funds can further protect themselves by opting for those that invest only in ultra-safe U.S. Treasury securities. But again, there is a cost for this extra margin of safety. The Fidelity Government Money Market fund (SPAXX | Get Prospectus), for example, is currently paying a seven-day yield of just 1.86% compared with a 3.08% seven-day yield for the Fidelity Money Market fund (SPRXX | Get Prospectus), which invests in corporate, as well as government, loans. The same holds true at Vanguard. The Vanguard Treasury Money Market fund (VMPXX | Get Prospectus) is yielding 1.35% compared with the Vanguard Prime Money Market fund (VMMXX | Get Prospectus) yield of 2.78%.

Don't forget about taxes and inflation

While bank savings accounts, CDs and money markets can help you sleep better at night, "they are terrible long-term assets because they are certain to depreciate in value over time," says Bill Walsh, president of Hennion & Walsh Asset Management in Parsippany, N.J.

The twin forces of taxes (interest income is taxed at your marginal rate, which can be as high as 35% on federal returns) and inflation will combine to make it virtually certain that the purchasing power of savings will decline over time.

But for many consumers, the prospect of a slight erosion of value due to inflation seems like a reasonable tradeoff given the drastic losses suffered recently by virtually every stock market around the world. Ultimately, the only way to beat inflation is to accept some degree of risk in exchange for an inflation-beating return.

"If your goal is to be a long-term investor, being out of the market is riskier in the long term," says Walsh.