How to Ladder Your Investments for Diversification, More Income, and Less Risk

Laddering is an investment strategy that many investors know about but very few practice. Laddering diversifies a portfolio by purchasing securities with different maturity dates. It also can increase a portfolio's overall income, reduce the risk of changing interest rates, and provide money for future investment opportunities. Review carefully this advisory and discuss it with your advisers.

Thomas J. Martin, *Publisher*
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Many uses: We use bank certificates of deposit (CDs) in our example, but the concept of laddering investment purchases applies to many investment instruments, including corporate bonds, preferred stocks, tax-exempts, zero coupon bonds, and Treasury obligations, all of which have varying yields and maturity dates. (Laddering doesn't apply to money-market funds since they have no maturity dates.)

The problem: The current interest rates paid on short-term certificates of deposit and other near-cash securities are very low, in the 1% to 2% range. *The question:* How can you increase your return, particularly when the direction of interest rates is uncertain? To answer the question, let's first review some axioms: The shorter the maturity of a fixed-income investment, i.e., less risk, the lower the interest rate you receive on that investment. Also, if you own long-term securities, e.g., a 20-year corporate bond, and interest rates increase, the price of that bond will drop, and it will drop substantially if there's a big, upward change in the interest rate. These observations apply to most fixed-income securities.

The strategy: **Ladder** your investment maturities. This technique involves taking the total money you want to commit to fixed-income securities and dividing it into smaller, equal portions and then investing each portion for varying time periods. For example, assume you have $100,000 to invest (five portions of $20,000). You invest $20,000 each in a 180-day, 1-year, 2-year and 3-year CD. You then take the last $20,000 and put it into a money-market account or short-term bond fund so you have *immediate* cash to invest.

The result: You have **diversified** your fixed-income investments, **reduced** the risk of changing interest rates, **increased** your overall interest income, and you still have the opportunity to increase your return further by **re-investing** the earlier maturities as they come due.

Why this approach works: Each CD earns a different interest rate, with the longer maturities earning the highest rates. By laddering your CD investments, you will **earn more** on average than if you bought a single, 30-day CD. In addition, with laddering, you will *always* have a CD maturing every year or two, giving you cash to reinvest at higher interest rates if they increase. As the longer maturities come due, you might want to adjust some of them to shorter maturities so you always have one or two CDs coming due within one year. That gives you **more cash** to invest if interest rates move upward.

Overall strategy: Buy short-term securities when interest rates are low and long-term securities when they're high, but always consider laddering your purchases, particularly if the direction of interest rates is uncertain.

Note: Sometimes, short-term interest rates are higher than long-term rates. When that happens, it's called an *inverted yield curve*. □

Thomas J. Martin, Publisher and President
tommartin@yourbusinesslibrary.com — www.yourbusinesslibrary.com