A Strategic Approach to Short-Term Fixed Income Investing

CHIEF INVESTMENT OFFICE

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EXECUTIVE SUMMARY

With low interest rates, it can be difficult to both protect your cash and secure attractive yields on it. In this paper, we highlight important practices that might help you preserve capital, stay liquid and pursue solid risk-adjusted yields.

- **An asset's investment risk can be relative to the role it plays in your portfolio.**
  - For example, a cash investment is essentially riskless over the short-term as it maintains principal value, but over longer time periods, it is unlikely to keep pace with inflation
  - A long-term cash investment, therefore, is "risky" for a longer-term goal, like retirement
  - An investment's risk, therefore, can depend on what you are using it for
- **When constructing a fixed income portfolio, begin the process by matching the average maturity of your bonds to your "investment horizon"—when you expect to use the funds.**
  - By holding bonds to maturity, you can be relatively sanguine about price changes related to market conditions or interest rates, and be less concerned about day-to-day price volatility
- **Avoid mismatches between the time frame of your investments and their intended goal.**
  - If bonds mature after you expect to use the assets, you will have to sell bonds prior to maturity. This makes you dependent on market conditions and bond prices at that time, increasing your market risk
  - If bonds mature before you need the funds, you forego higher yields on longer-term bonds, and have to reinvest proceeds at maturity, increasing reinvestment risk
  - Mismatching your assets and your goals increases risk
- **Discuss your short-term investment options with your financial advisor. Diversify both your selection of fixed-income assets and the vehicles you use to access them, including:**
  - Bank deposits and certificates of deposits
  - Open-end mutual funds, including money market funds and short-term bond funds
  - Separately managed accounts (SMAs)
- **Consider the three potential benefits of short-term fixed income investments—capital preservation, liquidity, and yield—and prioritize them according to their importance to you.**
  - If capital preservation and liquidity are key, consider government money market funds
  - If capital preservation and yield are key, consider certificates of deposit
  - If yield and liquidity are key, consider corporate bonds via diversified investment vehicles
- **Be particularly cautious about taking undue risk with your fixed income investments.**
  - Rates are lower than usual—but risk is not. If you pursue higher yields, realize that these come with additional risk. Take only those risks you understand and are comfortable with
  - Given today's low rates, it is critical to keep fees low, as they can erode a more significant percentage of a portfolio's yield than they did in the past

Overview

In the current environment of low rates and high volatility, managing short-term liquidity is a key concern for many clients. We aim to help you meet those challenges with this paper, which will:

- Explain why clearly defining your investing time frame is important; how a bond portfolio relates to that time frame; and how mismatching the two can make it more difficult to meet your financial goals;
- Describe the short-term fixed income investing landscape, including current monetary policy and changes to federal regulations impacting a key short-term investment vehicle and,
- Review the spectrum of short-term fixed income investment vehicles you may wish to consider.

I. A Framework for Short-Term Investing

Risk Redefined: Assets are Risky Relative to Their Intended Purpose

Every investor is familiar with the standard disclaimer, "Investing involves risk." What may not be evident, however, is that an investment's risk can be relative—dependent upon an investor's particular circumstances and goals.

Consider an investor with a specific, short-term need—say, $5,000 in three months for a down payment. For this person, investing in equities would be extremely risky because stock prices are volatile, and there is a good chance that $5,000 invested in stocks today may not be worth $5,000 when the payment is due. Cash or a suitable short-term investment would be more appropriate and significantly less risky for this investor.

For an investor saving for retirement in 40 years, though, investing solely in cash is extremely risky. Over longer time periods, cash has significantly underperformed stocks and bonds. Currently, cash actually earns less than the inflation rate. Investing 100% of one's retirement portfolio in cash would likely leave the investor with less purchasing power in retirement than she has today or, worse yet, increase the risk that she will outlive her retirement funds.

Under the Merrill Lynch wealth-management approach, risk is defined as the likelihood of an investor not meeting an investing goal. An investment—cash, in this example—can present varying degrees of risk, depending on an investor's time frame, which generally is determined by the purpose of the funds. As a store of nominal, stable principal value, cash is essentially riskless; as a tool to preserve or grow wealth over the long term, it is exceedingly risky. This illustrates that risk is relative; the asset (cash) is not risky in an absolute sense, only relative to its intended purpose for you.

Pairing Bonds with Your Investment Time Frame: Reducing Asset-Liability Mismatch and Market Risk

Your asset allocation, therefore, should be informed by factors specific to you—your time horizon, your investment objective, and your risk tolerance. Time horizon, in particular, is critical to constructing a bond portfolio. A reasonable starting point for an investor is to have the average maturity of a bond portfolio approximate the time frame when he expects to convert an investment into cash.

This is simple and intuitive. If you have a college tuition payment due in 2019, three-year bonds match the maturity of the portfolio (your assets, or what you own) to the investing goal (your liability, or what you'll owe). When there is a time difference between the two—"an asset-liability mismatch," in financial jargon—incremental risk is introduced to the strategy.

For example, if an asset's maturity is longer than its corresponding liability—if an investor bought a 30-year bond to fund a tuition payment due in five years, for example—that bond would need to be sold to raise cash when the payment is due. Depending on prevailing market conditions, the sale proceeds may be less than the initial investment. This introduces additional market risk, the risk that a portfolio's value changes based on market conditions. Goal success is now no longer reliant on the bond being repaid at maturity; it depends on the price the investor can achieve from the market when he needs to sell that bond to fund the tuition payment. Why would anyone rely on the fickleness of other investors—the market—to fund personal investing goals?

This example is an obvious mismatch. However, a more pernicious risk and an extremely common one since the financial crisis is being too conservative and under-investing relative to one's time frame by using short-term investments to fund long-term goals. This is a less overt but no less damaging risk because of the high cost of not earning the additional yield provided by longer-maturity-bonds. In today's "low-for-longer" interest rate environment, this has been a hidden but costly example of duration mismatch for many clients.

Assume, for instance, that an investor had a five-year time horizon in 2011 and a choice between buying a Treasury bond maturing in 2016 or buying a 3-month Treasury bill and "rolling" it—that is, continuing to buy 3-month Treasury bills at every maturity date. If the investor selected a five-year bond maturing in 2016, he would have earned $8,822 more on his initial investment of $100,000 than he would have generated by rolling over 3-month T-bills—without taking any additional credit risk (please see Exhibit 1).

Exhibit 1: Return Differential of $100,000 Investment in 3-Month and 5-Year Treasury

	5-Year Treasury	Roll 3-month Bills for Five Years	Difference
Initial Investment	$100,000	$100,000	
Value in year five	$109,767	$100,945	
Total return ($)	$9,767	$945	$8,822
Total return (%)	9.77%	0.95%	8.82%
Annualized return (%)	1.88%	0.19%	1.70%

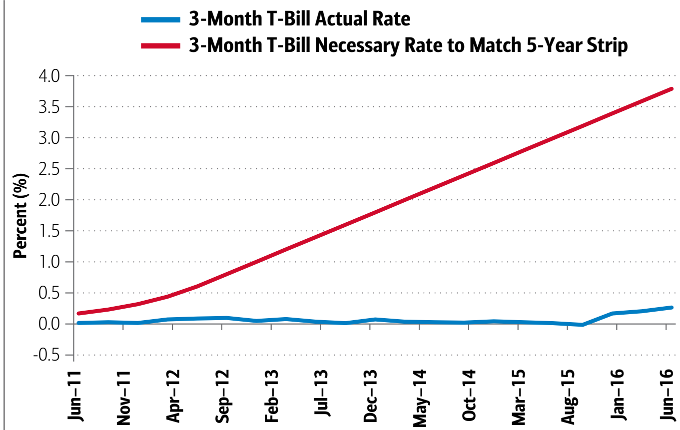
For illustrative purposes only.
Source: Bloomberg and GWIM Chief Investment Office. Data as of September 30, 2016
Past performance is no guarantee of future results.

Since longer-term rates are generally higher than short-term rates, short rates would have had to rise substantially to make the strategy of rolling the 3-month bill equivalent to buying a five-year security. This is the case whenever the *yield curve*—the difference between long and short rates—is positive, meaning that long rates are higher than those for shorter-term fixed income securities. On average, rates would have had to increase 1.70% per year to make the two options equal. Of course they did not; 3-month bills started the period at 0.01%, and averaged only 0.06% over the time period, significantly less than what would be needed to match the return on the five-year bond (please see Exhibit 2).

An investor might contend that this is obvious only in hindsight and that rates could easily have increased and that rolling T-bills could have been the superior strategy. This is true, which raises two key points.

First, under investing relative to one's time frame can be a sensible way to express a particular market forecast or "view." If the investor in the example believed rates would rise over his five-year investment horizon, rolling over T-bills instead of buying a 5-year Treasury would be a way of aligning his investment strategy with his market view. However, expressing a market view in this way should be a conscious decision. A duration mismatch should always be intentional (done with your "eyes wide open") after quantifying the risk should your forecast turn out to be wrong.

Exhibit 2: 3-Month Treasury Bill Rate and Rate Required to Match 5-Year Treasury Return



Source: Bloomberg and GWIM Chief Investment Office. Data as of September 30, 2016.

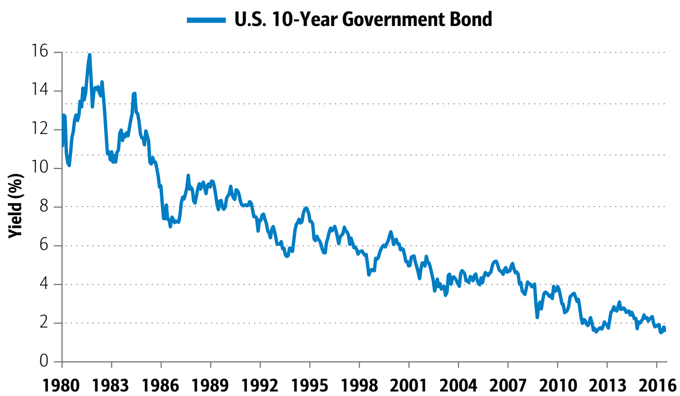
Second, while matching investments and goals does not eliminate market risk, it can significantly reduce its impact on you personally if you are able to hold the assets for your entire investment horizon. For example, if you need $25,000 in five years, you could purchase a zero-coupon Treasury for $23,750 today. (Zero-coupon bonds are similar to savings bonds in that they do not pay coupons; are bought at a discount to face value; and pay the full face value upon maturity.) If you hold that bond to maturity, you can ignore market movements because you are relying only on the payment at maturity to meet your goal. To use a financial term, matching bond investments with goals has *"immunized"* you against interest-rate and market risk because neither can impede your ability to fund your goals if you hold the investment for its entire term. (It does not, however, immunize you against credit risk, the risk that the issuer of a bond does not make full payment when due. Credit risk generally is not considered a risk for U.S. Treasurys, however.)

While we have used bonds of varying maturities for purposes of illustration, the same concepts are relevant to short-term liquidity investments as well. Holding cash or cash surrogates when you may not need the money for six months to three years can have a persistent negative effect on returns over time. This is especially true now when short-term government bond yields are close to zero. Extending out the curve—that is, buying longer-dated bonds—or taking a modest amount of additional credit risk is a potential avenue to achieving longer-term goals. A quick review of the current state of the short-term markets illustrates why.

II. Overview of Current Market Conditions

In the U.S. market, the biggest driver of short-term rates is the Federal Open Market Committee (FOMC), the policy-making body of the U.S. Federal Reserve (the Fed). Since the financial crisis, the Fed has been extremely supportive of the economy and wary of derailing any recovery. The FOMC left its benchmark rate at effectively 0% for a full seven years, from December 2008 until December 2015. With its first rate hike last year, the Fed began a gradual process of raising rates and was expected to hike twice in 2016. However, to date, the Fed has not raised rates this year, and rates have stayed persistently low (please see Exhibit 3).

Exhibit 3: 10-Year U.S. Treasury Yield



Source: Bloomberg and GWIM Chief Investment Office. Data as of September 30, 2016.

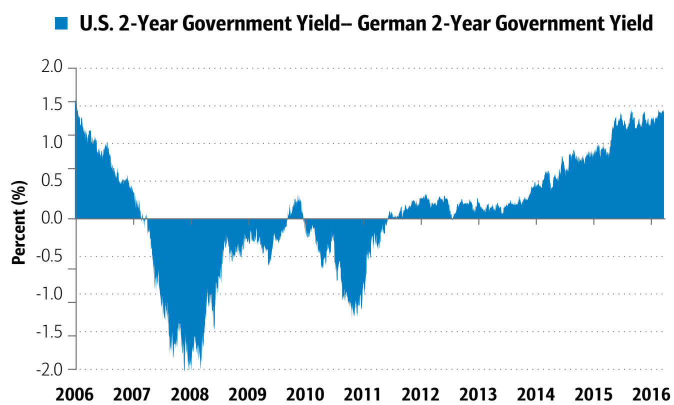
While U.S. rates are extremely low, they are high relative to those of other developed countries. The yield on the U.S. two-year Treasury is about 1.4%[1] higher than that on the corresponding bond issued by Germany, the most creditworthy sovereign in Europe (please see Exhibit 4). That differential is the highest since 2006. Globally, of the $46.8 billion in bonds in the Barclays Global Aggregate Index, 48% trade with less than a 1% yield and 23% have negative yields, meaning investors pay to invest in bonds and borrowers are paid to borrow. The relatively high yields in the U.S. are generating strong demand for U.S. debt by overseas investors. This could push up the price of short-term bonds, driving U.S. yields even lower (please see Exhibit 5).

Exhibit 4: 2-Year Sovereign Bond Yields

Country	2-Year Government Bond Yield
U.S.	0.77%
UK	0.10%
France	-0.29%
Germany	-0.64%
Sweden	-0.65%
Netherlands	-0.67%
Switzerland	-0.68%
Japan	-0.94%

Source: Bloomberg and GWIM Chief Investment Office.
Data as of September 30, 2016.

Exhibit 5: 2-Year U.S. Treasury Yield Versus 2-Year German Sovereign Yield



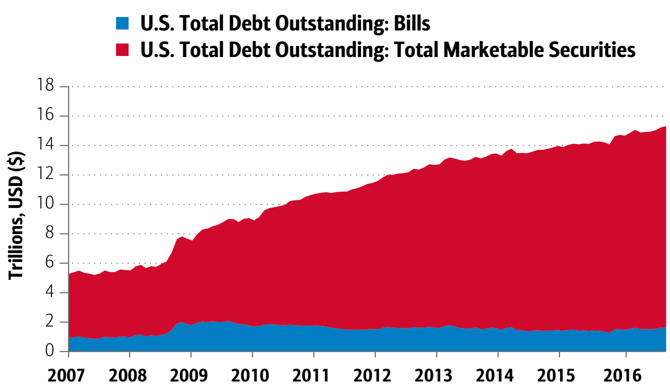
Source: Bloomberg and GWIM Chief Investment Office.
Data as of September 30, 2016.
Past performance is no guarantee of future results.

Two structural changes in the fixed income markets are creating additional challenges and opportunities for investors who are looking to increase the yield on their liquidity investments.

[1] As of September 8, 2016.

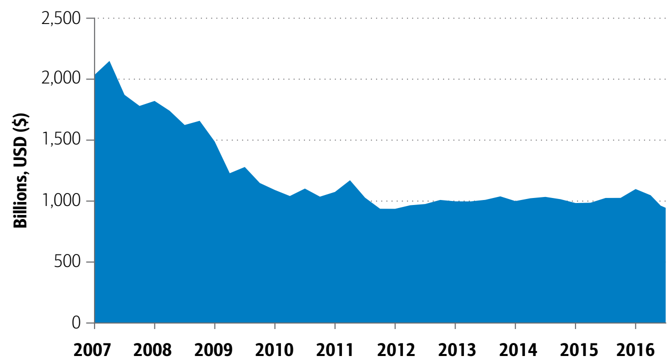
First, the supply of short-term securities—both Treasurys and corporates—has shrunk since the financial crisis. As a proportion of the Treasury market as a whole, for example, Treasury bills—securities with maturities of one year or less at issuance—make up only 12%[2] of the Treasury market now, down from a post-crisis peak of about 34% (please see Exhibit 6). Corporate commercial paper (CP)—short-dated corporate bonds that are essentially the private-sector equivalent of Treasury bills—has likewise declined in volume. From a peak of more than $2.2 trillion in August of 2007, CP outstanding is down 55%, to $0.9 trillion[3]. This is primarily due to U.S. financial firms reducing their reliance on short-term funding, as well as a decrease in CP backed by mortgage-related assets after the housing crisis (please see Exhibit 7). This decrease in supply and similar-to-greater demand has been an additional drag on yields for short-term assets.

Exhibit 6: Treasury Bill Share of Total U.S. Debt



Source: Bloomberg and GWIM Chief Investment Office. Data as of September 30, 2016.

Exhibit 7: Contraction of U.S. Commercial Paper Market



Source: Bloomberg and GWIM Chief Investment Office. Data as of September 30, 2016.

Coincident with the drop in supply of short-term Treasurys in particular is an increase in demand for these assets resulting from the second structural change in the bond markets—new regulations governing U.S. money market funds. Among these changes, which took effect in October 2016, is a new rule requiring institutional money market funds to adopt a floating net asset value (NAV). As with equity and bond mutual funds, $1 invested in a money market fund with a floating NAV may be worth more or less than $1 on any given day due to changing market conditions. This differs from government and retail money market funds with "stable" NAVs in which a $1 invested is redeemable at $1. Another rule change allows a money market fund's board of directors to impose a fee of up to 2% on redemptions or limit redemptions altogether for up to ten days if the fund's liquidity levels—a function of how easily the fund's assets can be sold—drop below a level mandated by the Securities and Exchange Commission.

[2] As of August 31, 2016.
[3] Ibid.

New Money Market Fund Rules and Their Impact on Your Cash Investments

On October 14, 2016, new rules governing the management of U.S. money market funds took effect. The rules, intended to make money market funds less vulnerable to the financial pressures created by heavy redemption activity, have significant implications for cash investors because they change the risk profiles of the effected funds. Some funds no longer are priced at $1 per share—a core feature of money market funds since their inception in the 1970s—and investors could face redemption restrictions under certain circumstances.

To understand the impact of the new rules, one must first understand the types of money market funds available to investors. They are:

Government funds, which are considered to be the most stable type of money market fund because they invest 99.5% of their assets in government securities.

Retail funds, which effectively are available only to individual investors.

Institutional funds, which are available to any investor, including corporations, businesses and individuals.

If a fund is not a government fund and does not meet the "retail fund" definition, it is an institutional fund. Both retail and institutional funds include prime funds and tax-exempt (municipal bond) funds. Prime funds invest in government securities and potentially higher-yielding assets, such as corporate debt. Tax-exempt funds invest in securities issued by city, county and state governments, among other issuers. Income from investments in tax-exempt funds is exempt from federal taxes and, in some cases, from state taxes.

Money Market Reform: Applicability by Fund Type

Money Market Fund Type	Net Asset Value (NAV)	Liquidity Fees	Redemption Gates
Government	$1 stable	No	No
Retail—Prime/Municipal	$1 stable	Yes	Yes
Institutional—Prime/Municipal	Floating	Yes	Yes

Source: Securities and Exchange Commission.

New Pricing and Potential Redemption Restrictions

The two most significant rule changes relate to the pricing of shares of some money market funds and checks on redemptions if funds' boards of director determine they are in the best interest of the funds' shareholders.

Floating NAV—Historically, money market funds priced their shares at a stable $1 net asset value (NAV); the NAV did not reflect the actual market value of funds' holdings. Under the new rules, institutional funds can no longer utilize this practice. They will instead price and redeem shares at a "floating NAV"—the current market-based value of their securities, rounded to the fourth decimal place (e.g., $1.0000). Government funds will continue to transact at a $1 NAV, as will retail funds.

"Fees and Gates"—The new rules permit the board of directors of a money market fund to impose redemption fees of up to 2% if the fund's *weekly liquid assets*—specific holdings that can be readily converted to cash – fall below 30% of the total portfolio. If weekly liquid assets fall below 10%, the board must impose at least a 1% fee, unless it determines that the fee is not in the fund's best interests. This applies to all non-government retail and institutional funds.

Finally, in addition to liquidity fees, the SEC now also gives boards of money market mutual funds the discretion to temporarily suspend redemptions. Such a suspension is known as a "redemption gate." Gates may be imposed for up to ten business days in a 90-day period if the fund's weekly liquid assets fall below 30% and the fund's board determines that imposing a gate is in the fund's best interests.

The fees-and-gates rule applies to all non-government retail and institutional funds. Government funds are permitted, but not required, to impose fees and gates. In practice, boards of government funds have been and are very unlikely to implement redemption fees and suspensions, and if they did, shareholders would have 60 days' notice.

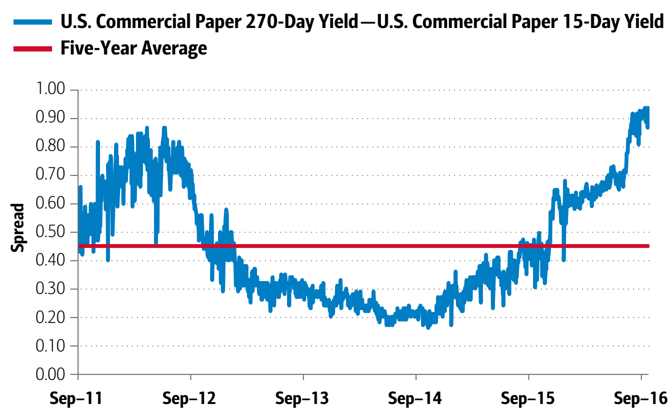
Given the potential impact of the new money market fund regulations, it is important that investors' choice of money market funds align with their risk tolerance and investment goals. Merrill Lynch advisors are well versed in the new regulations and can guide investors as they weigh the different types of money market funds available to them.

Collectively, these rule changes have increased money market fund demand for both Treasury bills relative to CP, and for shorter-term CP relative to longer-term CP. This is because many fund managers shortened their funds' duration to ensure they had adequate liquidity if many investors exited money market funds before the new money market fund rules took effect on October 14. The combination of reduced supply of Treasury bills and greater demand relative to commercial paper has made CP more attractive, as it has increased its relative yield.

Given the low yields on short-term debt securities, it is not surprising that investors are hunting for opportunities to enhance yield without assuming undue risk. One tried-and-true strategy is to invest in assets with longer maturities, i.e., "extending out the curve," but the effectiveness of the strategy depends on the shape of that curve. If the yield curve is *steep*, meaning that long-term rates are significantly higher than shorter rates, there is additional yield to be earned by investing in longer-dated securities. However, if a 2-year security yields the same as a 1-year security, an example of a flat yield curve—there is less incentive to invest in the longer-dated security because its higher interest-rate, market and inflation risk bring no additional yield.

Currently the Treasury yield curve is relatively flat—1-year bills yield only 0.33% more than 1-month bills—so there is little incentive to extend out the curve. Conversely, the corporate CP curve is significantly steeper. The yield difference between 15-day and nine-month CP is currently 0.92%, significantly higher than its five-year average and not too far from its five-year high, highlighting the additional, incremental yield that can be earned for a modest amount of duration risk (please see Exhibit 8). This is due in large part to the money market reform discussed above and may present an opportunity for individual investors without an immediate need for cash to extend further out the corporate curve and benefit from the additional yield the steeper curve offers.

Exhibit 8: Commercial Paper Presenting Opportunities to Boost Yield



Source: Bloomberg and GWIM Chief Investment Office.
Data as of September 30, 2016.
Past performance is no guarantee of future results.

Having discussed some key factors affecting the short-term debt markets currently, we'll now review the various short-term investment vehicles that you may wish to consider.

III. Short-Term Investment Vehicles

Investors' risk tolerance, time horizon and return goals should drive not only an investor's choice of short-term debt securities, but also the vehicles they select to implement a strategy. These investment vehicles have distinct risk, liquidity and return profiles. The most widely used investment vehicles include:

Bank Deposit Accounts—Among the most secure and liquid of short-term investments, bank deposit accounts include checking accounts, savings accounts, and money market accounts. Deposit accounts are particularly appropriate for investors whose primary investment goal is principal protection because the accounts' deposits are insured up to $250,000 per account by the Federal Deposit Insurance Corporation (FDIC). Oftentimes investors can open several different types of accounts to increase FDIC insurance coverage. They are highly liquid as depositors can withdraw funds from the accounts at any time. Yields on bank deposits, however, are often lower than those offered by other short-term investment vehicles.

Certificates of Deposits—Offered by banks and sold by the issuing bank or via broker-dealers, certificates of deposit (CDs) are savings certificates with a fixed interest rate and maturity date. They typically offer higher rates than bank deposits because investors generally cannot withdraw funds prior to maturity without an early-withdrawal penalty, or—in the case of brokered CDs—may have to sell them in the secondary market, resulting in a sale price less than what was invested. The interest rate offered by CDs varies by financial institution, and generally the interest rate increases as the maturity of the investment increases. Like bank deposits, CDs are insured up to $250,000 per account by the FDIC, making them a good option for investors who place a high premium on principal protection and who do not expect to need their cash until the CDs mature.

CDARS—One downside of CDs for investors with significant sums of cash to invest is that FDIC insurance is limited to $250,000 per account. To enjoy FDIC protection for larger amounts, an investor would need to purchase multiple CDs, with potentially multiple account-opening processes and statements. CDARS – the Certificate of Deposit Account Registry Service—allows investors with cash in excess of $250,000 to distribute the assets in multiple CDs through a single investment at one of the 3,000 financial institutions in the CDARS network. Investors enjoy all of the benefits CDs offer but with less paperwork and a consolidated statement.

Open-End Mutual Funds—Open-end mutual funds, so named because they can issue an unlimited number of shares, pool the assets of multiple investors. The funds' portfolios are structured and monitored by professional investment managers, who invest to achieve specific goals, such as capital appreciation or income. Actively managed funds seek to outperform their respective benchmarks—typically an index, such as the Bloomberg Barclays US Aggregate Bond Index. The funds' share prices reflect the market value of their portfolios' holdings at the end of the trading day.

As pooled investment vehicles, open-end funds offer a low-cost, efficient means of gaining exposure to various asset classes. They also offer good liquidity, as investors can generally exit the fund at the end of any trading day (please see the *New Money Market Fund Rules and Their Impact on Your Cash Investments* sidebar on page 6 for information on potential redemption restrictions with money market mutual funds). However, because your investment is commingled with many others, the value of your investment could be negatively affected by heavy redemption activity, i.e., "runs" on the fund during volatile markets. Additionally, actively managed funds that seek to outperform their benchmarks could underperform them due to faulty investment strategies. Finally the management fees of actively managed mutual funds typically exceed those of index funds and exchange-traded funds (ETFs), which seek only to match the returns of their benchmarks.

Many cash investors rely on two types of open-end mutual funds:

- **Money Market Mutual Funds—**A money market mutual fund invests in debt securities with maturities of less than one year. The short maturities and strong credit quality of fund holdings mitigates the funds' investment risk, making them a popular vehicle for capital preservation. Historically, money market funds have offered higher yields than bank deposits, but lower yields than bond mutual funds, whose holdings generally include longer-dated securities.

  Money fund yields depend on the interest rate environment and type of fund. Taxable funds, which are subject to federal and state income taxes, include government and prime funds. Government funds invest only in short-term debt issued by the federal government, government agencies, or securities backed by similar collateral. Prime money market funds invest in both government and short-term corporate notes, and may include securities backed by mortgage and consumer loans. Prime funds historically have yielded more than government funds because of the higher credit risk.

  Tax-exempt money market funds invest in high-quality, highly liquid securities issued by city, county and state governments, as well as by publicly owned utilities, such as municipal water companies, and special-purpose entities, i.e., airports. Income from tax-exempt money market fund investments is exempt from federal and, in some cases, state income taxes. Some funds invest only in debt issued by entities in a particular state, others invest across the U.S. Though the yield on tax-exempt money market funds may be lower than that of taxable funds, the after-tax return may be higher depending on an investor's tax rate. Investors must factor in their tax rate when weighing municipal bond money market funds against taxable funds. Income from investing in tax-free municipal money market funds may be subject to state and local taxation and the alternative minimum tax.

- **Short-Duration Fixed Income Mutual Funds—**Short-term bond funds are open-end mutual funds that invest in diverse debt instruments with maturities of less than three years, generally Treasurys, short-term corporate and bank notes, securitized products, and sometimes non-U.S. bonds. Depending on the type of fund, they may hold taxable or tax-exempt securities. Short-term bond funds carry more risk than money market funds. They have longer maturities than money funds—making them more vulnerable to changes in interest rates—and may be of lower credit quality, depending on the funds. Like institutional money market funds, short-term bond funds' price per share will fluctuate with the changes in the value of the funds' holdings.

Fixed Income Exchange-Traded Funds—Similar to their mutual fund counterparts, fixed income exchange-traded funds (ETFs) invest in a wide variety of diversified debt instruments. Unlike mutual funds, bond ETFs are generally passively managed with the goal of tracking – rather than outperforming—a certain index. They offer greater liquidity than open-ended mutual funds; as they trade throughout the day on a stock exchange, investors can make purchases or redemptions in real time, whereas mutual fund purchases and redemptions are transacted after the markets close. More important, relative to actively managed bond mutual funds, ETFs typically have lower fees and generate less capital gains tax liability. One drawback of ETFs is that during market stress periods, ETFs' net asset values can deviate from their NAVs at the open of trading due to illiquidity in the bond markets. Difficulty selling the funds' underlying bonds can force ETF managers to liquidate assets at less-than-optimal prices, which can pressure the funds' NAVs. This problem can be exacerbated by large redemptions by institutional investors, which are heavily invested in ETFs.

Separately Managed Accounts—A separately managed account (SMA) is a professionally managed, diversified portfolio of short-term debt instruments where the securities are directly owned by the investor. It has the benefit of professional management and diversification similar to a mutual fund or ETF, but it is not a pooled vehicle. For investors concerned about ETFs trading at a discount or about "run risk" in a mutual fund—the risk that other shareholders in a fund may make large withdrawals, forcing portfolio managers to sell assets at inopportune times—these are key advantages. Furthermore, SMAs often can be customized to the financial goals, return requirements and risk tolerance of each investor. Finally, because SMA investors own individual securities rather than shares of a mutual fund or other pooled vehicle, they can harvest losses to offset capital gains, potentially increasing the tax efficiency and after-tax return profile of their investments. In many ways, SMAs offer a combination of the professional management of a mutual fund or ETF, without the drawbacks of a pooled vehicle. However, one disadvantage is that generally they have a significantly higher minimum investment than mutual funds or ETFs. Also, because they are actively managed, they may have higher management fees than ETFs.

IV. Conclusion

Investors should invest with a purpose by articulating a specific investing goal, whether meeting a need for cash at a future date or achieving a more generalized objective, such as generating income or preserving capital. For your bond portfolio, you need to match your investments to your goals by aligning the duration of the portfolio with the time you will need the funds. If you deviate from this rule, do so *intentionally* and understand the risk that mismatch presents.

As an investor, many things are outside your control; ignore them and focus on what you can control. The "low-for-longer" interest rate environment and its negative impact on yields is a reality you cannot change, but you can maximize the available opportunities by considering investment-grade corporate bonds, for example, and by extending out the curve where appropriate.

In terms of security selection, we suggest discussing your options with your financial advisor, who understands both your unique circumstances and the solutions available. We recommend that you first define your time frame and risk tolerance and then rank the three potential benefits provided by short-term debt instruments—capital preservation, liquidity, and yield—in the order of their importance to you.

If yield and capital preservation are most important to you, consider bank deposits and certificates of deposit. CDs generally yield more but are less liquid than bank deposits, as most brokered CDs cannot be redeemed early and must be sold into the market if funds are required before maturity. The credit risk of both types of deposits is small, as bank insolvencies are relatively rare and deposit insurance is provided by the FDIC (subject to certain limits). However, creating a large portfolio of bank deposits can be difficult because of FDIC insurance limits.

If yield and liquidity are your priorities, consider targeting short-term corporate bonds via money market funds, fixed income mutual funds, exchange-traded funds (ETFs) and separately managed accounts (SMAs). While corporate bonds carry more credit risk than the strategies mentioned above, that risk is very low for high-quality corporates. One reason to target corporates through money market funds and the other investment vehicles mentioned above is that these solutions are easily scalable because they can accommodate large investment amounts.

However, while more liquid than brokered CDs, corporates are less liquid than Treasury securities. When considering money market mutual funds, keep in mind that the fees-and-gates rule that took effect in October could make it more costly and/or more difficult to redeem shares during volatile markets. When considering money market funds or short-term bond funds, be very conscious of fees. Given today's low rates, high fees can eat up a significant portion of any income the fund earns.

Finally, if capital preservation and liquidity are paramount, consider U.S. government money market funds, mutual funds, ETFs and SMAs. Be aware, though, that seeking added safety and liquidity could come at a price—the additional incremental return you might achieve by investing in short-term investments with manageable credit risk.

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