Fresh Invest S4E4 Transcript
Episode Title: Income investing is back
Episode Description: 2023 has been a year of soaring prices and rising inflation rates. In tough markets like today's, fixed-income maturities can help provide stability and growth. We review traditional income strategies—such as bonds, deferred fixed annuities, and CDs—as well as new innovations in the space, like fractional CDs.

Alex Lieberman:

Hey, everyone. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. Welcome to season four of Fresh Invest, the podcast where we explore all things investing sponsored by Fidelity Investments and powered by Morning Brew. In this season, we are exploring strategies and tips to help you invest wisely wherever you are in life. With help from our friends at Fidelity, we'll dive into the investing lifecycle in the context of today's market landscape, emerging trends, and long-term wealth building strategies. Let's get into it.

Last week we took a look at generational investing habits, covering emerging trends, all the way from boomers to zoomers. Today we are going to do some talking about how you can use income investing to help protect your finances and encourage growth during downturns. There are tons of ways to get into fixed income investing from putting your money towards age-old classics like bonds, to using newer, innovative tools like fractional CDs. To help you get a feel for the income investing landscape, we've added a few guests to today's episode. We're here with Katie Gatti Tassin, founder of Money with Katie and Richard Carter, VP of Fixed Income Products and Services in Fidelity's Personal Investing Division. Katie and Richard, thanks for joining the show.

Katie Gatti Tassin:

Thank you.

Richard Carter:

Thank you. Great to be here.

Alex Lieberman:

Before we make bonds and fixed income sound sexy, let's do some intros. Richard, let's start with you.

Richard Carter:

Okay. Well, I'm vice president of fixed income in Fidelity's personal investing division. It involves leading a team that's responsible for the offering of bonds that we have and also the surrounding software. Things like the research information, news, analytic reports, things to help investors make an informed decision, whether they're using our website or mobile app or working with one of our representatives.

Alex Lieberman:

Love it. So if there is ever someone who joined the show to talk about bonds, you're the guy. Katie, how about you?

Katie Gatti Tassin:

Well, I'm not the guy for fixed income, but I am Money with Katie online and I really just love having conversations about money and money adjacent topics and the types of lives that money enables us to lead.

Alex Lieberman:

So let's talk about fixed income, because I think when the retail investor hears about investing, the thing they always think about is the stock market, equities. But obviously fixed income plays a huge part of an investor's portfolio. So talk about how fixed income is playing an even bigger part in today's current financial environment. Richard, let's start with you.

Richard Carter:

Okay. Well, like the term suggests, fixed income products like bonds and CDs pay out a steady flow of income to the investor and in return at the end of the life of those instruments, they pay the initial investment or the principle back. The rate of return that they pay is fixed generally, that's known as the coupon. And another way of looking at it is that a bond is like a loan where you the investor are lending money to the borrower. It could be a company, it could be a corporation, and in return they're committing to pay you back over time.

Bonds can be bought individually like a stock, or they can be bought inside investment vehicles like stocks too, like a mutual fund or a ETF. You asked me how they're relevant for today's investor, and I think one reason is pretty simple is that right now we're seeing a much better rate of return. That's pretty nice in itself, but it also means that the power that bonds can play is diversifying and as a buffer for times when the stock market is weathering some tough conditions, is more powerful now that they have a higher stream of income than they did just a few years ago.

Alex Lieberman:

So it sounds like the increase in rate of return is something that's super powerful today. And as you use the example of kind of the coupon and the principle before, if I'm someone who invests in bonds, let's just say I loan you $100 and the rate of return is 10%. I'm going to get $10, let's call it a year until we reach maturity, and then at the end I'll get the full $100 back.

Richard Carter:

That's exactly right.

Alex Lieberman:

Love it. Katie, anything you want to add?

Katie Gatti Tassin:

Well, I am 28 years old, so when I think of fixed income and my investing life, this is the first time in my investing life where fixed income has really been a viable option because for the last decade or so we've been in this zero interest rate environment. And so if you wanted yield, if you wanted a return, you had to take on a lot of risk to get it because the yield really wasn't there in fixed income instruments. That's not really the case anymore. But I think whether or not focusing on fixed income instruments or equities for each individual investor, whether or not that makes sense for you is going to depend on your age, your risk timeline, and what you're trying to achieve.

Alex Lieberman:

Love it. So before we started this season of Fresh Invest, we surveyed Morning Brew readers and we asked them about what are their biggest concerns as it relates to investing and their financial health. And there were two interesting findings. 66% of people who took the survey said that they worry about having enough money for retirement, and then 49% said that they were concerned generally about market volatility. I would love for you both to speak about how fixed income instruments play a role in both of these concerns that our audience has. So Katie, let's start with you.

Katie Gatti Tassin:

Yeah, I think bonds might generally be less volatile than stocks because their income flow is more certain. That said, if you are in your 20s and you're investing for retirement, that's 40 years away, that volatility in the stock market might not actually be all that relevant to you because your timeline, your time horizon in the future is just so far away. And those wild swings can be scary. But ultimately we know that there's no 20 year period wherein the S&P 500 has lost money, but having bonds in your portfolio tend to function as I kind of think of downside risk protection.

Alex Lieberman:

What about you, Richard?

Richard Carter:

Yeah, I think Katie pretty much covered it. Historically, what we've seen is that stocks are more volatile than bonds, yet at the same time, the stock market has been a very good place to earn wealth or generate wealth over time, particularly the US stock market. At the same time, bonds can be this great diversifier and you asked about the concerns of the Morning Brew community being both at volatility versus the growing wealth for retirement. And I think it's very hard to have one without the other. And indeed, certainly bonds can be volatile too at times, but I think the key difference is this notion of the contractual obligation that bonds have to pay, as we said at the beginning, pay your money back at the end of their life and to pay a certain known rate of flow of income at known periods over that lifespan of the bond.

And not only does that provide a steady form of income, but it can also help psychologically, A, as Katie was saying, to encourage people to hold on through tough times in the market and not sell out at the bottom. And then from a bond's point of view, it allows you to be less concerned perhaps with the day-to-day price swings of the bond because at the end of the bond's life at maturity, you'll be paid back the principle value so long as the bond issuer doesn't default, and that comes back into the consideration of risk. But if you hold it to maturity and the issuer survives if you like, and can pay you, you don't have to be so concerned with the day-to-day price volatility of the bond itself.

Alex Lieberman:

Absolutely. So I'm particularly interested about this next question because actually pre Morning Brew, started my career in fixed income trading. Despite that, I know very little about the next fixed income instrument we're about to talk about. So I'm excited for you to educate me. Let's talk about deferred fixed annuities since they are often used to secure guaranteed returns on retirement savings. What are deferred fixed annuities? What are their benefits? How should our listener be thinking about them? How should I be thinking about them?

Richard Carter:

Yeah, Well, I'll take a crack at that, Alex. Deferred fixed annuities are a type of fixed income instrument that offer both a guaranteed rate of return, as you mentioned, and the opportunity for tax deferral. So in a way, they behave like a bond, a customer would be choosing both the term, the length of that instrument, the annuity, and the provider, the insurance is an insurance company. And so as they assess the insurance company, for example, that's important to look at the financial strength of that company, not just look at the return and the terms of these annuities generally last from three to 10 years.

So that's another choice that people can make. So now back to the idea of deferred income, that gives you one of the opportunity to grow the return of that instrument over the period over the term without being taxed. The caveat there is so long as the investor doesn't withdraw money or start receiving income, then they're subject to tax. Another point of note is that if you withdraw funds from the deferred fixed annuity before the age of 59 and a half, you may be subject to a 10% IRS penalty.

Alex Lieberman:

Got it. So okay, we've talked about deferred fixed annuities. Now I want to pivot over to bonds. And let's say we have just a lot of listeners who, like Katie are millennial investors, and up until the last few years when rates were basically zero and they didn't think that they had to think about bonds at all, and finally they're taking up more oxygen in kind of the minds of investors like myself or Katie, how should we all be thinking about bonds in the context of just the current financial environment and thinking about them as an instrument?

Richard Carter:

Yeah. Well, I'll take a crack at it. I mean, it is a big subject, so there's a lot to cover. I think just distill it down to two things for me. One is that not all bonds are created equal. And number two is that yield, which is this rate of return, is also think of it as a good measure of risk. So let's just look at these two things in turn, not all bonds are created equal. So most people may be familiar with the treasury bond or the government bond, and these are bonds that can be as short as three months or even a month and go out to 10 years, 30 years. But there's also bonds issued by other entities such as, for example, the agency bonds issued by entities like Fannie Mae, Freddie Mac, that support the housing market. There's also municipal bonds, and these can be issued by states and cities and even issuers like water municipalities or electrical companies.

Alex Lieberman:

Sports stadiums.

Richard Carter:

Sports stadiums. You got it. You got it. Yeah. Hospitals and all kinds of vital or less vital things and corporate bonds and not just the big companies we know of from the stock market, even private companies can issue bonds. So an investor has a lot to choose from, a lot of different risk in that. And even within those categories I mentioned, there's the issuers, right? So the issuer, one company can be less risky or more risky than another. So there's a lot to research once you get into it, arguably, to think about this, where are you on the risk spectrum? And so coming that to my second point is to consider yield as a measure of risk, not just as your return. So what I mean by that is that if you think about it, the bond market, the wider bond market out there full of professionals and investors all around the world continually is evaluating the market as it presents itself for investing opportunities.

And if you think about the idea that these investors are continually thinking, "Would that issuer of this particular bond be capable of paying its contractual obligation, the cash flows, the coupon we spoke about, plus the principle at maturity?" And then imagine, well, what happens if people begin to have doubts about that, the investors have doubts? Some might begin to sell their holding, right? So if they sell, what does that tend to do? Well, that tends to drive down price and in bonds, if price goes down, what happens to yield? It goes up, right? Yeah, exactly.

So if you're looking at the bond landscape and you see a bond that's yielding more than its peers for say a similar maturity, similar type of issuer, but yet the yield is quite a bit higher, if you ask yourself, "Well, why is this?" Is the market giving you a break? Unlikely, has the market overlooked something that you found? Possibly, but also maybe be somewhat skeptical and just realize that this idea that if investors are selling something, the yield can rise, the price goes down, the yield can rise. So consider that as much as being inclined to go for the highest yield you see out there. Again, the end of the day for bonds, the proposition is to hold it and make sure that it doesn't default right? And if it defaults, then the yield as advertised doesn't actually materialize for yourself.

Alex Lieberman:

Got it. So all things being equal, I should be thinking about the yield of the treasuries, bonds and WeWork bonds to have a different level.

Richard Carter:

Quite different. Exactly.

Alex Lieberman:

Katie, any thoughts on bonds?

Katie Gatti Tassin:

Well, my first thought is that I wish I could have asked Richard all these questions when I started investing because the best way that I had ever heard it explained previously was a lot more high level, but I still think it's worth including, which is that most of us are probably familiar with the process of taking out debt. We're taking out a loan because we need to buy a car, or we're buying a home, or we're getting an education. And we know that as we pay back that debt to the lender, we have to pay them interest and pay them for the pleasure of borrowing their money.

So when I think about bonds, I just flip that and say, "Okay, well, this is now the opposite. I'm lending the government money, or I'm lending a corporation money or a municipality or what have you, and in return, they're paying me interest and I'm getting something for it." So that reframe though really helped me make sense of it. I think the fixed income markets are quite a bit more complicated than the stock market. So I think it can take more time to kind of wrap your head around what is functionally happening in that transaction.

Alex Lieberman:

Yeah, totally. Yeah, I feel like there's just a lot that feels counterintuitive and daunting to just the fresh investor who's looking at bonds for the first time, even just the fact of price and yield, moving in.

Katie Gatti Tassin:

Coupon, yield, price, there's so many different terms that feel-

Alex Lieberman:

It can be super daunting. Okay. I want to talk about another instrument that I probably know as little about as deferred fixed annuities. And that's CDs. I think I know more about the discs that I put into my computer when I was nine than CDs. So Richard, educate us on CDs.

Richard Carter:

Okay. So yeah, the other type are CDs, it stands for certificate of deposit. It's really just like a bond in that, as Katie was just saying, you are lending money and this time the borrower is a bank and the bank will take that money and create a deposit on their balance sheet. Now, in return, the bank will pay you a fixed rate of return, generally speaking, and your principal bank at the end of the life of the CD. And the unique thing about a CD distinct from a bond is that most of them are insured by the FDIC, Federal Deposit Insurance Corporation. And that insurance is pretty powerful. It extends to $250,000 per issuer per account registration, and this enables the investor to consider CDs somewhat of a simpler type of bond if you like, to remain within that insurance limit.

Now, there are basically a couple of ways of buying CDs. One is through a bank directly or you can buy what's known as a brokered CD. Then these are the type of CDs that Fidelity offers that can be purchased through investment companies, brokerage companies, and the maturities that are available extend from anywhere from a month to a couple of years, up to 10 years, generally speaking, from a variety of different banks. And the minimum amount that you invest in is typically $1,000. I would just say last year, Fidelity launched a slight variant on that, which is known as a fractional CD where the minimum investment and incremental investment is $100, which might be useful for a younger investor or people who would like to invest a smaller amount over a regular interval as an option.

Alex Lieberman:

Awesome.

Richard Carter:

And the rates that those pay are just as the same rates as they would pay if you bought a larger amount.

Alex Lieberman:

It's just making them more accessible.

Richard Carter:

Exactly.

Alex Lieberman:

Got it. So now I want to talk about something that's a little bit more timely, which is just the inflationary environment that we've been in over the last several months. How do you think about fixed income instruments as a potential hedge for inflation?

Richard Carter:

Yes. Well, that's a very interesting and challenging question. As you say, we've all experienced that over the last 12 months, and in fact, any type of inflation eats away at the real value of your dollar versus what it's worth right now. In this past year alone, we've seen inflation go from just over 9% last summer, and today it's just over 3%. So it can be volatile, whereas your fixed income yield is fixed, right? If you buy a bond, it's a fixed rate of coupon and so on. We've just discussed. So right now, the benefit can be that you could earn a real rate of returns, as Katie was mentioning, some of the pretty safe fixed income instruments yield around 5% CDs, for example, and yet inflation's just over 3%. Now that could change because inflation can go up and that would erode that real return.

So there's always that unpredictability. One way that you might want to mitigate that is considering a strategy like a ladder. A ladder basically is a way of spreading your investments in bonds or CDs over time. And this allows a maturity to occur at regular intervals. So for example, we have on our website what are known as model CD ladders. These are CD ladders that are either one year, two year, or five year in maturity. A one-year ladder would basically take the investment that you put in, spread it over four CDs, a three month, six month, and nine months to 12 months. And so every three months you have a maturity and that gives you the flexibility as the investor to have your money come back and then decide, "Well, what should I do with it? Do I want to spend it or do I want to reinvest it? And what do I want to reinvest it in?"

Alex Lieberman:

So provides some optionality.

Richard Carter:

Some optionality, exactly. That's worth something. And it's also an instrument that some of your audience may have heard of called TIPS. These are treasury inflation protected securities. And although just like the bonds we've discussed there, coupon is fixed. What's interesting about them is that the principle adjusts over time to inflation. So as inflation goes up, the principle will adjust as the consumer price index adjusts in the US. So the fixed rate, your coupon is multiplied then by this higher principle over time. And this means that the coupon payments dollar-wise go up in reflection of that. And at the end of the day, the principle value has increased when the bond matures. So that's another thing to consider. Just one thing to bear in mind with those that they're typically a longer term investment, they invest in bonds that are either 5, 10, 20 years, and sometimes the value of that instrument can be affected by broader bond market conditions. So it doesn't change the cashflow that they're creating, but the valuation of those bonds could be going up or down whatever inflation is doing. So that's just something to bear in mind.

Alex Lieberman:

Super interesting. Last question for you both, and I'm going to be very strict in holding you to one recommendation. Let's say we have a listener who, like Katie, has gotten more interested in the fixed income market over the last several months, given the rate of return on bonds has overall increased, but they're daunted by the complexity of this asset class. What is one recommendation you each have for them to start getting involved in the space? Richard, we'll start with you.

Richard Carter:

Well, that's a toughie, but I think first off, I'd say trying to get educated. I mean, that's maybe a softball answer, but it's basically saying that it is complex, it is challenging, and there's no free lunch. We've just discussed. So at Fidelity for example, we offer a lot of education on the different bond types, the product types we've just been discussing. You could also go to our learning center where we have webinars like this, or we invite monthly guests to come in from outside as well as Fidelity's subject matter experts on different types of the bond market.

And finally, I'd say perhaps just get invested yourself. Take the time to go through the whole procedure, like research the instrument you're about to invest in. Think about that. Why did you invest in it? Maybe put a little bit of money, either the fractional CDs you've mentioned, $100 or even a bond mutual fund for it as little as a dollar. And then think about keeping an eye on it, watching its reaction as the market changes. And then if you come to liquidate it or let it mature, again, see what that experience is like. So I think start slowly, read and learn over time. It's certainly a journey for everybody.

Alex Lieberman:

Katie, what about you?

Katie Gatti Tassin:

I would encourage someone who's interested in getting into fixed income investing to start with the end in mind. So really thinking about as an investor, what is your philosophy? What are you trying to get out of your investments? So are you on a 40-year timeline because you want to retire before you're 70, or maybe you're trying to buy a house in five years, or maybe you're just trying to add some predictability to an otherwise aggressive portfolio for a goal that's maybe 15 or 20 years away. I think depending on the answers to those questions, you'll have an easier time knowing what the next best step should be. So for purely illustrative purposes only, maybe I have $50,000 that I need for a down payment, and I pretty much already have that money, but I need it to be closer to $60,000 in five years from now. But you won't know what instrument or what path makes the most sense until you've really thought about, "Okay, what is the end goal for this money? And where am I really trying to go?"

Alex Lieberman:

Totally. I mean, maybe it's the boring answer, but it sounds like both of what you are saying is that the best way to learn more about bonds is to learn more about bonds.

Katie Gatti Tassin:

I love that he goes, "Read."

Alex Lieberman:

Read. Listen.

Katie Gatti Tassin:

Yes.

Alex Lieberman:

No, you should be thinking about this episode as kind of just the tip of the iceberg. And Richard, you made a good point about oftentimes the best way to educate yourself on the topic is just maybe get a little bit of skin in the game where it isn't going to change your overall financial health, but it creates a little bit of a force function to want to learn more about the asset class. I will say, historically, I have found as someone who worked in bonds, I have found bond talks to be a snooze fest. But you two in fact made it not a snooze fest. So thank you for that. Richard and Katie-

Richard Carter:

We try. Thank you.

Alex Lieberman:

Thank you so much for joining Fresh Invest.

Katie Gatti Tassin:

Thank you.

Richard Carter:

My pleasure. Thanks.

Alex Lieberman:

Thank you so much for tuning into Fresh Invest today. I hope you all feel like you have a stronger understanding of your options when it comes to fixed income investing, and hopefully you feel confident and ready to explore some of these opportunities. Between concerns over market volatility and rising inflation costs, a lot of folks are looking to establish a stable foundation for building wealth via more traditional means, and the opportunities to do that with fixed income are huge. Thanks again for listening, and make sure to join us next week to learn how to live off your investments. That's right. We will discuss what to do with all of your earnings, how to adequately plan for retirement and the ins and outs of generating passive income. It's some pretty important information, so be sure to tune in. Thanks for tuning into Fresh Invests, sponsored by Fidelity Investments and powered by Morning Brew. Check out fidelity.com/freshinvests to open a Fidelity account and learn more about the topics we covered in this week's episode. See you on the next one.

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