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Include Cash Reserves: Savings, CDs, and Money Market Accounts

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You may think of cash as the comfort food of investing. When things get dicey, you feel like pulling your money out of investments and moving it to where it'll be safe. Maybe you simply can't stand the thought of watching your investments decrease in value, a frequent problem in times of economic uncertainty. Having an investment strategy that holds up in good times and bad can help overcome those concerns. And cash is one component of every good investment strategy.

You can use cash for a variety of things, including the following:

- **Your emergency fund:** Use emergency funds to cover unexpected expenses.
- **Short-term goals:** These include goals that are less than five years away, such as saving for a car or a down payment on a house.
- **Investment stability:** Include cash investments in your investment strategy as a *core investment* (primary holding) and to reduce *volatility* (a measure of how rapidly the value of your portfolio goes up and down).
- **Temporary component:** You can also use cash as a temporary component of portfolios meant for long-term goals. You may hold cash in these portfolios for a variety of reasons, including the following:
  - You've sold an investment and a suitable replacement isn't immediately available.
  - You want available cash so you can take advantage of an anticipated investment opportunity.
  - You need to take income from your account, so you have to keep a portion of it in cash for safety. You don't want to have to sell an investment at an inopportune time so you can take income out of your portfolio.

Your Cash-Equivalent Savings Options

Savings accounts, CDs, and money market accounts are three vehicles that you can employ to ensure that your cash is working for you. Generically called *cash equivalents,* each of these investments has been designed with safety in mind — in other words, their value remains relatively stable.

Savings accounts

Savings accounts offered by banking and thrift institutions are safe, very safe. The Federal Deposit Insurance Corporation (FDIC) insures savings accounts at member institutions up to $100,000 per depositor. And certain retirement savings accounts, such as IRAs, are insured up $250,000.

Savings accounts are liquid, too. This means you can pull your money out whenever you need it without having to worry about early withdrawal fees, gains, losses, or other complications that often come with other investments.

Savings accounts also have a downside: They pay low interest rates. When interest rates in the general economy decline, interest rates paid on savings accounts can be downright pathetic and may not even keep up with inflation. If inflation is increasing the cost of the things you buy by 3 percent each year and your savings account is paying you only 1 percent in interest, the purchasing power of the money in your savings account is actually declining by 2 percent per year. It actually costs you money to keep your funds in a safe account.

Online savings accounts, such as ING Direct (`www.ingdirect.com`) and HSBC Direct (`www.hsbcdirect.com`), offer FDIC-insured savings that typically yield a bit more interest than regular bank savings accounts. Because these institutions don't have physical branch buildings and staff and because all activity is conducted online, their expenses can be lower. To use them, simply open an account at their Web site and then fund the account by initiating an online electronic transfer from your regular savings institution to your new account. You can transfer money back whenever you want to in the same manner. You can also pay many of your bills electronically from these online savings accounts. This can even save you money in postage!

Keep money in savings accounts only for your ultra short-term needs, such as your emergency fund or that down payment you're making next month. You have better options available for your longer-term investments.

Certificates of deposit

Certificates of deposits, or CDs, are offered by the same institutions that offer savings accounts. CDs are FDIC-insured, so they're safe like savings accounts. However, they generally pay slightly higher interest rates than savings accounts.

CDs can offer both safety and higher rates because they aren't as liquid as savings accounts. CDs have predetermined maturity terms, typically ranging anywhere from six months to two years or longer. When you buy a CD, you should plan to keep it until the end of its term. If you redeem your CD before it matures, you may have to pay an early withdrawal penalty or forfeit a portion of the interest you earned.

TIP

A bank's CD rates may be negotiable. Banks often offer special rates to attract funds from investors like you. Shop around on the Internet or by phone to find the best rates in your area. If they're better than your bank's rates, talk to an investment specialist at your bank and ask her to match the better rate — it can't hurt to ask. Just like any other business, banks don't like to lose customers, and they'll sometimes do what it takes to keep you from taking your money elsewhere.

Money market accounts

Although they aren't FDIC-insured, money market accounts combine some of the best features of savings accounts and CDs.

Like savings accounts, money market accounts are liquid. You can write checks on them and take your cash out anytime you want; you don't have a waiting period like you do with CDs. Restrictions, however, may include minimum check size, how many checks you can write per month, or minimum account balances you have to maintain to get the best rates and/or avoid monthly fees.

Money market accounts offer better interest rates than savings accounts. Sometimes the rates aren't quite as attractive as those for CDs, but you have access to your money anytime you want; you don't get that with a CD.

You can open a money market account at most banks and institutions that offer savings accounts and CDs. Many mutual fund companies also offer money market accounts. Money market mutual funds frequently offer even better rates than bank money market accounts, so be sure to do some checking before you invest.

An added feature of money market mutual funds is that they invest your money in a variety of investments. For example, you can purchase municipal money market mutual funds (also called *munis*) in which your earnings will be exempt from federal and possibly even state taxes. Or you can choose a U.S. Treasury money market fund that invests only in rock-solid government securities. Be sure to read the fine print in the brochure or prospectus.

So Which One Is Right for You?

When you're choosing the type of cash accounts to use, consider the following:

- Your investment strategy
- When you may need your money
- The current rate of inflation and whether the interest rate will keep up with inflation
- Your comfort with using Internet institutions versus your local bank
- Your familiarity with mutual fund companies
- How easily you can access your money
- What restrictions and limitations are associated with each type of cash account

TOUGH TIMES

When times are tough and markets are going down, keep your short-term cash needs in mind. If you know you're going to need cold, hard cash sometime in the next couple of years, keep that amount in a nice, safe cash option. Keeping short-term money in long-term securities like stocks and bonds is flirting with disaster.