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YOUR MONEY

Options for Savers Seeking Better Rates

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If you're a saver, you're probably frustrated, even angry. There's nothing worse than being punished for good behavior, and that's exactly how it feels if you're trying to amass a pile of cash before making a big purchase, particularly when banks pay interest rates that don't come close to keeping pace with inflation.

That frustration is precisely what prompted Mark Sweeting, a high school history teacher in Portland, Ore., to pull his emergency savings fund out of an online savings account at ING Direct. It had lured him two years ago with an annual rate of 1.25 percent that has since dwindled by more than a third.

"It just seemed so obnoxious," he said, adding that he recently moved his money to Barclays, which is paying 1 percent. "The more money I had in my emergency account, the less and less it made."

He said that he was well aware that his new rate might eventually sink, too, but that he would continue playing the rate-chasing game.

Other consumers are tempted, or at least curious, about potentially riskier options beyond the world of federally insured savings — perhaps short-term bonds or dividend-paying stock funds. But what sort of trade-off does that entail? And are there any safer alternatives?

I asked several advisers how comfortable they were with the risk of options that might pay a little more.

Some were slightly more cautious, but most offered similar advice: if you're more concerned about the return "of" your capital, then you probably shouldn't get too ambitious with the return "on" your capital, as advisers like to say, particularly if you expect to tap the savings in five years or less.

"Consumers also need to be aware of their natural behavioral instinct to believe that someone out there can find the silver bullet for them that will give them the return they want at minimal risk," said Barry Korb, a financial planner and president of Lighthouse Financial Planning in Potomac, Md.

You don't have to dig too far back to find examples of people burned by investments that promised higher yields in exchange for only a tad more risk. Remember auction-rate securities? Sold by brokers, these investments froze during the financial crisis, locking investors out, even though the securities were billed as safe and liquid as cash.

And then there was Charles Schwab's YieldPlus Fund, which was marketed as a cash alternative but whose value plunged by more than 42 percent during the financial crisis.

Given that rates are at record lows and are expected to stay that way for the next few years, finding options that beat the national averages will take a bit of work.

Currently, the national average on an interest-bearing, federally insured savings account is a meager 0.13 percent, according to Market Rates Insight, a financial data research firm, down from 0.79 percent in July 2007.

And the national average rate on certificates of deposit — with maturities from three months to five years — is 0.70 percent, down from 4.56 percent in July 2007.

"Based on a statistical analysis that I did going back even further, almost 50 years, interest rates on deposits have never been this low," said Dan Geller, executive vice president at the firm.

Considering that the inflation rate is running at about 1.7 percent a year (and many consumers are experiencing even higher costs), many savers are losing purchasing power. So here are a few options to consider.

LESS THAN A YEAR OR TWO For people who need to tap their funds within a year — whether for an emergency or a short-term goal like a down payment on a home or a car — experts advise keeping your money as liquid and safe as possible.

So you might start searching for a higher-yielding online savings account on Web sites like MoneyRates.com, Bankrate.com or MoneyAisle.com, where bank and credit unions "bid" on how much they're willing to pay you in interest (though a recent search in my Brooklyn ZIP code yielded an unimpressive 0.50 percent).

When evaluating these accounts, pay close attention to any investment minimums, fees or other restrictions. For now, TIAA Direct appears to be offering one of the highest-yielding savings rates at 1.24 percent.

The Web site Nerd Wallet has come out with a monthly interest-rate monitor, which lists deposit accounts that beat one measure of inflation, as my colleague Ann Carrns recently pointed out on our Bucks blog. Many of the accounts were offered by credit unions, which usually have eligibility restrictions, but it's worth perusing.

Certificates of deposit obviously aren't as liquid as savings accounts, but you can seek out higher-yielding C.D.'s with terms that will mature when you need the money. Or, you can consider playing a little game with Ally Bank's five-year C.D., which pays 1.73 percent; it charges a penalty that amounts to 60 days' worth of interest if you withdraw your money before the C.D. matures. This lets you take advantage of a relatively attractive rate with a minimal penalty should rates spike and you want to reinvest your money elsewhere, Mr. Korb said. He figures that plunking your money into Ally's five-year certificate of deposit, as long as you can keep your money there for about six months, would be a better choice than its one-year C.D., which pays 1.01 percent.

Savings accounts, C.D.'s and money market deposit accounts are generally insured by the Federal Deposit Insurance Corporation up to $250,000 per depositor per bank. Federally insured credit unions generally follow the same rules as banks. (And money market deposit accounts shouldn't be confused with money market mutual funds, which are not insured; the seven-day average rate on taxable money funds was a mere 0.03 percent as of July 3, not far from its record low, according to iMoneyNet.)

TWO TO OVER THREE YEARS Several financial planners recommend sticking with the ultrasafe options described above even if you have a little more time. But short-term bond funds may be appropriate for some savers, as long as they fully understand and can handle the risks.

So what are the risks? Rising interest rates, for one. When rates rise, bond prices will fall. This is especially important for bond fund investors; if you hold an individual bond until maturity, you will generally receive your initial investment back. But assembling this type of portfolio typically isn't cost-effective for smaller investors.

Bond funds with shorter maturities are less susceptible to interest rate risk. That's why it is important to pay attention to a fund's duration, which measures its sensitivity to rate changes. Generally speaking, for every percentage point that rates rise, a bond's value will decline by its duration (stated in years). So if rates climb by one percentage point, the value of a bond fund with an average duration of two years will drop by 2 percent.

"If you absolutely need X amount on a certain date, such as for a college tuition bill that must be paid by Aug. 25, that's one thing," said Russell Wild, an investment adviser and bond expert. But if you have some "fudge room" for hitting a short-term goal, like buying a car, he said you may consider splitting your money between a savings account and a short-term bond fund that invests in high-quality, or investment-grade, bonds, like the Vanguard Short-Term Investment-Grade Fund. The fund currently pays 1.59 percent (after expenses) for those with at least $3,000 to invest, and pays an even higher 1.70 percent for people who put in more than $50,000. (A more diversified but lower-yielding alternative is the Vanguard Short-Term Bond Index fund.)

The danger, of course, is that you can lose money. Beyond interest rates, there are other potential pitfalls, including the risk of default. Mr. Wild points out that, during the height of the financial crisis in 2008, the investment-grade bond fund lost 4.65 percent. "It's a gamble you're taking, for sure," he said. "But the odds are heavily in your favor."

Other low-cost options recommended by planners included the Vanguard Short-Term Treasury Fund, which invests only in government-backed Treasury securities and has an average duration of 2.2 years (but it currently yields a meager 0.23 percent). People in higher tax brackets may consider the Vanguard Short-Term Tax-Exempt Fund, which invests in municipal securities — meaning investments that are generally exempt from federal income taxes, unless you're subject to the alternative minimum tax — with an average duration of 1.2 years and currently yielding 0.42 percent.

"If one is considering investing in an ultrashort bond fund, keep in mind that they can vary significantly in their risks and rewards," said George Kiraly Jr., president of the LodeStar Advisory Group in Short Hills, N.J. Review the credit quality and maturity dates of the fund's investments, as well as its duration and overall costs, he added. Also look at how well it performed during the crisis of 2008. And he said all bets were off if the financial crisis in Europe intensifies, which could increase the risk of default, potentially for corporate as well as government bonds.

"Always be skeptical of any investment that promises you a greater potential for return at no additional risk," he cautioned.

Several advisers said the extra returns that some funds might provide were simply not worth the risk. "In the current environment, people need to save their way to meet short-term financial goals," said Jerry Verseput, a financial adviser in Folsom, Calif., "and not try to invest their way to short-term goals."