Low Rates Make Retirees Gnash Their Teeth

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Savers Languish on Fixed Income

In late 2012, Federal Reserve Chairman Ben Bernanke fessed up and revealed the worst-kept secret in finance: The low rates the Fed has maintained in an attempt to ignite the U.S. economy are badly hurting retirees and others who rely on fixed income.

“My colleagues and I know that people who rely on investments that pay a fixed interest rate, such as certificates of deposit, are receiving very low returns, a situation that has involved significant hardship for some,” Bernanke said in an October speech in Indianapolis.

Such sympathy is probably small consolation to millions of Americans who saved diligently over the years but now find themselves struggling, thanks to rates that have remained near zero percent for more than four years.

“Our firm has long been of the belief that artificially low interest rates have punished savers and retirees,” says Samuel Scott, president at Sunrise Advisors in Leawood, Kan.

“We heard someone say that the ‘haircut’ to depositors by Cypriot banks pales in comparison to the ‘theft’ by Bernanke and the Fed from savers.”

How does Fed policy hurt retirees? Bankrate counts six ways.

Fed Policy Effect No. 1: Paltry Returns on Savings

In June 2006, the federal funds rate stood at 5.25%. At the Federal Reserve’s meeting in September 2007, it began lowering the federal funds rate and continued to do so until it fell to a range of between zero percent and 0.25% in December 2008. It remains there today.

Rates on certificates of deposit, money market accounts and savings have plunged in tandem.

The result has been devastating for retirees counting on safe, fixed returns, says Michael Rubin, founder of Total Candor, a financial planning education firm based in Portsmouth, N.H.

“They’re earning a lot less on their savings than any other time in recent history,” says Rubin, author of “Beyond Paycheck to Paycheck.”

Despite such low returns, CDs and other savings vehicles still have a place in a retiree’s portfolio. Even getting a sad-sack 1% return is better than exposing all your savings to higher levels of risk, says Alan Moore, founder of Serenity Financial Consulting in Milwaukee.

“I look at cash as market insurance,” he says. “When the stock market takes a dive, (retirees) don’t want to be in the position of having to sell stocks to fund their lifestyle.”

Fed Policy Effect No. 2: Low Rates on Fixed Annuities

Many retirees buy an annuity in hopes of getting a safe stream of income. Low rates undercut that strategy, Moore says.

“The problem is that the monthly income a client receives from their fixed annuity is based on interest rates at the time they purchase the annuity,” he says. “With interest rates at all-time lows, annuity payouts are also at all-time lows.”

Nathan Kubik, a Certified Investment Management Analyst at Carnick & Kubik, which has offices in Denver and Colorado Springs, Colo., agrees that now is among the worst times to buy an annuity.

“Locking in these historically low rates right now through fixed-rate annuities is the height of folly,” Kubik says.

Kubik suggests talking to a fee-only adviser who is an expert in fixed-income investments. Such a pro can suggest alternatives to annuities.

Meanwhile, Moore urges investors to avoid purchasing annuities until rates climb.

“Another option is to buy a smaller annuity today, such as 25% of what (investors) would normally buy,” he says.

Doing this several times from different companies over a few years allows you to buy at various interest rates, he says. Plus, buying from separate companies protects you if one of the companies goes bankrupt.

Fed Policy Effect No. 3: Underfunded Pension Funds

Today’s pension funds are in big trouble. Ninety-four percent of corporate defined benefit pensions were underfunded in 2012, according to a recent report by Wilshire Consulting.

Pension funds must make sure their assets grow at a pace adequate to cover future liabilities. The Wilshire report notes that today’s low interest rates make this especially difficult to achieve.

“It is putting pressure on the already-weak pension system,” Scott says.

But Rubin notes that pension woes are unlikely to affect large numbers of retirees.

“Most retirees don’t have pensions and will not be affected,” he says.

He also believes that current pension recipients are unlikely to see their payout cut. But future retirees may not be as lucky, he says.

Moore agrees. “It is hard to know if clients can depend on them for their retirement income,” he says. Workers who are worried about their company’s pension plan must take action now. “They need to save more or work longer, as well as delay Social Security, to maximize the benefit they will receive.”

Fed Policy Effect No. 4: Costly Long-Term Care Premiums

Long-term care insurance covers the cost of a wide range of expensive services you may need in your final years, including nursing home care, assisted living facilities and adult day care. This insurance potentially can save you and your family hundreds of thousands of dollars.

But thanks to falling interest rates, long-term care insurance premiums have skyrocketed, says Jesse Slome, executive director of the American Association for Long-Term Care Insurance.

“Lower rates have wreaked havoc on long-term care insurance costs,” Slome says. “Rates today are about 50% higher than they were five years ago.”

As interest rates have fallen, insurers have seen the return on their investments slip. For every 1% decline in rates, insurers need to hike premiums by between 10% and 15%, according to Slome.

Consumers may be tempted to delay buying long-term care insurance while they wait for interest rates to rise. But that strategy carries risks, Slome says.

“Twenty-four hours from now, your health can change,” Slome says. “Or, you go to the doctor and some condition is diagnosed. Now, you are uninsurable.”

Instead of delaying a purchase, Slome encourages people to talk to a long-term care insurance specialist who can offer options for making care more affordable.

Fed Policy Effect No. 5: Making Safe Havens Unsafe

Scott says many retirees are risk-averse and typically park a good percentage of their cash in “safe havens,” such as savings accounts and CDs. But low returns are forcing many older Americans to wade into the more turbulent waters of the stock market.

Other retirees are buying bonds with the belief they are safer than stocks. But Scott says Fed policy may be creating a bubble in the bond market that will burst once rates return to normal.

“For 30-plus years, bonds have been safe, and this seems ingrained in the minds of people,” he says. “But with a rise in rates, these safe assets will lose value.”

That’s because when rates rise, bond prices fall. Investors purchasing new bonds with higher yields will shun existing low-yielding bonds.

Kubik agrees that safe havens are not what they used to be. He urges investors to consult with their financial adviser and create a plan for dealing with rising rates.

“The most important thing investors can do right now is ensure that they are properly positioned for the impending rising interest rate environment,” he says.

Moore believes the danger lurking in today’s supposed safe havens presents a lesson that investors should remember in all markets.

“Safe-haven investments have never truly been safe,” he says. “Investments that did well during one market downturn may do awful in another.”

Fed Policy Effect No. 6: Stoking Future Inflation

The Fed’s policy of keeping rates low is intended to make borrowing less costly and, thus, stimulate the economy. But all that “cheap money” may come with a high price if the money supply ignites inflation somewhere down the road.

A surge in prices would easily overwhelm the returns retirees get from CDs, savings and other fixed-income investments.

The Fed is closely watching for any hints of rising prices. Raising the federal funds target rate is the best way to tamp down incipient inflation.

“I suspect that the Fed’s policies will change at the first sign of inflation,” Kubik says.

But once inflation starts, it can be difficult to stop. In the early 1980s, the Federal Reserve was forced to crank up rates to a high of 20% before it got inflation under control.

Moore says investors who fear future price increases should keep some of their bond portfolio in Treasury inflation-protected securities, or TIPS, which increase your principal in tandem with rising inflation.

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