

Mega Millions: Should Winner Take Annuity or Lump Sum?

By YUNJI DE NIES

March 30, 2012—

go.com

Which is the Smarter Choice?

With the Mega Millions jackpot at half a billion dollars, many are fantasizing about what they would do with all that dough. A new mansion in Lake Como? A yacht to sail the Amalfi coast? My personal favorite: dive into a pool of hundred-dollar bills à la Scrooge McDuck.

The odds of winning are slim: one in 176 million. But whoever gets lucky (the next drawing is Friday night) will face the practical choice of taking the money on a yearly basis, or opting for the mega lump sum.

If the jackpot is \$500 million, that means the cash option would yield a one-time lump sum payment of \$359.4 million. The annuity option would provide estimated payments of \$19,250,000 a year over 26 years. That's more than a million dollars a month, every month, for the next 26 years!

Remember, those numbers are pre-tax. Right off the top, the lottery withholds 25 percent for federal tax, then, depending on where you live and your tax bracket, another 6 to 9 percent for state taxes.

The sheer amount of money is mind-boggling.

"We've never seen anything like this," said lottery spokesperson Elias Dominguez with a laugh, "It's almost scary."

Dominguez said Mega Millions does not try to sway winners one way or the other, though they do provide every winner with a handbook with advice -- namely to get an attorney and a financial advisor. They have no hard numbers, but generally most people take the lump sum.

"Most of them want all their money now. They're not sure what's going to happen in 26 years. Plus, people think they can take that lump sum and invest it and make more money on their own," he said.

Clearly, the upside to the lump sum is having access to all that money to do as you please. But spreading the payments over time guarantees a steady income stream, and can help reduce taxes. Age may be a consideration, though Mega Millions promises to continue to send out those checks every year, even if the winner dies, to a designated beneficiary.

Economist Austan Goolsbee, a professor at the University of Chicago who also chaired the White House Council of Economic Advisers, says the choice comes down to interest rates. And with interest rates at zero, the lump sum just makes better financial sense.

"If you are fortunate enough to win the lottery, you most certainly want to take the lump sum," Goolsbee said.

Here's why: to fund the lottery, the lottery operators buy a zero coupon bond, which is a type of bond that ultimately pays the full amount in the final year. In this case, the bond value \$500 million paid in the 26th year. So the value of that bond today is the lump sum.

As the interest rate goes down, the value of that bond shoots up, because the lottery deducts the interest rate every year over time. So, in normal times, when the interest rate is say, 3 to 5 percent, Goolsbee said the value of the lump sum was about half the stated value of the lottery. But today, with interest rates near zero, the lump sum is worth much more.

"Whoever wins, they should go thank God, and then the second person they should thank is Ben Bernanke because he just gave them an extra \$90 million," Goolsbee said.

This calculation only changes when interest rates rise, and since the Fed chairman has indicated he's not raising rates until at least 2015, Goolsbee said the choice is clear.

Of course, there is the matter of self-restraint. Can you trust yourself not to spend all that money if you have access to it? Consider the cautionary tale of Jack Whitaker, who won \$314.9 million in the Powerball lottery in 2002. At the time, Whitaker, a West Virginia businessman, was the largest single jackpot winner ever. He went for the cash option of \$170 million, and after taxes, ended up with \$114 million.

But after several high profile brushes with the law, including large cash robberies, Whitaker lost most of the money, and was the subject of several lawsuits. The Lottery Post dubbed him "the un-luckiest lottery winner ever."

AN EXAMPLE OF
IMMUNIZATION WITH ZEROS

164

Wall Street Journal

Five Surprising Ways Bond Investments Can Hurt You

In Today's Market, Rising Interest Rates Are a Threat, but They Aren't the Only Concern

By

Michael A. Pollock

Updated May 4, 2014 5:10 p.m. ET

May 5, 2014 p. R1

By now, most investors know that in the current economic climate, bonds are becoming a lot riskier.

They understand that rising interest rates can knock down the value of existing bonds and mutual funds that own them—as happened in spring and early summer last year, when Treasury rates spiked.

As a result, some investors are pursuing bond strategies that they hope will offer better protection, such as high-yield issues or floating-rate funds.

But there are other risks associated with bond investing that aren't as widely understood, and some of them involve the very strategies that investors consider to be the safest.

Here are five surprising ways a bond strategy can backfire:

1. Shorter maturities used to be safer, but aren't anymore

Conservative investors traditionally have avoided long Treasury-bond maturities, which are much more susceptible to being whipsawed by fears of inflation and rising rates than are intermediate-term and short-term bonds. But with the Federal Reserve moving forward on its plan to wean the economy off monetary life support, conventional wisdom may not apply: Now, it's the short and intermediate maturities that may carry significant price risk.

Here's why: After five years of holding yields low to spark growth, the Fed has begun trimming its bond purchases. So far, bonds with maturities of 10 years and longer have been the most to react, with yields jumping more than one percentage point since a year ago.

Now, the focus is shifting to when the Fed will raise its target lending rate at the very shortest end of the market. Expectations are that the Fed could boost that rate, which it has kept near zero since late 2008, as early as next year, depending on how quickly the economy recovers. But even anticipation of such a move—say, as a series of employment reports show the labor market strengthening—could send yields surging for Treasuries in the two-to-five-year area, according to Meg McClellan, global head of fixed-income strategies at J.P. Morgan Asset Management. Bond prices, which move in the opposite direction of yields, would drop. The intermediate area, with maturities of three to 10 years, also is losing a huge buyer as the Fed cuts back on its purchases of those bonds, which is likely to push prices down there, as well.

Meanwhile, the prices of long bonds could remain steady or even rally a bit in that scenario because the market would expect the Fed's actions to damp growth and reduce future inflation, Ms. McClellan and others say.

2. Some bonds grow even more sensitive to rising rates at exactly the wrong time

164a

Long-dated, tax-exempt municipals are among bonds whose rate sensitivity can increase as rates rise. Rate sensitivity, or duration, is a measure of the extent to which a bond's price will move in reaction to a broad movement in interest rates. Rate sensitivity is a big issue for munis for two reasons:

First, these bonds typically are sold in maturities of as long as 20 to 30 years, and in general, the longer a bond's maturity, the more sensitive it is to broad rate moves.

Second, these bonds are typically sold with a call, or redemption provision that allows the issuer to redeem them after only 10 years. The issuer might do that if yields are lower at the 10-year date, repaying holders of the existing issue and selling new bonds at a lower, less-expensive rate.

As long as investors expect a 30-year bond to be called at 10 years, it trades at the prevailing 10-year yield. But if yields were to rise and it no longer made sense to call it after 10 years, the market immediately would reprice it at the higher yield—and lower price—of a similar 30-year muni.

After its price fell, that 30-year muni would have an annualized return on paper of almost negative 6%, estimates Gary Pollack, head of U.S. fixed-income trading for wealth management at Deutsche Asset & Wealth Management.

The risk is similar for bonds backed by mortgage loans. When rates fall, homeowners refinance their loans at lower rates, and that leads to mortgage-backed bonds being redeemed ahead of maturity. But when rates rise, refinancings ebb, and the bonds are repriced in the market to reflect expectations that they will have a much longer maturity.

3. High-yield bonds no longer provide as much protection against rising rates

Companies with lower credit ratings must pay higher interest rates to borrow, and in past years, their bonds paid juicy yields of around 7% to 9%. That provided bondholders with a nice cushion against any market volatility, since the interest would offset most or all of any price loss.

But as investors have piled into the high-yield space in recent years, they've bid prices higher, and yields have dropped. Yields now stand at around 4% to 5%, down about two percentage points from just a year ago. Because that's a thinner margin above Treasury yields, it has made high-yield bonds more sensitive to rate volatility.

Last spring, when Treasury yields spiked, some high-yield bonds briefly had total returns around negative 5%, though the sector recovered and performed strongly for 2013.

High-yield bonds still afford more protection against rising rates than many other kinds of bonds, says Wesley Sparks, who heads U.S. taxable fixed income at the U.S. investment management unit of Britain's Schroders PLC. But if you don't own them already, don't rush in because there's a risk of buying near the top.

4. Floating-rate funds protect against rate volatility, but may pose other concerns

Funds that invest in floating-rate debt securities—also called bank-loan or senior-loan funds—have been soaring in popularity: Last year, they took in more than \$67 billion, more than five times as much as in 2012, according to Morningstar Inc.

The key attraction is that because these funds invest in corporate loans pegged to a variable interest-rate benchmark such as the London interbank offered rate, or Libor, they won't be hurt by a broad rise in rates. Still, they can have other disadvantages.

Because of the way the loans owned by such funds are structured, the funds' yields—currently around 3% to 4%—won't rise quickly if short-term rates do finally head higher. For some of the loans, it may take nearly a one-percentage-point rise in three-month Libor, which is now about 0.22%, to have any impact on returns. That could disappoint those investors who were counting on higher coupons when rates rose.

Meantime, people who own such funds are trading rate risk for credit risk, since the loans are to companies with ratings below investment-grade. That could be a problem if the economy runs into trouble. In 2008, when investors fled riskier markets, floating-rate funds had annual total returns of around negative 30%.

"Investors need to understand that bank-loan funds are at least as risky as high-yield bond funds," says Jason Brady, a fixed-income fund manager at Santa Fe, N.M.-based Thornburg Investment Management.

5. Leveraged closed-end bond funds could give you a bumpy ride

Closed-end bond funds trade on exchanges like stocks, and their share prices can move up or down on shifting market sentiment, as well as changes in portfolio value. Most of them use leverage to generate much higher yield than investors might get otherwise.

A closed-end fund that owns intermediate- or longer-maturity munis can yield more than 6%, compared with yields of around 2% to 3% for conventional long-term muni funds that don't use leverage.

While leverage can pump up gains, it also magnifies losses. In last year's second quarter, when munis were hit by both rate volatility and default worries, Nuveen Municipal Opportunity Fund—with a leverage ratio of about 39%—posted a negative price return of 5.4%. That compared with a negative return of about 3.5% for conventional long-term muni funds that didn't have leverage.

In addition, a broad rise in rates would boost the funds' financing costs, which could lead the funds to trim distributions to shareholders.

"If you are planning to invest in a leveraged closed-end fund, it's very important to understand the underlying investments that are generating its yield," says Morningstar analyst Sumit Desai. "You aren't going to get significant income generation without a corresponding level of risk."

Mr. Pollock is a writer in Ridgewood, N.J. Email him at reports@wsj.com.

Copyright 2013 Dow Jones & Company, Inc. All Rights Reserved

Wall Street Journal

April 12, 2016

p. C1

Winning Funds Bet on Rate Fall

By

Min Zeng

Updated April 11, 2016 6:11 p.m. ET

For investors, one of the best bets of 2016 has been a wager via U.S. Treasurys on falling interest rates.

The \$460 million Pimco Extended Duration Fund posted a total return of 11.8% in the first quarter, making it the best performer among 2,015 U.S.-based bond mutual funds, according to data from Morningstar. Total return reflects price gains plus periodic payments.

The runner-up was \$1.3 billion Vanguard Extended Duration Treasury Index Fund, which returned 11.7% during the quarter, according to Morningstar.

Both funds posted their best returns since the last quarter of 2014 and have extended those gains in the early days of the second quarter. Duration refers to a fund's exposure to interest-rate risk, meaning its prices will rise more when rates fall and fall more when rates rise.

Analysts have warned repeatedly that bets on duration are risky, given the long decline in interest rates over recent years. The gains are striking at a time when stocks and other riskier assets have rebounded from an early-year selloff that at one point left the Dow industrials down 10%. The Dow fell 20.55 points, or 0.1%, on Monday, but is up 0.8% for the year.

While safer securities such as U.S. Treasurys and German bunds tend to decline in price when stocks and low-rated corporate bonds rally, many analysts say the simultaneous rise of safer and riskier assets this spring is tied to the unexpectedly slow pace of policy tightening by the Federal Reserve, along with signs the global economy continues its slow healing.

At the same time, many investors are concerned that the rally in stocks, bonds and commodities off Feb. 11 lows may have gone too far too fast.

"We are still stuck in low growth," Jack Flaherty, portfolio manager at money manager GAM, which has over \$119 billion in global assets under management. "It may be time to lighten up a bit and pause" on purchases of riskier assets, he said.

The uncertainty is why many investors are buying long-term U.S. government bonds, even though analysts have warned that slim yields leave bondholders vulnerable to potentially large capital losses if interest rates do rise.

The average U.S. equity mutual fund posted a total return of minus-0.4% between January and March, according to Morningstar. The average return for all U.S.-based bond funds tracked by Morningstar was 2.1% for the period. Quarter-end data for all funds are typically finalized in the early days of the following period.

“It has been a good start for bond funds,” said Jeff Tjornehoj, head of Americas research at Lipper. That performance “may be hard to repeat this quarter.”

Stock funds on average returned 4.4% in the fourth quarter last year, according to Morningstar. Bond funds posted a negative 0.1% return in the final quarter of 2015.

U.S. Treasury bonds overall have posted a total return of 3.6% this year through Friday, according to data from Barclays. U.S. bonds sold by lower-rated firms, or junk bonds, have returned 3.8% over the same period. S&P 500 has returned 0.8%, according to FactSet.

The Vanguard fund passively tracks an index of long-term Treasury bonds. The fund “will tend to have extreme results—both on the up and down side” given its focus on buying government bonds with very long-term maturity, said a representative of Vanguard in a written statement.

The Pimco fund is actively managed by three fund managers at Pacific Investment Management Co.: Stephen Rodosky, Michael Cudzil and Josh Thimons. A representative at Pimco declined to comment.

The Pimco fund attracted \$19.7 million of new cash between January and February, topping the \$11.9 million it obtained for the whole year of 2015, according to the latest data from fund tracker Lipper.

The Vanguard fund attracted \$20.4 million of new cash during the first two months of the year, after suffering a net withdrawal of \$115.7 million in 2015, according to Lipper.

The Vanguard fund posted a loss of 20.9% in 2013, according to Morningstar, when worries about the Fed reducing bond purchases rattled the bond market. The Pimco fund lost 21.2% that year.

But U.S. bond yields have largely been on a downward trend since the financial crisis. The two funds both posted an annualized return of about 17% on average over the past five years through Friday, according to Morningstar.

Write to Min Zeng at min.zeng@wsj.com