Money market accounts or CDs might be a good way to earn short-term income on savings

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It has been a long time since money market funds and certificates of deposit (CDs) offered attractive levels of income. After a rapid rise in interest rates over the past year, investors face two decisions. First, should they move cash out of regular bank accounts to capture the higher income on their savings? Second, with relatively attractive risk-free income available, should they even bother putting money at risk in stocks?

While interest income of 4 percent or more is widely available in low-risk assets, you have to actively pursue it. Regular bank checking and savings accounts do not offer this type of income. Banks aren't that generous. You have to opt-in to these more attractive savings vehicles. A typical bank savings account may pay 0.10 percent or less. On $50,000 of savings for your emergency fund, you would earn $50 annually. Move that money to a 4 percent money market fund, CD or Treasury bond, and your annual income would be $2,000. There are billions of idle dollars that could, with little effort, be earning much more.

Not all banks offer attractive CD or money market rates. Your bank might have free checking and be good with loans but stingy on interest-bearing deposits. If that is the case, an investment account might be more useful than your bank. Money market funds in brokerage accounts and IRAs currently offer interest closer to 4.25 percent. A quick search at Charles Schwab shows many 6-month CDs paying 4.5 percent or more and 12-to-18-month CDs at 4.7 percent. Treasury bills are near the same territory. These rates haven't been available since 2007.

Once you move beyond the amount you need to set aside as a cash reserve, then there is a decision about how attractive risk-free interest rates are in the context of other investments.

For money positioned for long-term growth – that is money that you don't expect to need for at least a few years – prospective returns for stocks and bonds in a balanced portfolio likely remain a better alternative. If history is useful at all as a guide, you would be better off positioning for returns beyond what CDs and money markets can presently provide. Over periods of five years (all rolling 60-month periods since 1950) a 50-50 mix of the S&P 500 Index of U.S. stocks and a U.S. aggregate bond market index has never lost money (in nominal terms before inflation). The average annual return within those 60-month periods since 1950 has been 8.7 percent according to analysis from J.P. Morgan. The 50-50 mix is no one-size-fits-all recommendation. It's just a starting place to think about what your investment strategy should be given your short- and long-term objectives and your tolerance for dealing with fluctuating values of your investments.

Some investors, placated by 4-plus percent income, might be tempted to hold the cash equivalents like money markets and CDs and wait for some future moment when conditions seem to be more favorable for investing in stocks. While tempting, this is likely a fool's errand. It is time in markets, not timing markets that is the most consistently useful strategy. You might get lucky and time a move from cash to stocks correctly, but that luck is likely to convince you that you can also time the next move from stocks to cash. You can't time markets persistently and neither can professional investors with supercomputers using all available data searching for signals. In the short-term, markets are not efficient, investors are not always rational, world events and human psychology create way more volatility in stock prices than is necessary. But over time, these features of investing tend to moderate.

Short-term interest rates are likely close to a peak. If there is a recession later in 2023, something Vanguard's latest market outlook places at a 90 percent likelihood, the U.S. Federal Reserve would cut interest rates to stimulate the economy. The money market fund and CD rates we see today at 4-plus percent might retreat. For short-term reserves that require liquidity, keep that money in a money market fund or short-term bond fund that has shares that can be sold and returned to cash in a day. For money that doesn't require the same level of liquidity, it might be helpful to invest some money in a CD for a known period that locks in the higher income. If, by the latter portion of 2023, money market funds are back down to 3 percent, you might be grateful for having some money that will still capture the higher rate a little bit longer.

Regardless of your short-term or long-term needs, don't let easy opportunities for your money to work harder for you pass you by.

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