Are Investors Holding Too Much Cash?

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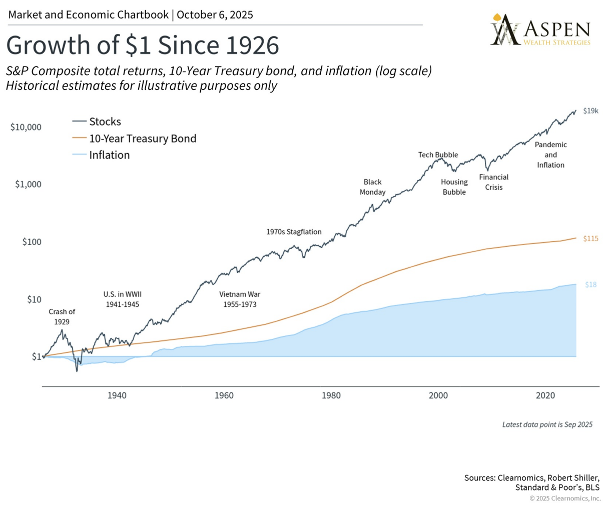
For long-term investors, a growing challenge today is how to manage cash as short-term interest rates fall. What appears safe actually comes with real costs beneath the surface, since holding too much cash can quietly undermine long-term financial goals. This comes at an important time, when some investors find themselves with “cash on the sidelines,” including a record $7.3 trillion held in money market funds.

Investing isn't about deciding between risky assets versus cash, or trying to time the market – it's about holding the right mix of assets that are aligned with long-term financial plans. Cash does play important roles in these plans, especially when it comes to having enough liquidity to pay expenses and for emergencies.

However, when investors hold more cash than may be appropriate for their goals, sometimes referred to as “excess cash,” they may miss out on opportunities for income, growth, risk management, and other objectives. In this market environment, how can investors most effectively position cash in their portfolios to fulfill their long-term goals?

Stocks and bonds have outpaced inflation over the long run

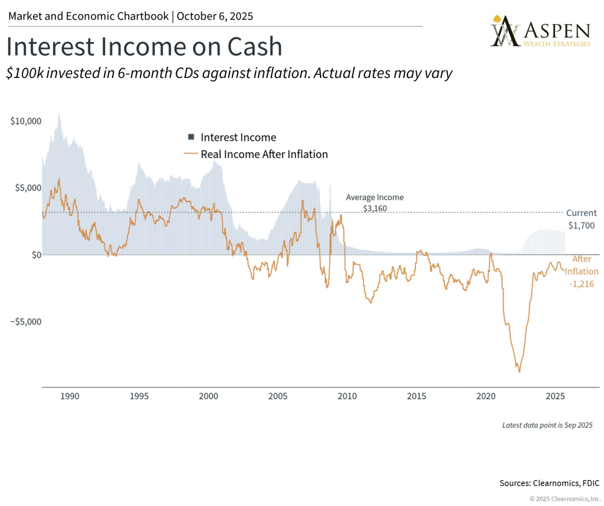


The history of financial markets is clear when it comes to growing the value of hard-earned savings and beating inflation. As shown in the chart above, stocks and bonds have risen magnitudes more than inflation. Even though what used to cost $1 in 1926 now costs $18 today, stocks and bonds have risen many multiples more, creating true wealth for those who were positioned for these long trends. This is true despite periodic market pullbacks, financial crises, and recessions over the past century.

The past is no guarantee of the future, but this year's market rebound shows how quickly market pessimism can give way to a market rebound. Even the high inflation rates of the past few years have paled when compared to the returns of a balanced portfolio. Over time, the compounding effect of even modest returns above inflation can create wealth.

From a financial planning perspective, cash provides essential liquidity and flexibility for near-term spending needs and emergencies. For instance, a down payment for an upcoming home purchase will likely involve holding cash-like instruments, as would tuition payments and other bills that need to be paid within a year. Similarly, maintaining an emergency fund provides important protection against unexpected events like job loss or medical emergencies.

Holding excess cash quietly erodes purchasing power



The problem occurs when investors hold more cash than is needed for these practical needs. This has been understandable over the past few years due to periods of market uncertainty and high cash rates. When interest rates on cash are high compared to bond yields or stock dividends, it may seem reasonable to try to generate income from cash since it may appear to be "risk-free." However, there are at least two hidden costs with this approach.

The first hidden cost of excess cash is inflation. Even when interest rates on savings accounts or money market funds seem reasonable, or offer attractive rates at the start, they often do not keep pace with the rising cost of goods and services year in and year out. The accompanying chart shows that the real, inflation-adjusted income on cash has been negative throughout most of the past two decades when considering average certificate of deposit rates.

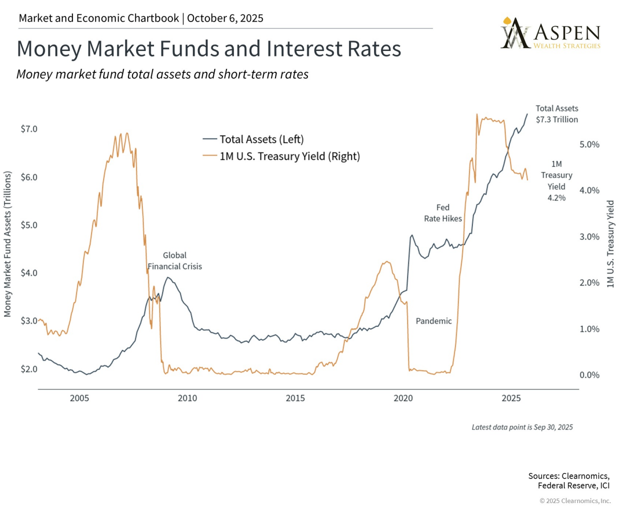
The second hidden cost relates to how short-term interest rates work. While yields on money market funds, short-term certificates of deposit, and savings accounts may appear attractive, especially compared to the near-zero rates during the decade after the 2008 global financial crisis, these rates aren't locked in. By definition, they are short-term in nature and are subject to change. So, while some introductory rates can be quite attractive, these rates are variable and require careful attention as they roll over.

In general, the fact that cash and short-term bond instruments must be reinvested at whatever rates prevail at that time creates what's known as "reinvestment risk." For example, if the Federal Reserve continues to cut rates as many expect, short-term interest rates could continue to decline, possibly generating income below the rate of inflation. Investors then need to decide whether to accept lower yields at each maturity date or switch back to longer-term investments. Since the prices of longer-term investments tend to rise when rates fall, investors could be giving up returns in the meantime.

The situation is quite different from longer-term bonds, where yields can be locked in for years or even decades. An investor who purchases a 10-year Treasury bond today secures that yield regardless of what happens to interest rates, even if the current market price of the bond changes. Similarly, while the stock market is always uncertain, investing with a long time horizon has historically helped investors achieve long-term growth that avoids constant reinvestment risk.

Cash feels safe because the number that shows up on an account balance can be stable, even when there is market uncertainty. However, what we can purchase with our money is ultimately what determines our financial security, not the nominal dollar amount in our accounts. If inflation runs at 3% annually while cash earns 2%, the purchasing power of those savings declines by 1% each year, even if it seems that nothing has changed on paper. This seemingly small difference can compound considerably and have a significant impact on planning goals that span decades, especially for retirees.

Cash on the sidelines is at record levels



Cash isn't just about our own financial plans, but also speaks to the overall market. As the accompanying chart shows, money market fund assets have reached near-record levels of $7.3 trillion, nearly double the assets held prior to the pandemic. This reflects both investors seeking higher short-term interest rates and a hesitancy to invest in longer-term assets.

However, as rates have begun to moderate and are expected to decline further, these excess cash holdings could face reinvestment challenges. Investors who moved significant assets to cash when rates were temporarily high, or during periods of market stress, could face difficult decisions. This is often referred to as "cash on the sidelines," and reflects the possibility that some investors may move back to stock and bond investments over time.

The best approach to handle excess cash will depend on your goals but may include strategies such as dollar-cost averaging. This is important today as the stock market continues to rally and bond yields remain attractive. The interest generated from longer-term Treasury, corporate and high-yield bonds, as well as other fixed income securities, is still attractive compared to history. And while interest rates are difficult to predict, bond market volatility has settled. The same is true for the stock market, which has defied expectations this year.

The bottom line? While cash serves important purposes, holding too much creates hidden costs. For long-term investors, maintaining an appropriate cash buffer while staying invested in long-term portfolios is still the best way to achieve financial goals.

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