

The Role of Cash in a Portfolio

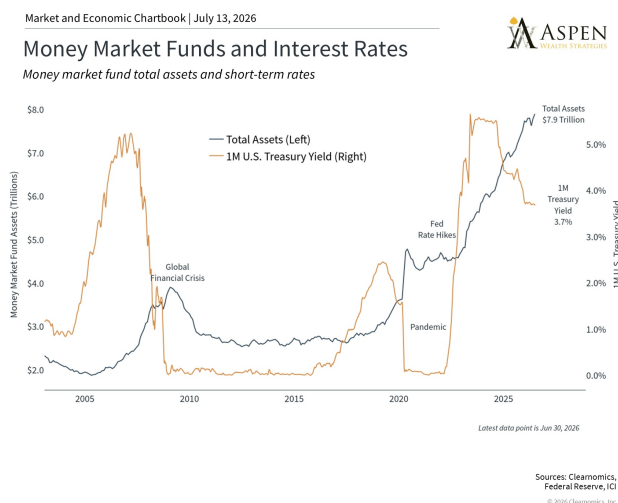
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The baseball player Yogi Berra once said that “a nickel ain’t worth a dime anymore.” With inflation still elevated, many investors and consumers may be feeling this way as well. Not only are everyday costs higher due to energy prices, but short-term interest rates have fallen over the past two years.

This means that investors who have a significant portion of their portfolios in cash are seeing the purchasing power of their savings decline both as prices rise and as cash yields fall. With money market fund assets near record highs at \$7.9 trillion, it’s likely that many investors have cash allocations that exceed what is appropriate for their financial plans.¹ What do investors need to understand about the role of cash in their portfolios today?

Managing cash requires careful planning



The role of cash can be a complex topic because it serves many purposes in portfolios, financial plans, and in life. Holding too much cash, however, comes with real long-term costs. These are easy to overlook because cash feels safe, especially compared to the daily swings in the stock market. However, history shows that this can create a drag on wealth accumulation, since the value of cash, unlike stocks, bonds, and other assets, does not compound as much over time.

From an investing and financial planning perspective, the term “cash” is often shorthand for any liquid, short-term holding or vehicle. The most common examples include savings accounts, money market funds, certificates of deposit (CDs), and similar instruments. These serve important

purposes, including savings for near-term expenses, building an emergency fund, setting aside money for a home down payment, tuition payments, and more. These are all legitimate and important uses of cash that are a part of any

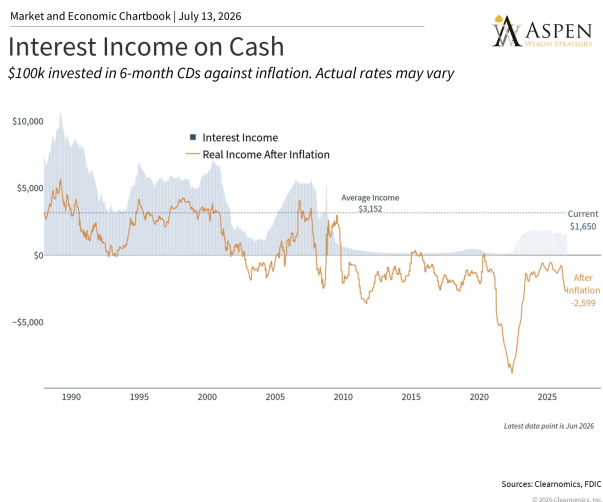
financial plan.

The question is not whether to hold cash, but how much is appropriate given an individual's goals, time horizon, and broader portfolio. Having too much cash is sometimes described as "cash on the sidelines," since it's not actively growing, paying dividends, or receiving bond coupons.

As the accompanying chart shows, money market fund assets remain at record levels after climbing alongside interest rates a few years ago. Higher short-term interest rates can appear attractive especially when the stock market seems volatile. However, because they are short-term in nature, these rates are not locked in, creating what investors often refer to as "reinvestment risk." In order to keep pace with inflation and support financial goals, this cash needs to be put to work in asset classes with the right characteristics.

This is especially important today since short-term rates have already declined. Investors who moved to cash are not only experiencing lower yields, but most likely missed much of the broader market rally of the past few years.

Inflation quietly erodes the value of cash



One misconception about cash is that it is truly risk-free. While it may feel this way because the nominal balance on a bank statement doesn't fluctuate the way the stock market does, its true value can decline all the same. This is because the value of cash is based on what it can purchase, and inflation quietly erodes this over time. This inflationary effect may be small in a given year, but compounds across years and decades unless there are interest payments or asset appreciation to offset it.

As the chart above shows, the inflation-adjusted return on cash, measured using current CD rates according to the FDIC, has been negative for most of the past two decades.² In other words, even when cash appeared to be generating some income, inflation was running ahead of it. With headline

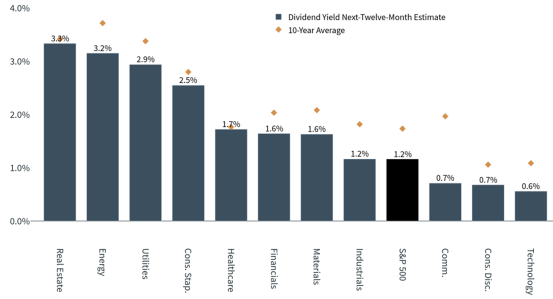
inflation currently at 4.2% and the one-month Treasury yield at 3.7%, real cash yields remain negative today by many measures.³

Money market funds, savings accounts, and short-term CDs must also be rolled over regularly as they mature. This reinvestment risk not only needs to be managed, but is dependent on changing market and economic conditions. Thus, many of the factors that affect stocks and bonds also affect the yields on cash.

Stocks and bonds support long-term growth

Dividend Yields by Sector

Next-twelve-month dividend yield estimates and 10-year averages
S&P 500 Index and GICS sectors



Sources: Clearnomics, LLC
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Stocks and bonds are traditionally the foundations of portfolios because they can generate both long-term growth and income. Dividend-paying stocks, for instance, can provide income along with the potential for capital appreciation. While dividends are not guaranteed in the way bond coupons are, sectors of the S&P 500 such as Real Estate, Energy, and Utilities currently offer yields above 3%, comparable to many shorter-term cash and bond instruments.

Extending the maturity on bonds can also result in more attractive interest rates. For instance, the 2-year Treasury yield is currently around 4.2%, which is both a significant increase from short-term cash yields and also matches the latest inflation rates.

Investment grade corporate bonds currently yield 5.3% on average, compared to a historical level of 3.9%. The Bloomberg U.S. Aggregate Bond Index yields 4.8%, more than one and a half times its average since 2009. Unlike cash, bonds can gain in value as well, especially in ways that balance the rest of the portfolio.

Ultimately, what history shows is that a portfolio with the right mix of asset classes can not only outpace inflation over time, but can compound to support financial goals. This is not an argument against holding cash, but rather a reminder that the purpose of cash in a portfolio is to serve specific, near-term needs. For investors who have accumulated excess cash over the past few years, it's important to put it to work thoughtfully.

The bottom line? Cash plays an important role in financial planning, but holding too much comes with long-term trade-offs. Staying invested in a diversified portfolio of stocks and bonds remains the best way to work toward long-term financial goals.

References

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2. <https://www.fdic.gov/national-rates-and-rate-caps>
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Index Descriptions

S&P 500

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Bloomberg US Aggregate Bond Index

The Bloomberg U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

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