Understanding the role of cash in your portfolio

Perhaps no other asset class elicits such mixed feelings among investors as cash. In bull markets, cash is shunned. In bear markets, it's embraced. Having a better understanding of the role cash plays in your financial program and its relationship to stocks and bonds is a critical step toward reaching your financial goals.

The dual roles of cash in your financial program

Cash pays for your short- to intermediate-term spending needs. But cash also plays two critical roles within your overall financial program.

1. **A stable defense against the unexpected.** A cash reserve cushions the blow of financial setbacks, such as unexpected expenses, a pay cut or a job loss. Without the liquidity of cash, emergency spending needs could force the sale of your stock and bond holdings at precisely the wrong time. A cash reserve equal to six to 12 months of income is typically recommended; for retirees, the recommended amount is two to three years of income.
2. **The flexibility to pursue new opportunities.** In your portfolio, cash can help cushion against volatility and enable you to take advantage of attractive investment opportunities as they arise.

The risks associated with too much cash

Investors who are approaching retirement turn their focus to preserving their savings the closer they get to their retirement day. And while it may make sense to pursue a more conservative asset allocation as you approach retirement, "more conservative" doesn't necessarily equal 100% cash. Investors who shift to cash may be putting their future buying power — and their future goals — in jeopardy by abandoning their portfolios' growth potential. While cash provides liquidity and stability, it's not intended to be the primary holding within your investment portfolio because of low returns.

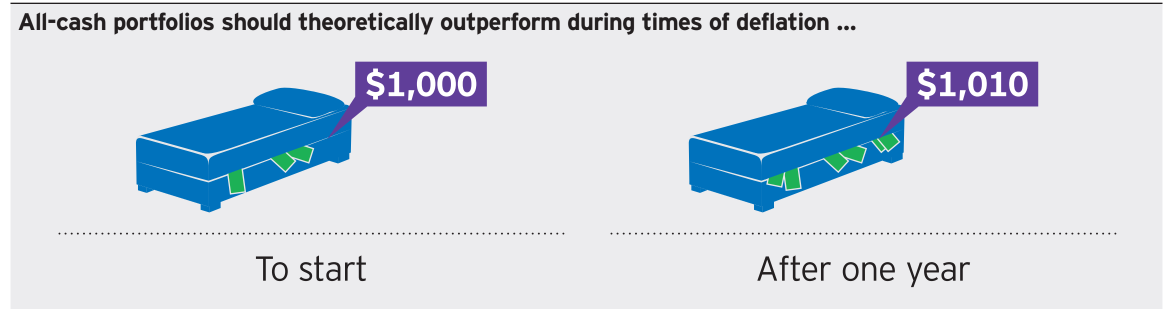
Investors are especially prone to maximizing cash allocations — and consequently limiting growth potential — during volatile bear markets when stock and bond prices are low. All-cash portfolios could be particularly vulnerable in times of **deflation** and **inflation**.

How cash performs during deflation

Deflation is defined as "a fall in the general price level or a contraction of credit and available money."[1] **During times of deflation**, cash has its greatest value because it buys a greater amount of goods and services.

The effects of 1% monthly deflation on $1,000 under the mattress — the amount of money doesn't change, but its purchasing power increases.

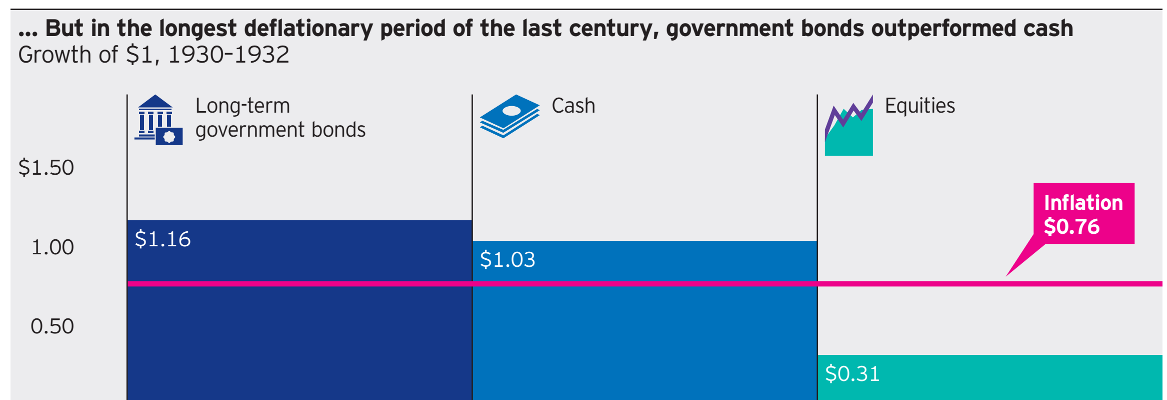
All-cash portfolios should theoretically outperform during times of deflation ...



Source: Invesco. For illustrative purposes only.

It would stand to reason, then, that during the longest deflationary period during the last century – from 1930 to 1932 – that cash would have the highest return. But that wasn't the case – government bonds actually outperformed cash.

... But in the longest deflationary period of the last century, government bonds outperformed cash
Growth of $1, 1930-1932



Source: Ibbotson. Cash is represented by the Ibbotson U.S. 30-Day T-Bill Index, US inflation by the Consumer Price Index, long-term government bonds by the Ibbotson U.S. Long-Term Government Bond Index, and equities by the S&P 500 Index. An investment cannot be made directly in an index. *Past performance is no guarantee of future results.*

Key points

- During times of deflation, cash's purchasing power increases.
- Cash has underperformed bonds during deflation.

1 Source: Investopedia.com

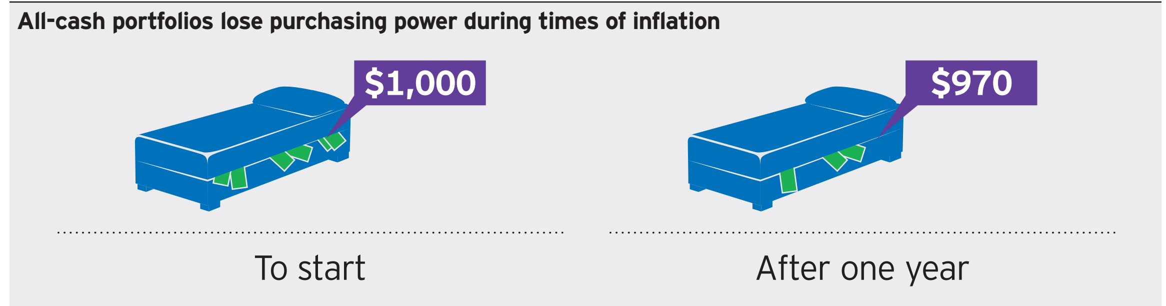
Exploring other options during inflation

Inflation, on the opposite end of the spectrum, is defined as "a persistent, substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of currency.[1]"

During times of inflation, interest rates tend to rise, elevating the nominal return on cash while other fixed income asset classes typically struggle. But holding cash during times of inflation may not be as beneficial as it seems on the surface. While the nominal return on cash rises, investor purchasing power erodes.

The effects of 3% annual inflation on $1,000 under the mattress — the amount of money doesn't change, but its purchasing power decreases.

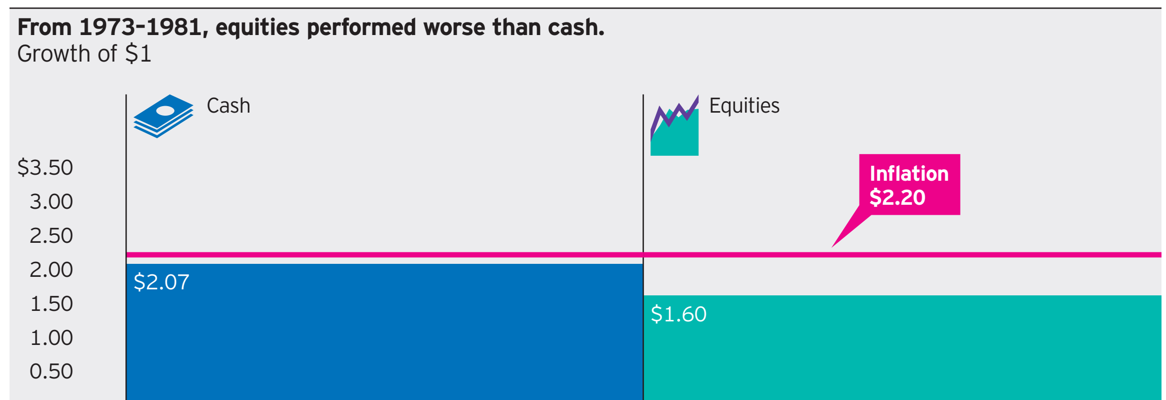
All-cash portfolios lose purchasing power during times of inflation



Source: Invesco

You may be surprised by stocks' performance shown in the chart below because equities are often viewed as an inflation hedge.

From 1973-1981, equities performed worse than cash.
Growth of $1



Source: Ibbotson. Cash is represented by the Ibbotson U.S. 30-Day T-Bill Index, US inflation by the Consumer Price Index and equities by the S&P 500 Index. An investment cannot be made directly in an index. Past performance is no guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

While the chart illustrates only one inflationary period, it's important to understand that equities can be an effective hedge against inflation, but only after the markets have had time to adjust valuations to account for its impact.

Key point

- During times of inflation, cash's purchasing power decreases.

Talk to your financial professional

Cash plays a critical role in your financial program and is a key building block of a well-constructed investment portfolio. But holding too much cash in your portfolio simply replaces the risk of principal loss with the risk of not achieving your financial goals.

Before you increase your portfolio's cash level, talk to your financial professional about your current cash exposure from all sources (including cash inside mutual funds), as well as your tax concerns, financial goals, and cash flow and liquidity needs. Having a full picture of your current cash exposure is the first step toward building an investment plan that's intentionally structured to meet your needs.

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Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

The Ibbotson U.S. 30-Day T-Bill Index is an unmanaged index representative of 30-day Treasury bills. The Ibbotson U.S. Long-Term Government Bond Index is an unmanaged index representative of long-term US government bonds. The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics. The S&P 500® Index is an unmanaged index considered representative of the US stock market.

In general, stock and other equity security values fluctuate, and sometimes widely fluctuate, in response to activities specific to the company as well as general market, economic and political conditions. An investment in fixed-income securities carries interest rate and credit risk. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. Credit risk is the risk of loss on an investment due to the deterioration of an issuer's financial health.

Savings accounts are insured by the FDIC; other investments can lose principal.

Holding cash or cash equivalents may negatively affect performance.

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