CASH BENEFITS: A DUAL-PURPOSE ASSET CLASS

By Maria Crawford Scott

Cash is boring to investors concentrating on long-term return attributes. But its investment characteristics make it useful both as protection against emergencies and as a portfolio stabilizer.

How much cash should you have in your portfolio?

That's the first question many investors ask when struggling with the asset allocation question. And it's a more complicated question to answer than it may seem at first blush.

Cash can appear simply boring to investors concentrating on the long-term return and current income attributes of the major asset classes. It has no real long-term growth, and typically the income is the lowest among fixed-income alternatives. On the other hand, cash has the advantage of liquidity. These investment attributes, though, allow cash to serve several purposes within an investor's portfolio:

- It serves as a ready source for spending money and for protection against emergencies, so that longer-term investments need not be liquidated at inopportune times.
- It serves as a stabilizer for your overall portfolio, tempering the overall downside risk of what may otherwise be a very volatile portfolio.

These are two separate functions, and the amount of cash in your portfolio needs to be determined based on both of these needs. That doesn't mean that you can't keep the assets in the same money market fund, but you need to make sure you establish different "paper" or "mental" accounts for these various needs.

SPENDING & EMERGENCIES

What's the minimum amount individuals need to keep for spending and emergencies?

A useful rule of thumb is that cash reserves should equal three to six months' worth of take-home pay, or six months' to a year's worth of living expenses.

Individuals who are working really don't need to maintain a large "spending" account, since they have a ready source of monthly income to meet expenses. The amount needed for spending is a function of personal preference in terms of how much you desire to have on hand to meet expenses, particularly for upcoming major purchases.

On the other hand, individuals who are working do need emergency cash reserves to protect against a major loss—primarily a loss of income due to loss of work or disability.

Assuming you are properly insured, disability insurance should eventually cover most of any income shortfall due to a disability. In this case, your primary liquidity need would be during the waiting period when there are no disability benefits; the shorter the waiting period, the less there is a need for liquidity. On the other hand, a loss of income may occur that is not covered by disability insurance—for instance, a cutback or firing. If this were to occur, you would need enough income to offset expenses over the time you are out of work. The best way to determine this liquidity need is to estimate your monthly living expenses and assume that those expenses need to be covered for some time—six months to one year.

Retirees have somewhat different emergency and spending needs. While the

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financial emergency that threatens workers is the loss of income, a retiree receiving income from Social Security, pension plans, and personal investments has little to fear from an interruption in income. Of course, savings will fluctuate based on the volatility of the markets, but the proper protection against this risk is a diversified asset allocation plan.

On the other hand, retirees who are living off of investments do need relatively larger cash accounts from which to withdraw spending money. The size of the cash reserve would depend in part on the frequency with which you rebalance your investment portfolio and add to your spending account. Less frequent rebalancing may be more convenient—and less time-consuming at tax time—but it will cause the spending account to fluctuate more.

The size of cash reserves for retirees would also depend on comfort and convenience. Some retirees may regard several months spending amounts sufficient for emergencies; others may be more comfortable with six or 12 months.

TEMPERING VOLATILITY

A separate function of cash within an investment portfolio is to temper portfolio volatility that is the result of investments in riskier asset classes.

In general, stocks provide the most growth. Bonds and cash produce a steadier source of income than stocks do; a much larger percentage of their annual return comes from income rather than growth. Cash has the advantage of immediate liquidity, but the disadvantage of lower levels of income.

Cash investments are often viewed as risk-free, but they do in fact face several major investment risks:

- *Inflation risk*: The long-term returns from cash investments have been the lowest of the three main asset classes. Taxes can take a further bite out of returns. Thus, if cash is held in a taxable account, your aftertax return could easily be below the rate of inflation. For this reason, allocation of a substantial percentage of assets to cash as a long-term investment can be highly risky.
- *Income risk*: Cash investments face the risk that the income provided will fall sharply in a relatively short time, in tandem with declining short-term interest rates. Short-term interest rates are much more volatile than long-term rates over time. For example, returns from cash investments climbed from 4.9% in 1977 to 17.1% in 1981, they declined to 8.7% in 1983, and in 1993 they averaged a mere 2.6%.

While cash tends to have higher income risk than longer-term maturity bonds, they do not face interest-rate risk. When interest rates rise, a bond's value will drop, and the longer the maturity, the greater the drop, all other things equal. It is this characteristic of cash investments—virtually no downside risk over the short term—that makes it quite useful when combined with more risky, growth-oriented investments in an investment portfolio.

Adding cash to the portfolio mix can allow you to lower your portfolio's downside risk, or it can allow you to increase your investment in more growth-oriented stocks without increasing your downside risk.

Table 1 provides an extreme example of how this can work: Portfolio 1 invests only 25% in stocks and 75% in bonds, in an effort to keep the downside risk low. The worst-case scenario for this portfolio (all asset categories suffering bear-market returns at the same

TABLE 1. USING CASH TO TEMPER DOWNSIDE RISK

	Downside Risk (%)	Yield (%)	Potential Growth (%)	Total Return (%)
Stocks	–25	1.5	8.5	10.0
Bonds	–10	5.0	0.0	5.0
Cash	0	4.0	0.0	4.0
Portfolio 1:				
25% stocks, 75% bonds	–14	4.1	2.1	6.2
Portfolio 2:				
25% stocks, 40% bonds, 35% cash	–10	3.8	2.1	5.9
Portfolio 3:				
60% stocks, 40% cash	–15	2.5	5.1	7.6

Notes: Downside risk is an annual decline based on severe bear market conditions; for the portfolios it assumes that all categories decline simultaneously. Yields are based on approximate current yields. Total returns are conservative annual return estimates based on historical returns over the past 50 years.

time) is a loss of 14%.

Portfolio 2, on the other hand, is able to reduce the downside risk to a loss of 10% by including cash in the portfolio—25% stocks, 40% bonds, and 35% in cash.

Neither of these portfolios, however, offers growth potential, due to the extremely low commitment to common stocks.

Portfolio 3, however, is able to maintain nearly the same downside risk as Portfolio 1 (a loss of 15%), while substantially increasing both the potential for growth and the total return. It does this by substantially boosting the stock commitment to 60%, while investing the remaining portion in cash. Although the income thrown off by this portfolio is less than either Portfolio 1 or Portfolio 2, growth investments can be used as sources of income both from any dividends provided by stocks and by simply selling stocks periodically to supplement income needs. The same concept could be used to offset the risk when adding more aggressive stocks to your portfolio, such as small-cap or international stocks.

Of course, these three portfolios are extreme examples to illustrate the concepts. Many combinations are possible, and you should use an allocation that best matches your return and income needs, as well as your own risk tolerance.

CASH BENEFITS

Here are some thoughts to keep in mind when pondering your cash commitments:

- Cash reserves should be kept so that you are not forced to sell long-term investments at inopportune times due to unexpected emergencies. A good rule of thumb is to keep six to 12 months' living expenses as cash reserves for emergencies.
- Cash accounts for spending will fluctuate based on your spending habits and your own level of comfort.
- A substantial commitment to stocks will most likely be needed to provide growth and prevent a loss in real terms of the value of your long-term investment portfolio. However, cash can be used to moderate the downside risk introduced by a large stock component and investments in more aggressive stocks.
- Your spending account is a different concept than the "cash" account that is part of your asset allocation plan used to temper downside risk. You may prefer to keep the actual assets in the same account, but you should keep them separate in your own "paper" or "mental" accounting systems. ✦