Cash Alternatives can Play an Important Role

Cash alternatives (“cash”) fill several needs for investors, but they should not be viewed as a primary, long-term investment.

Cash Gives You Time to Plan
Cash can be a temporary parking place for funds awaiting investment. When you have a large sum, such as from the sale of a house or from an inheritance, you should not rush to invest it but rather take the time to plan a strategy and, if appropriate, ease into the market.

Cash Can Be Used to Manage Portfolio Risk
When you are invested in an asset class that has had a big run-up in prices and seems overheated, you might take some risk off the table by converting some of your investment to cash (which may have tax implications), even if you have not yet decided where to reinvest.

Cash Is for Near-Term Expenses
Cash is the appropriate asset earmarked for big expenses within a year or two, from college tuition to a planned house purchase. You would not want to risk any loss on these funds because there would, in all likelihood, not be sufficient time to recover.

Cash Is Great to Have When You Need it
Cash is perfect for an emergency fund. Job losses or unexpected major expenses can occur. You should be prepared so that you don’t have to sell your long-term investments at what might be an unfavorable price.

But Cash Can’t Do Everything
Overusing or misusing cash can jeopardize your long-term investment objectives. Cash does not grow significantly over time. It sometimes outpaces inflation and sometimes doesn’t.

How Much Cash Should I Hold in My Portfolio?

Key Takeaways

- Cash has important uses, but it is not likely the best, long-term investment option for most investors. For most investors, cash should not represent the majority of their asset allocation dollars.
- Wells Fargo finds that its clients, on average, hold much more cash than their investment professionals recommend.

What Is “Cash”?

By “cash,” we don’t mean just dollar bills or even the money in your checking account. We use the term as shorthand for a spectrum of assets that have typically been very stable in value and can usually be liquidated quickly when you need to cover an expense. Short-term Treasury bills and money market funds are classic examples.

What Tradeoffs Does an Investor Face When Choosing Cash?

In the longer term, cash doesn’t help preserve purchasing power. Inflation may be low right now, but it is expected to accelerate, and that would erode the purchasing power of cash.

Meanwhile, riskier assets typically have the ability to outpace inflation but come with increasing volatility.

When Is Cash the Answer?

Your time horizon matters. If your goal is near-term, cash may well be the way to go. For a long-term goal, though, investors may want to use “longer-term investments” and be prepared to take the bumps in stride because the upward path can be a rocky one.

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Investment and Insurance Products:
- NOT FDIC Insured
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- MAY Lose Value
What Can Happen if You Hold Too Much Cash?

For decades, it was possible to earn a small after-inflation return, or “real return,” on cash. The orange line in the chart below shows that the real value of money invested in three-month Treasury bills from the beginning of the 1980s until the early 2000s rose very gradually. Then the trend reversed, and the all-cash investor has been losing ground ever since.

Meanwhile, the typical balanced-fund investor, who typically looks for capital appreciation and income in a 60 percent/40 percent mix of stock and bonds, has seen real portfolio growth. This hypothetical investor has persevered through some significant downturns.

There is no guarantee the trends in this 39+-year graph will continue. Also, an unlucky investor could begin the journey just before a major market drop. The hypothetical balanced-portfolio investor experienced a minor market drop in the early 1980s that put the portfolio into a loss position for a short time. It could have been a lot worse. An investment journey begun just before the major market drop of 2008–09 would probably have made the loss position persist for several years.

Inflation: There’s More Than One Kind

The inflation numbers we’re used to seeing in the headlines represent the Consumer Price Index (CPI), which is general in nature. Some prices consistently outpace the overall inflation number. For example, medical costs loom large for seniors, as do tuition costs for parents of future college students. This dynamic can make your real return on cash even lower than outlined above. That is why a well-balanced and diversified portfolio is important for most investors.
Let’s Talk About Fear

Nine years after the financial crisis, many investors still tend to keep a significant allocation in cash or jump to cash when markets get volatile. They may promise themselves they will reinvest “when the market settles down.” These investors may be overestimating their ability to make tough decisions. Year after year, stock mutual fund investors in the Dalbar “Quantitative Analysis of Investor Behavior” study underperform the average stock mutual fund because of an unsuccessful attempt to time the market.

It’s time in the market, not timing the market, that often matters. The 2019 Dalbar, Inc., study (see chart at right) showed that over the 20 years from 1999–2018 the average annual return for equity mutual fund investors in the study was 3.88%. However, during that time, the average annual return for the S&P 500 was 5.62%. According to Dalbar, the 1.74% difference was the cost an investor incurred for chasing performance and other bad investing habits.

Think about it. Successful market timing would require making two decisions correctly: selling before a decline and buying back in after the bottom. Selling during a decline is actually the easy part. Buying beaten-down assets and waiting for them to recover is the hard part.

Another fear investors have is that they could miss out on an attractive investment opportunity unless they have “dry powder” (cash) in their portfolios. Dry powder isn’t really necessary. Whatever the attractive opportunity is, it often can be funded by rebalancing or selling whatever asset in the portfolio is less attractive than the opportunity. Unless the portfolio is chock-full of non-traded instruments, which we advise against, there should be sufficient liquidity in most asset classes to do this.

Putting Your Cash to Work

Ready? There’s no need to invest your surplus cash all at once. It may be better to invest it in equal amounts, $1,000 per month, for example, over a period of months. This strategy is called “dollar-cost averaging,” which can take advantage of market volatility. By using it, you are unlikely to invest all your cash at peak prices. Instead, your cash will buy more shares when prices are lower and fewer when they are higher, biasing your portfolio toward the lower-priced shares.

Impact of Emotions on Investment Returns

Excitement or panic can hurt returns: Investors who allow their emotions to get the best of them can suffer lower returns over time as shown here. More than half of the gap in returns can be attributed to performance chasing and other bad investing habits, Dalbar found. The message from the Dalbar’s yearly analysis has been consistent since its first study in 1994: “No matter what the state of the mutual fund industry, boom or bust: Investment results are more dependent on investor behavior than on fund performance. Mutual fund investors who have held on to their investment have been more successful than those who time the market.” Past performance is no guarantee of future results.

Dalbar computed the “average stock fund investor return” by using industry cash flow reports from the Investment Company Institute. The “average stock fund return” figure represents the average return for all funds listed in Lipper’s U.S. Diversified Equity fund classification model. All Dalbar returns were computed using the S&P 500 Index. Returns assume reinvestment of dividends and capital gain distributions. The fact that buy and hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future. The performance shown is not indicative of any particular investment.
But What About an Emergency Fund?

It’s helpful to set money aside in an emergency fund. That may free you to think less about needing a certain amount of cash in your investment portfolio and enable you to focus on your investment objective(s). The knowledge that you may not have to sell investment assets at an inopportune time is a key part of helping you stick to your investment strategy in unfavorable markets.

The size of your emergency fund depends on your situation. A common recommendation is three to six months’ worth of salary, assuming that you are living off your salary rather than a pension or investments. But that may not be the right number for you. Are you a single earner or part of a two-earner couple? And how secure is your job? Or are you retired? How comprehensive is your medical plan? Are you prepared for a natural disaster that may damage your house or car? Only you can assess what unexpected events you need to provide for.

As a rule of thumb, Wells Fargo Investment Institute believes that it’s important for investors to set aside the equivalent of at least 3 to 6 months of living expenses in an emergency fund.