American Heritage Financial

September Update September 4, 2014

CASH: Hero or Zero?

We step away from our normal market update this month to focus on a unique and extremely important part of your portfolio: **CASH!** Cash is an asset unlike all others; it provides different kinds of risk, return and other characteristics compared to stocks, bonds, commodities, art, real estate, or other "typical" assets.

First, a definition: Investors use the term "cash" to identify an asset which is completely safe and fully liquid. Hard currency, checking accounts, savings accounts, and most money market accounts (or funds) fit our description of cash. CD's may be *"near cash"* because they satisfy the safety feature but, even extremely "short" CD's are not fully liquid. Most money market funds can be considered equivalent to cash although they are not guaranteed and thus do not meet the strict definition of "fully safe." Without getting into technicalities, most money market funds are extremely safe and satisfy the "cash" definition for all but the most cynical doom and gloomers. Cash in an investment account is usually held in money market funds and we use the term cash and money fund inter-changeably although, technically, cash does not earn interest.

Many people do not consider cash an "investment" for various reasons. Primarily, cash is the default form for money so if we fail to make a proactive decision to "invest," we simply hold cash. Also, cash provides virtually zero return in today's low interest rate environment and, as mentioned, it is different from other investments since it is fully liquid and safe. This is a misperception—**cash most definitely IS an investment and it is an important part of your portfolio and overall investment strategy.** In fact, a frequent discussion we have with clients involves questions about the type, amount and timing of cash investments and cash versus the alternatives.

The popularity of cash sky-rocketed during the 2008 and 2009 financial crisis as investors fled the stock market for the safe haven of cash. (Although at the time there were also concerns about the safety and liquidity of a few money market funds and even some bank accounts.) During the crisis, the Federal Reserve cut interest rates to near zero and "cash" went from earning attractive returns to near zero.

Even today, cash and/or money funds pay virtually nothing (just 0.02% on average, according to Crane Data). In spite of strong returns in stocks, bonds, real estate and other asset classes, and the negligible returns from cash, investors remain more heavily invested in money funds today than at any time prior to the crisis. Money fund assets have been fairly stable over the past five years at a level about 35% higher than the three years prior to the crisis.

The high level of cash investors continue to hold is an indication of continued high levels of anxiety and fear of riskier assets such as stocks. The correlation between the popularity of money funds and the stock market is reflected in Investment Company Institute data that showed net withdrawals from money fund balances for six straight months prior to July. The stock market dropped by 1.5% in July and investors immediately poured $3.8 billion into money-market funds. Outflows returned in August as the stock market rebounded.

There are two important things to understand about cash. First, even with current interest rates near zero, **cash does have a place in your portfolio because of the safety and liquidity it provides.** Cash will reduce overall volatility, help balance your portfolio, add stability and provide an immediate source of funds for investment opportunities or emergency needs. The maximum amount of cash in a "typical" portfolio is usually a small percentage, say 5% to 15%, and will vary depending on short-term strategy, opportunity and needs. Technically, you are losing ground if you are holding cash because of the impact of inflation. You may lose purchasing power but the stability of cash reduces the overall portfolio loss when other asserts are in decline.

The second thing to understand is exactly **what constitutes "cash" and how far you should venture into those "near-cash" alternatives.** Everyone is searching for that slightly higher return in a "safe" investment and the financial industry has responded with many "near-cash" alternatives. Nearly all of these alternatives have the potential (not guarantee) of just a tiny bit higher return than true cash investments but **that extra return comes with risks that are often misunder-stood and out of balance with the slightly higher return.**

Ultra-short mutual funds and exchange traded funds (ETF's) are the most popular "near-cash" alternative but most of these funds still pay less than 1% because the low interest earned from bonds they invest in is eaten up by fees and trading costs. Plus, they have the risk of loss in value when interest rates rise. A few select short-term bond funds, those with low fees, limited trading and high grade bonds, might be worth the risk for that slightly higher yield but keep in mind this is NOT cash.

Another alternative for the investor who wants to maximize their return on cash is to use an online bank product. Bankrate.com is a good source to research such offerings but it requires reading terms closely to understand potential risks or liquidity issues. Be sure the bank product has FDIC insurance and if it offers over 1% there are probably risks. Also, look at the actual difference in dollars you might gain in "near-cash" alternatives. Earning an extra ½ percent on $100,000 nets you just $500 in a year, for example.

The bottom line is that the small incremental gain from stretching for short-term yield in today's environment is probably not worth the risk or the hassle.

Best regards,

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?
Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com