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Learning How to Manage Cash as an Asset Class

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How much cash should you have in your portfolio? After the trading days we had in late August and early September it's tempting to say 100%. When markets are dropping we can never have enough cash and when they're going up some people go as far as carrying negative balances by buying stocks on margin accounts.

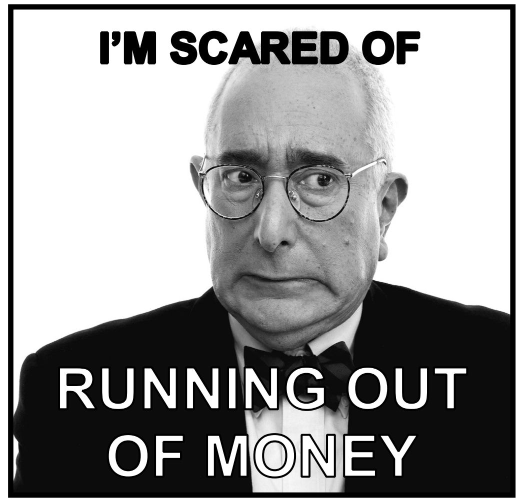
Cash is an asset class just like stocks in U.S Large or Small capitalization companies, International Emerging Markets or Intermediate Investment Grade Bonds. Because it is a specific asset class, cash plays a useful role in constructing an investor's asset allocation strategy and it should not be treated differently than the others.

When you make the decision to invest in the stock and bond markets, one of the first tasks that you need to complete is creating a long term investment strategy that details how much you'll invest in stocks, bonds and cash. If you are determined that you'll keep no more than 5% of your total assets in cash, then that needs to be the appropriate level of cash to maintain regardless of whether the market is in a correction phase or is chugging along with upward momentum. Remorse is not an emotion you should often feel as an investor, nor should you do too much handwringing because you're sitting in cash as markets are going up or you're fully invested when they are going down. These feelings need to be avoided to accomplish relaxed investment success.

If you find yourself hoarding cash, or getting nervous during market corrections because you don't feel like you have enough of a safety net, then it's possible that you haven't taken the time to get an accurate assessment of the amount of risk you're willing to take. Poor evaluation of real risk appetite and careless procrastination seem to be the two leading causes of inefficient stockpiles of cash that would otherwise be deployed in your portfolio.

A common infraction committed by individuals is to use a barbell approach in their portfolios: Allocating 50% of money committed to stocks on one side and 50% of assets in a money market account on the other. This method probably leads to disappointment at best; and at worst it can prohibit the investor from achieving the financial security desired.

The barbell approach will not immunize you from market losses and could lead to frustration when markets drop 40% in value and your account still loses 32% despite the 50% exposure limit you have to stocks. This can happen if the stock exposure you selected is not sensibly diversified. What's more serious is



-Ben Stein
Photo courtesy of: Fameimages.com

that this short term outcome isn't an isolated event; it has long term financial planning consequences. If you relinquish most of your returns in half of your investments by keeping it in cash while the balance of your money is invested in stocks that manage to achieve good results, the chances of reaching an average total return over the next 25 to 40 years necessary to fund your living expenses aren't very good. Even if you have zero investment costs in your portfolio the maximum average annual return a barbell approach will produce is probably no more than 5% for years to come.

Cash is undoubtedly the best safety net. Investment grade bonds are good, but they don't have the price stability that cash offers. So, if you need a safety net that will help you

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Identifying Valid Reasons for Holding Cash

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sleep during turbulent markets, then give some thought to what that amount might be. An objective way of identifying that figure might be to think about the amount of cash you need to meet the next twelve months of living expenses exclusive of non-guaranteed sources of income. If twelve months doesn't do it for you, then consider two years. Going beyond this amount is probably overdoing it.

There are valid reasons for holding cash, such a foreseeable expenditure. Maybe you plan to buy a home; a car; or you need to fund significant expenses such as tuition or a family vacation. These are all good reasons why you should increase your cash holdings. If you know that you'll need to spend $50,000 in the next 18 months without financing, then you should not risk that amount in volatile investments. The funds need to be set aside in reserve.

More than ordinary levels of cash also may be held if you want to reduce a little risk in your investments. To raise an extra 5% - 10% in cash in anticipation of a correction in an over-valued market is not an extreme measure. However, before doing so, be aware that deviating from an investment strategy has the potential to damage returns at least as much as it has the possibility to enhance them.

Don't forget that cash has a very sneaky enemy too. Most asset categories will provide returns that help to offset the loss of purchasing power caused by inflation. Cash does not offer that hedge. We haven't had to worry much about inflation for years but global money printing by central banks has the ability to quickly reverse that trend.

Market Snapshot: 10% Correction is in the Books, but More Pain Could be in Store

By: Michael Alexenko, CFA

Our last 10% correction happened in 2011 which makes this correction about four years past due. Nearly every year the market experiences a 10% correction, but we've been pampered by a Federal Reserve determined to keep asset prices fluffed up to persuade wealthy people that they feel richer so they'll go out and spend money to stimulate our economy.

The Fed's plan since 2009 has kept the market on a steady pace, increasing by 75% in the last three years alone. The Fed's first objective was achieved; higher asset prices. But the second, to grow the economy, has been somewhat elusive. If you examine a chart of how the market has performed for the past 6+ years and how the economy has grown, you'd notice that the gap between the two is striking. Stock prices are a function of a couple of main factors; health of the economy and growing corporate profits. It's hard to have the second element without the first occurring. We've had growing profits through some real organic activity but also through some crafty financial engineering techniques that may have made things a look better than they are.

The recent price action in our market and other global markets have been unsettling. Too many trading days are seeing intraday swings of nearly 2% in value from the peak to the trough. That's caused volatility measurement to soar and that means more risk. I don't like to carry too much cash in portfolios but if your portfolio is fully weighted or possibly over-weight in stock it might not be a bad idea to be thinking about raising a little cash in your accounts when the market offers some sharp rally opportunities.

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