SilverOak
WEALTH MANAGEMENT LLC

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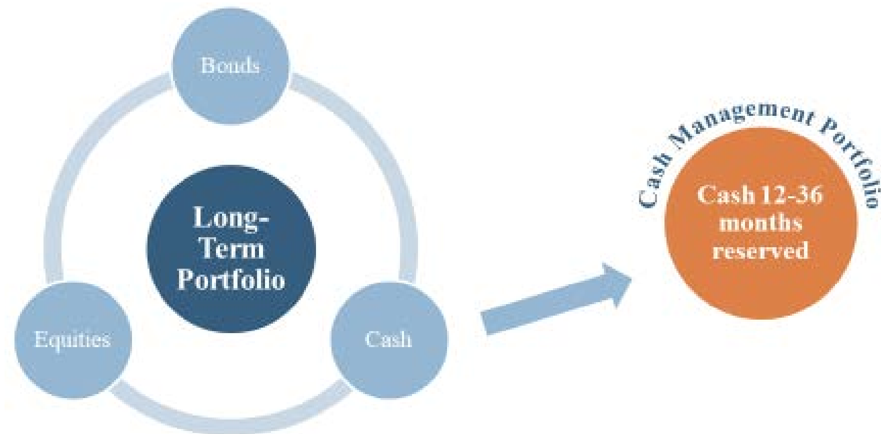
Role of Cash

With today's interest rates at levels not seen in a decade, it is important to revisit the role that cash plays in financial management to ensure that you are on track to meet your goals.

At SilverOak, we do not view cash as an appropriate asset for a long-term portfolio. However, as part of an overall financial plan, cash can play many roles. Cash can be a source of stability to investors who may have anxiety about market volatility, while also providing them with a strategy to weather unforeseen events and plan for upcoming expenses. Thus, for many clients, it is prudent to manage a cash reserve separate from their long-term portfolio.



Cash can serve as an emergency fund or cash buffer:

- A general recommendation is a reserve large enough to cover three to twelve months of expenses.
- For those in retirement, a cash reserve that covers one to three years of living expenses may be desired to avoid drawing from the long-term portfolio in the event of a market downturn.

Cash reserves can also be useful for non-routine expenses:

- Unexpected expenses like employment changes, health expenses, and other life events.
- Planned expenses over the next one to five years, such as a house purchase, wedding, new child, new car, etc.

How to invest cash and where:

There are many prudent ways to invest cash. When choosing a strategy, it is important to determine the liquidity needs, yield desired and time horizon of the savings goal.

- If liquidity is the priority, then a yield-bearing savings account or a money market fund may be ideal.
  - Savings account – often has a lower yield than other cash options and is FDIC insured[1].
  - Money market fund – invests in very short-term high-quality debt. The yield fluctuates, but tends to be higher than a traditional savings account. Money market funds are not FDIC insured, but they are SPIC insured[2].
- For goals that have a more extended time horizon, yield may be more important than liquidity. A CD, treasury or short-term bond fund may be appropriate.

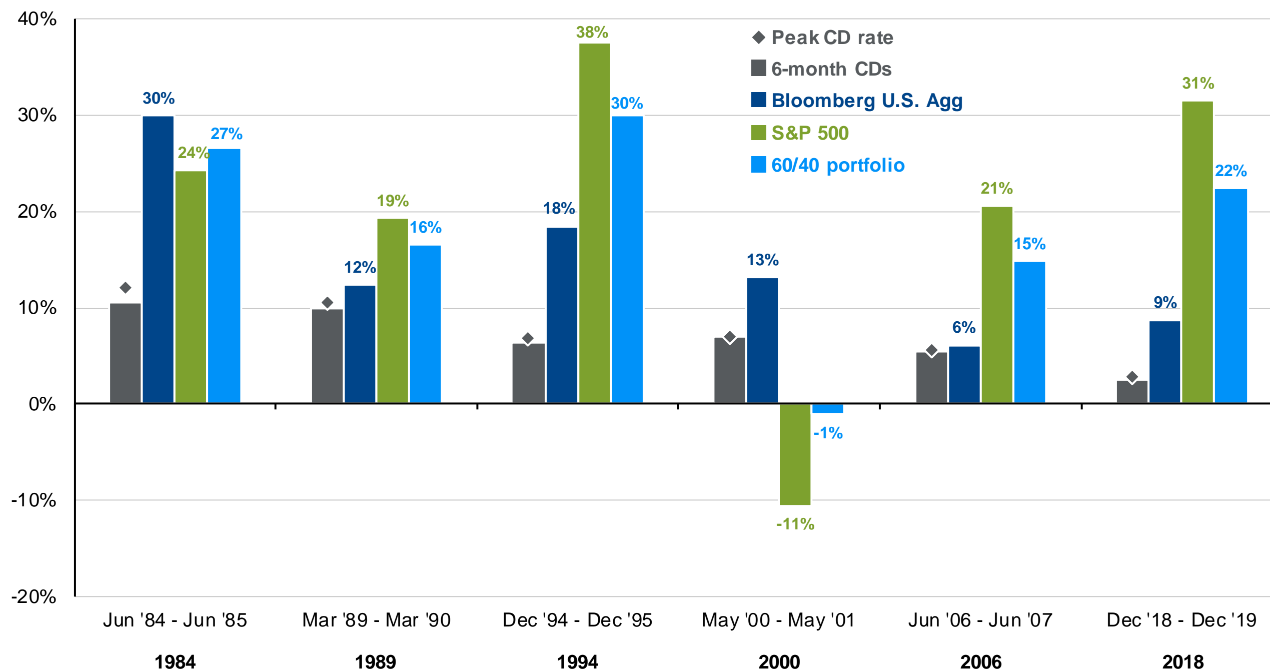
- o Certificate of Deposit (CD) – earns a fixed rate over a specific term, and are FDIC insured. Brokered CDs can be traded on a secondary market, and are SPIC insured[2].
- o U.S. Treasuries – issued by the U.S. government and have a fixed term and yield. Not FDIC insured, as they are backed by the U.S. government.
- o Short-term bond fund – invests in a basket of short-term fixed income securities. As these are investments, they are not FDIC insured. If held in a brokerage account, they're SPIC insured[2].

The right level of cash may be different for each client based on their goals. Having too little cash may result in having to draw from your investment portfolio to cover shorter-term expenses and needs, reducing the capital available to meet your long-term objectives. However, cash returns do not keep up with inflation so having an over-abundance of cash in your portfolio can also reduce your investment power over time, potentially impacting your financial goals.

Risks of cash

Cash instruments currently have relative high yields, making them attractive to investors who are trying to forget the negative returns in fixed income and equities in 2022. However, it is important to note that even safe cash instruments come with risks that need to be considered and balanced.

- Reinvestment risk is the potential that interest rates decline and the reinvestment of cash would be done at lower rates. For instance, in a recession the Federal Reserve would cut rates and investors in cash would have to reinvest at lower rates.
- Though current yield percentages on some cash vehicles are very attractive, it is important to note that yields are annualized based on the maturity of the instrument. Thus, a 3-month Treasury bond yielding a 5% annual return only achieves that return if, at the 3-month maturity mark, it is then reinvested into additional Treasuries yielding 5% for a total investment period of one year.
- Cash is particularly susceptible to inflation risk. Cash returns may not keep up with inflation over the long-term, resulting in a decline in the purchasing power of held cash.
- Additionally, there is the risk that the return from cash will not be enough to meet long term goals. The chart below highlights reinvestment risk and potential missed opportunities of sitting in cash at peak interest rate over several 12-month periods.



Source: Bloomberg, FactSet, Federal Reserve, Robert Shiller, J.P. Morgan Asset Management.
The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. The S&P 500 total return figure from the 1984 period was calculated using data from Robert Shiller. The analysis references the month in which the month-end 6-month CD rate peaked during previous rate hiking cycles. CD rate data prior to 2013 are sourced from the Federal Reserve, whereas data from 2013 to 2023 are sourced from Bloomberg. CD subsequent 12-month return calculation assumes reinvestment at the prevailing 6-month rate when the initial CD matures. Guide to the Markets – U.S. Data are as of March 19, 2024.

Cash management is an important part of financial planning. If cash is appropriately managed, investors will have liquidity to fund short-term needs. Investors may also feel less of a temptation to try timing the market or endlessly shift assets to cash from stocks or bonds. At today's interest rates, it is important to seek the best location for funds and to match risk with goals. However, parking investments into cash instruments/low duration products due to currently high short-term rates and a perceived avoidance of risk is usually not a prudent long-term investment strategy.

Disclaimer:
Information and analysis provided in this white paper are for general and educational purposes only. Any opinions expressed in this summary are not intended to be accounting, legal, tax or investment advice.

Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.

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1) The Federal Deposit Insurance Corporation (FDIC) provides insurance on deposit accounts at member bank and financial institutions. A depositor is automatically covered up to $250,000 per category when they open an account.

2) The Securities Investor Protection Corporation (SIPC), a non-profit created by federal statute in 1970. The SIPC functions similarly to the FDIC, insuring client brokerage accounts in the event that their SIPC-member brokerage firm is forced into bankruptcy. Investors are covered up to $500,000 in securities (including a max of $250,000 in cash) per "separate capacity" or account category.