

# It's Costly to Hold Cash

September 10, 2014

## Summary

*Staying in cash while waiting for the Fed to raise interest rates requires a large sacrifice in income. It's important to remember that the losses incurred in a rate rise are mainly temporary, rather than permanent. And historically, the average price drop associated with a one-percentage-point rise in short-term interest rates has been relatively modest. For a large proportion of investors, the risk-reward tradeoff will favor keeping cash balances low and enjoying the benefits of higher income generation.*

## Analysis

Are you staying in cash while you wait for the Fed to start raising short-term interest rates? It's natural to want to protect principal, knowing that the prices of income-producing assets generally decline when interest rates rise. There is a cost to staying in cash, however: You sacrifice income that you could otherwise collect by owning such assets as bonds, preferred securities, master limited partnerships, and dividend growth stocks.

Each investor has a unique, personal basis for deciding what percentage of assets to hold in cash. The right answer for you depends on your liquidity needs, risk tolerance and the extent to which you depend on investment income. To make the best choice, however, you should clearly understand the nature of the risk and quantify it.

First, on the nature of the risk associated with Fed tightening, **it's important to differentiate between temporary and permanent losses.** If you own a fixed-rate bond, for example, its price will decline when interest rates rise. Unless the bond defaults, however, the price will eventually return to par (100). In that case, you'll suffer no permanent loss unless you sell at a discount prior to maturity. The key advice is to stay away from very long maturities. That way, you won't have to wait too long to roll over maturing bonds into the new, higher yields.

Rising interest rates may also put price pressure on dividend growth stocks. Over time, however, dividends on well-selected stocks will continue to grow along with the companies' earnings.

The multiple that the market applies to those earnings will vary from year to year. But the stocks should not just recover their value, as with bonds, but ultimately increase in value.

Turning to the quantification of risk, the table below shows what has actually happened to prices of various asset categories during past increases of approximately one percentage point in short-term interest rates. The asset categories are listed in order of their duration, a measure of interest rate sensitivity that is partly a function of average maturity, as of August 31, 2014. (In the preferred category, only investment grade issues are included, due to lack of sufficient historical data on the speculative grade index.)

On average, the loss of principal during a roughly one-percentage-point rise in short-term rates has ranged from just 2.42% on BB corporate bonds to 4.87% on ten-year Treasury bonds. Equities *rose* by an average of 10.36% during these periods. The comparatively strong performance of BB corporates and stocks makes sense when you consider that rising interest rates are ordinarily associated with an improving economy, which stimulates demand for credit.

A few caveats are in order. First, the most recent episode depicted occurred in 2006. The U.S. economy has not undergone a radical transformation since then, but the six historical incidents took place before the Federal Reserve instituted its present, unconventional monetary policy. Note, too, that the bottom-line numbers are averages of figures that vary from one episode to another. So the outcomes during the next one-percentage-point rise in short-term rates may diverge significantly from the averages.

<b>Historical Price Impact of 1-Percentage-Point Rise (Approximately) in 3-Month Treasury Yield</b>						
<b>Period</b>	<b>Price Change (%)</b>					
	<b>5-Yr Treasuries</b>	<b>BB Corporates</b>	<b>Inv. Grade Preferreds</b>	<b>AA Corporates</b>	<b>10-Yr Treasuries</b>	<b>Equities</b>
9/98-12/99	-9.10	-6.28	-11.08	-9.17	-14.94	+40.95
12/99-9/00	+1.90	-4.38	+5.36	+0.89	+2.88	-2.29
6/03-9/04	-2.52	+3.02	-2.84	-3.92	-3.94	+15.81
9/04-3/05	-3.39	-1.93	-3.45	-2.50	-3.06	+5.92
6/05-12/05	-3.19	-2.95	-2.54	-2.82	-4.07	+4.78
12/05-6/06	-3.38	-1.99	-3.72	-3.48	-6.08	+1.76
<b>Average</b>	<b>-3.28</b>	<b>-2.42</b>	<b>-3.05</b>	<b>-3.50</b>	<b>-4.87</b>	<b>+10.36</b>
Duration (8/31/14)	4.76	4.92	6.21	6.62	9.04	NM

**Indices:**

- BofA Merrill Lynch Current 5-Year US Treasury Index
- BofA Merrill Lynch BB US High Yield Index
- BofA Merrill Lynch Fixed Rate Preferred Securities Index
- BofA Merrill Lynch AA US Corporate Index
- BofA Merrill Lynch Current 10-Year US Treasury Index
- Standard & Poor's 500 Index

Sources: BofA Merrill Lynch Global Research, used with permission; Bloomberg. August 31, 2014

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**On the whole, though, a large proportion of investors should feel comfortable with the magnitude of rate-hike risk embedded in a portfolio that is diversified across several asset categories. They will conclude that it is not worth giving up substantial income by keeping a large portion of their wealth in cash, just to avoid a modest, temporary loss of principal value.** Barring defaults and dividend suspensions or reductions, their income will hold steady or even grow as the Fed hikes short-term rates. And it is the level of that income, rather than the fluctuating market value of their portfolios, that most directly affects their lifestyles.

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