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Is your Cash Dragging you Down?

By Gil Hanoch, June 5, 2006

Updated Data February, 2011

This article presents the effects of holding unplanned cash in an investment portfolio and the benefits of optimizing the cash level.

Let's first discuss planned cash. Every investor needs cash in order to meet daily expenses during severe declines of the investment portfolio. This amount should be decided upon before putting any money in the stock market, because sharp declines can come at a surprise leaving no time for last minute planning.

Once you set aside the amount of planned cash, your goal should be to minimize the amount of extra cash in your investment portfolio. This excess cash is a well-known investment phenomenon. It can come from many different sources, but they all can be summarized by the following definition.

Cash Drag: the negative effect on a portfolio's performance due to holding cash beyond the amount specified in the Investment Plan.

Each of the following is a reason to minimize your Cash Drag:

1. You already defined the amount of cash needed for your short-term security and set aside this amount. Any extra cash is eating away at your long-term growth.
2. If you don't plan how much you will leave in cash and therefore don't have a set amount that is consistently available, you cannot count on a set amount to be there when you need it most.

We shall identify a few categories of Cash Drag. For categories you can control, the impact will be presented. The cash will be assumed to earn 15% less than the stock portfolio[1]. In addition the impact will be expressed in terms of loss for a retiree with a portfolio of $1,000,000.

Cash inside mutual funds: All mutual funds carry cash to meet potential daily redemptions. There is no way to avoid this amount altogether, but you can minimize this by choosing index funds that tend to have a low percentage of cash.

Cash for liquidity: Cash that brokers and investment advisors hold inside investment accounts for upcoming management fees and transactions. This can be completely eliminated, if the investment professional plans right. These amounts tend to be relatively small, but not insignificant. 2% excess cash for this purpose would reduce your total returns by 2%x15% = 0.3%, lowering the 17.2% growth to 16.9%, or costing the $1,000,000 retiree $3,000 per year.

Cash waiting for the right investment opportunity: Investment professionals and individuals that try to pick promising stocks have to leave cash available for the right moment. These amounts tend to be significant and can run as high as 30% or more. The impact of 30% in cash, would be 30%x15% = 4.5%, lowering the 17.2% total growth to 12.7%, and costing the retiree $45,000 per year.

[1] The 15% difference in growth is based on:

- 2.2% growth of cash, reflecting the returns of various cash accounts and their inferior tax position compared to stock funds.
- 17.2% growth of stocks, based on the long-term simulated returns for Long-Term Component by Quality Asset Management.

Cash allocated to protect from an anticipated recession: This is the most dangerous category of Cash Drag, for two reasons: the size of the cash allocation and the attempt to time the market. Some people allocate large amounts of cash when a recession is anticipated. A not uncommon allocation of 50% costs the investor an average of 50%x15% = 7.5%, lowering the 17.2% annual growth to 9.7%, costing the retiree $75,000 per year!

The impact is magnified by the timing component. In nearly all cases, the allocation to cash happens after the beginning of a decline or well before it, and the allocation back to stocks usually happens after the surge in stock prices is over.

When making the allocation after the decline began, you immediately realize a loss. For example, many stock portfolios frequently decline by 10% from their recent peak. Anyone that gets nervous about the future of the portfolio, and allocates 50% to cash, would realize an immediate 50%x10% = 5% loss, or $50,000 for our retiree!

When reverting the allocation to stocks after the recovery began, you give up these gains. People that experienced a dramatic shock by the 2000-2002 recession, waited for a long time to put money back into stocks. A retiree that had 50% in cash and waited until the end of 2004 to put the cash into stocks would have given up more than 100% growth in a portfolio like Long-Term Component. If our retiree had $500,000 of the $1,000,000 portfolio in cash, this would amount to losing $250,000!

To Summarize

No matter how adventurous you feel, how strongly you believe in your predictions or how fearful you are of a recent decline turning into the worst recession you've ever seen, please be very careful with your money. This is not a $20 gamble in Las Vegas – you are gambling with your life's savings. The most conservative approach to investing involves planning *in advance* for severe scenarios. Once your plan is ready, keep it in writing, and stick to it without gambling on stock increases or recessions.