HEALTH WEALTH CAREER

CASH: RETURN OF THE KING?

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"We always keep enough cash around, so I feel very comfortable and don't worry about sleeping at night. But it's not because I like cash as an investment. Cash is a bad investment over time. But you always want to have enough so that nobody else can determine your future."

— Warren Buffet

As Buffett explains, the primary role of cash is to serve as a valuable pool of liquidity, available to meet investors' short-term liabilities, and to protect investors from falling into the trap of forced asset selling to cover their outgoings. However, in the current market environment investors with high risk aversion or constraints may have other reasons to hold cash. 2018 reminded us of the real risk that bonds and equities may produce negative returns in the same period, with cash outperforming both, simply by not underperforming. With historically low bond yields following a decade of loose monetary policy in developed markets, the relative attractiveness of bonds is reduced and cash could offer tactical advantages in an investor's toolkit.

CASH PRIMARILY PROVIDES LIQUIDITY

How much money or how many outgoings an investor requires from a portfolio at any one time can be described as the liquidity need. The level of liquidity required, and where that liquidity is sourced from, can be informed via a liquidity budgeting exercise. These exercises stress test an investor's liability needs and asset liquidity together under different (including highly stressed) environments.

This process tests the liquidity across the asset base, and cash is clearly not the only liquid asset. However, "emergency funds" should be available in an emergency and cash is somewhat unique in this regard in being both highly liquid and exhibiting *almost* no downside risk.[1]

In this context, we need to be clear what we mean by "cash" — "cash is cash" is not a fair description of what is a broad universe. An investor in a cash fund needs it to be true to its label, and this will depend on the fund's underlying construction. Most famously, in the global financial crisis (GFC), the largest US cash fund, the Reserve Fund, "broke the buck"[2] due to a significant holding of now-defaulted Lehman Brothers' notes. In this highly illiquid environment, cash funds (as investors' most liquid asset) also faced significant liquidity demands and, as a result, some mark-to-market losses. This result was akin to a run on a bank, with investors withdrawing money for fear their cash holding was not truly low default risk "cash."[3]

In the years following, regulation has limited the underlying holdings that a cash fund can hold, so that cash is truly cash, but investors should be aware of the underlying securities of cash funds and ensure that these are in line with their investment objectives and reasoning for considering a cash investment.

Our reference to cash in this paper refers to the asset class invested in by institutional investors, with the asset class typically holding very-short-dated fixed income instruments through pooled funds or segregated accounts with investment managers. Money market investments have historically been widely regarded as safe as (or safer than) holding deposits in a bank, while also providing a marginally higher yield.

INSTRUMENT	DESCRIPTION
Treasury bills or notes	Government-Issued short-term bonds (up to one year in maturity)
Bank floating rate notes	Typically, longer maturity of one to five years; interest rate is tied to a benchmark — e.g., in the US to the US Federal Funds rate
Certificates of deposit	Short-term securitized bank lending (up to two years maturity)
Commercial paper	Unsecured, short-term debt instrument issued by a corporation; up to 270 days in maturity but typically very short term in nature
Asset-backed commercial paper	Commercial paper, secured against assets
Repurchase agreements	Short-term lending of government debt (usually overnight but can be up to one year)

1. Cash is considered very low risk relative to bonds, equities and property. It is not completely risk free, however, as it has a small risk exposure in a number of areas (reinvestment risk, counterparty risk, liquidity risk relating to the underlying securities held).
2. This is when the Net Asset Value of a cash fund falls below $1.
3. A number of investors were invested in "cash" funds, but that held underlying securities subject to default risk.

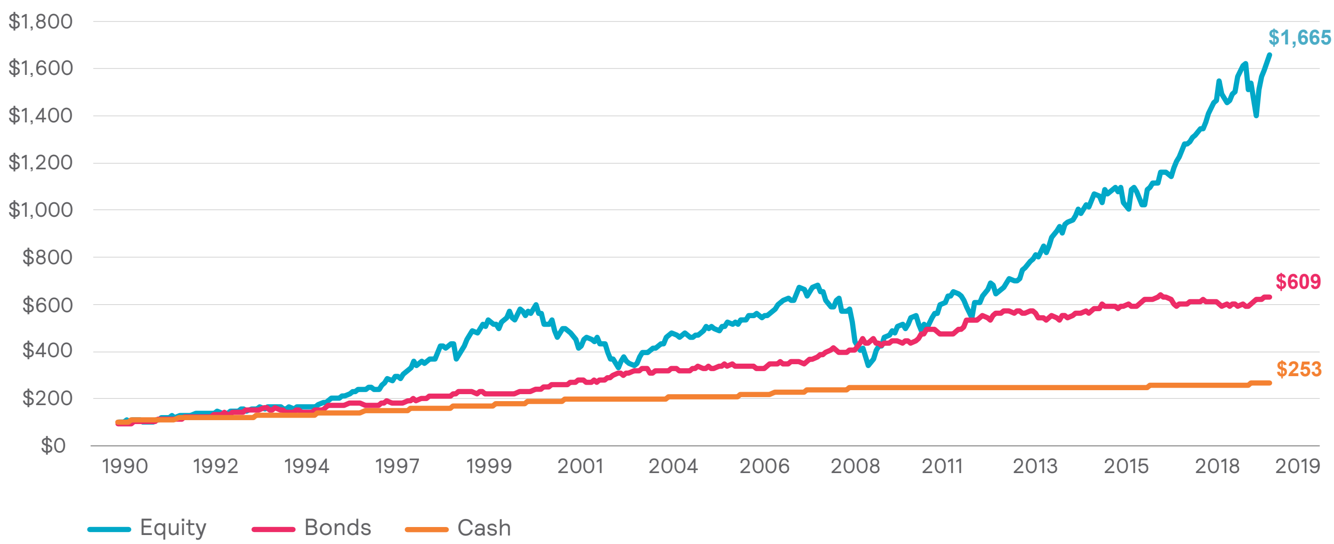
CASH IS NOT A LONG-TERM INVESTMENT

While how much liquidity is **required** is a strategic decision, how much liquidity is **desired** (in excess of that) is a function of a shorter-term or dynamic asset allocation process. This can include both the extent to which an investor has the ability to be opportunistic and the strength of an investor's views in relation to the balance of risks and opportunities in investment markets at any one time. More opportunistic investors tend to have more cash around, looking for the big wins.

Investors who are more long-term strategic in nature do not hold large pools of cash because of its limited return potential. In the context of long-term investing, a holding in cash is often seen as "underinvested."[4] Figure 1 clearly highlights the opportunity cost of investing in cash.

Figure 1 also clearly shows the 10 years since the financial crisis, when cash returns were very poor relative to riskier assets, especially equities, due to low to zero official interest rates and quantitative easing (QE).[5]

FIGURE 1. GROWTH OF $100 IN US EQUITIES, BONDS AND CASH
JANUARY 1990 TO APRIL 2019

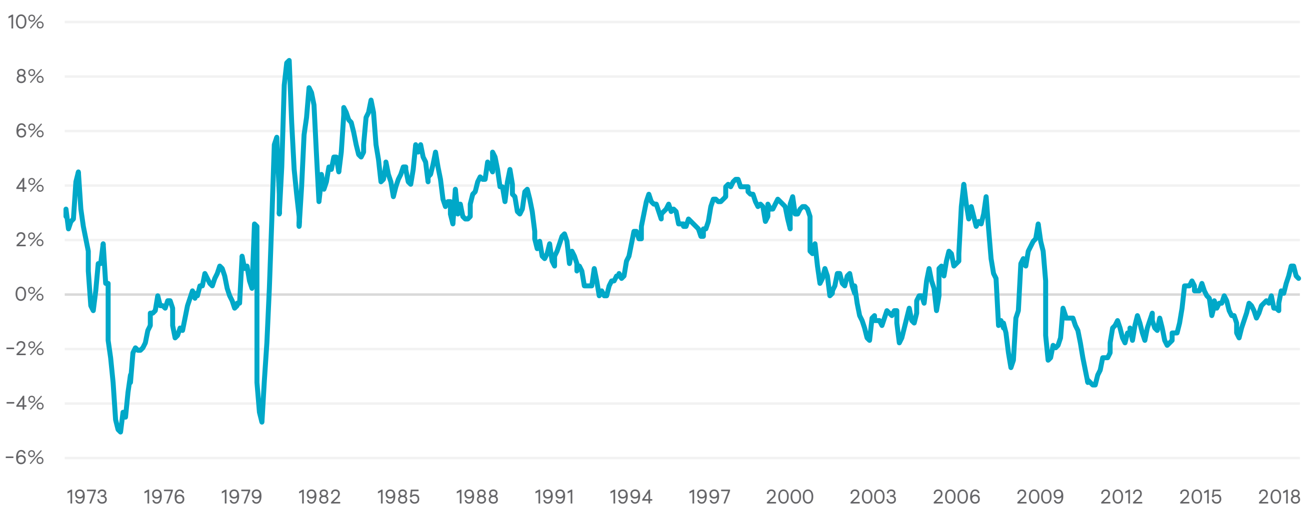


Source: Thomson Reuters Datastream
Nominal returns. S&P 500 Index, ICE BofAML US Treasury 7-10 years, 3-month LIBOR

4. Or not invested at all, in the case of investors with a cash return benchmark.
5. QE is the name given to central bank asset purchase programs that were implemented in the wake of the GFC. The majority of these assets were bonds.

Rates during this period challenged the conventional wisdom that the cash rate should be at least equal to the rate of inflation or higher — the median US real interest rate for the period since 1972 has been around 1% per annum, but for much of the post-crisis period real interest rates have been negative in most developed countries (Figure 2).

FIGURE 2. US REAL INTEREST RATE
DECEMBER 1972 TO APRIL 2019



Source: Thomson Reuters Datastream
Returns are in nominal terms. S&P 500 Index, ICE BofAML US Treasury 7–10 years, 3-month LIBOR.

WINNING BY NOT LOSING

Although it is hard to argue a long-term return-based rationale for holding cash,[6] a stronger case could be made for including cash in more conservative portfolios to help with risk reduction. Total multi-asset portfolio risk can be reduced in one of three ways:

A. Increase exposure to negatively correlated assets (increase diversification and downside risk characteristics).

B. Increase exposure to low positive correlated assets (increase diversification and therefore risk-adjusted return).

C. Reduce exposure to higher risk assets in favor of lower-risk assets (reduce average risk per dollar invested).

Historically, sovereign bonds have met the first criterion. This is why bonds have historically been the "40" in a traditional "60/40" portfolio. Cash really meets only the third criterion and is why long-term strategic allocations have preferred longer-term bonds for risk reduction.

However, the level of current yields and the outlook for bonds are such that the relative attractiveness of bonds is reduced. Our unconstrained balanced reference portfolio includes allocations to cash as well as sovereign bonds to manage downside risk. This is on the grounds that, while sovereign bonds may still provide some negative correlation benefit in a severe equity market setback, there are certain conditions — captured in our stress tests — that could see both bonds and equities fall together.

Such conditions were seen in 2018 — a poor year for investors, in which more asset classes had negative returns than in 2008. Investors were reminded that equities are indeed volatile, that what goes up can come down, and that in environments where markets become concerned about inflation and interest rate risk, both equities and bonds can produce negative returns at the same time. Cash, in true Steven Bradbury style, emerged as the winner, simply by not losing (Figure 3).

6. Our global diversified growth portfolios, which target equity-like returns over seven years with two-thirds of the risk, do not hold any cash (favoring cash-plus strategies, such as absolute return bonds and hedge funds).

FIGURE 3. RETURNS OF MAJOR ASSET CLASSES, 2008–2018, IN USD

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
TOP PERFORMING	Global Bonds 4.8%	EM Equities 79.0%	REITS 27.6%	Global IL Bonds 10.2%	Europe Equities 20.1%	S&P 500 32.4%	REITS 27.1%	REITS 2.3%	Global HY 14.2%	EM Equities 37.8%	US Cash 2.3%
	US Cash 3.8%	Global HY 59.4%	EM Equities 19.2%	US IG 8.1%	REITS 20.1%	Europe Equities 24.4%	S&P 500 13.7%	S&P 500 1.4%	S&P 500 11.9%	Europe Equities 26.1%	Global Bonds -1.2%
	US IG -4.9%	Europe Equities 38.5%	S&P 500 15.1%	REITS 7.3%	Global HY 19.6%	Global HY 7.3%	US IG 7.5%	US Cash 0.3%	EM Equities 11.6%	S&P 500 21.8%	US IG -2.5%
	Global IL Bonds -7.7%	REITS 27.4%	Global HY 14.8%	Global Bonds 5.6%	EM Equities 18.6%	REITS 3.2%	Global IL Bonds 3.4%	US IG -0.7%	Commodities 11.3%	Global HY 10.4%	Global HY -4.1%
	Global HY -26.8%	S&P 500 26.5%	Commodities 9.0%	Global HY 3.1%	S&P 500 16.0%	US Cash 0.3%	Global Bonds 0.6%	Global HY -2.7%	REITS 9.3%	REITS 9.3%	REITS -4.1%
	S&P 500 -36.9%	US IG 18.7%	US IG 9.0%	S&P 500 2.1%	US IG 9.8%	Commodities -1.2%	US Cash 0.2%	Europe Equities -2.7%	US IG 6.1%	Global IL Bonds 8.7%	Global IL Bonds -4.1%
	REITS -37.3%	Global IL Bonds 13.6%	Global Bonds 5.5%	US Cash 0.3%	Global IL Bonds 8.5%	US IG -1.5%	Global HY 0.0%	Global Bonds -3.2%	Global IL Bonds 3.9%	Global Bonds 7.4%	S&P 500 -4.4%
	Commodities -46.4%	Commodities 13.5%	Europe Equities 5.1%	Commodities -1.2%	Global Bonds 4.3%	EM Equities -2.3%	EM Equities -1.8%	Global IL Bonds -5.0%	Global Bonds 2.1%	US IG 6.4%	Commodities -13.8%
	Europe Equities -47.2%	Global Bonds 6.9%	Global IL Bonds 3.0%	Europe Equities -11.2%	US Cash 0.4%	Global Bonds -2.6%	Europe Equities -6.7%	EM Equities -14.6%	Europe Equities 1.0%	Commodities 5.8%	Europe Equities -14.2%
WORST PERFORMING	EM Equities -53.1%	US Cash 0.7%	US Cash 0.3%	EM Equities -18.2%	Commodities 0.1%	Global IL Bonds -3.2%	Commodities -33.1%	Commodities -32.9%	US Cash 0.7%	US Cash 1.3%	EM Equities -14.2%

EM = Emerging Market; REIT = Real Estate Investment Trust; IL = Inflation Linked; HY = High Yield; IG = Investment Grade

Source: Thomson Reuters Datastream. Indices used (highest to lowest return order in 2008)
Bloomberg Barclays Global Aggregate; IBA US Interbank 3-month LIBOR; Bloomberg Barclays US Corporate Investment Grade; Bloomberg Barclays Global Inflation Linked; Bloomberg Barclays Global High Yield; S&P 500 Composite; FTSE Nareit All REITs; S&P GSCI; MSCI AC Europe; MSCI Emerging Markets

CURRENT CONDITIONS

Market conditions have softened in recent months, as outlined in *Mercer's Global Dynamic Asset Allocation* report (April 2019), but longer-term bond yields could still face upward pressure (leading to poor bond performance).

"The shift in the Fed's stance reduced the short-term risk that overly restrictive Fed policy could lead to a downturn. Moreover, it has contributed to an easing of financial conditions, which has improved the global growth outlook. Still, with a tight labor market, the Fed might eventually need to lift rates to anchor (higher) inflation expectations."

Furthermore, yields are currently so low that we prefer shorter-duration exposure, with the yield curve inverted in the US.

"With virtually no yield premium for extending duration (aside from liability hedging), we prefer shorter-duration exposure."

A near-zero or negative difference between the yield on a three-month treasury bond versus a 10-year treasury bond (but with a 10-year treasury bond having higher sensitivity to rising interest rates), combined with yields that are historically low, means that we have a preference for shorter-duration or cash-like bond exposure, due to the fact that an inverted yield curve makes cash a better alternative to bonds from both real and nominal perspectives.

CONCLUSION

Over the 10 years that have passed since the GFC, low inflation expectations and historic experiments in monetary policy have driven a bond bull market in investment assets. Investors with a strategic allocation to cash would have seen a significant return drag in their portfolio, compared to traditional stocks and bonds.

However, what the next 10 years will hold is likely to differ greatly. 2018 was a good example of a market that is wary of central banks reducing the support they have offered post-GFC. Although the Federal Reserve has paused in its tightening, feed-through from tight labor markets to inflation would likely see the Fed shift back from support to constraint. In this hypothetical environment of inflationary pressures and tightening monetary policy, negative returns from both bond and equity assets could be a realistic outcome.

Even in the absence of a tightening monetary policy environment, the outlook for global growth and trade remains uncertain, and certain investors with the governance allowance could be wise to keep some "dry powder" in their portfolio, ready to deploy in the case of significant market turmoil.

For these reasons, cash could potentially wake from its decade-long sleep to become a useful and desired tactical asset class in any investor's portfolio.

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