Cash Is Important To Your Portfolio

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Cash and Your Mother: Important To Your Portfolio

By Linda McDonough (bio at end)
April 11, 2018

I once had a finance professor who began the semester with the shocking line, "Cash is more important than your mother". Certainly, this grabbed the attention of forty sleepy-eyed co-eds accustomed to the more conservative stance of a Jesuit institution.

However, thirty years later, the bulk of them spent analyzing stocks, I must admit some truth to his statement. Look no further than the demise of Toys R Us to witness the harm of not enough cash. This retailer is an outlier, of course. The company wilted under the weight of $5 billion in debt that its private equity owners ladled onto it. When expected sales failed to appear, the company had too little cash flow to cover its interest payments.

Also, the recent wild swings in the stock market and the crash of speculative investments like Bitcoin illustrate the benefits of holding some cash in your portfolio.

Portfolio managers have been trained to hold very little cash. In a bull market, each dollar left un-invested nips a bit profit off a manager's fund. In a world where these managers must prove their funds can perform better than a market index, even a small bit of cash can put a drag on returns.

But, lucky you! You are not required to publish your returns or showcase great numbers to entice potential customers. You can structure your portfolio in any way that generates sufficient returns and allows you to sleep at night.

The decision of how much cash to hold perfectly illustrates the combatting forces of fear and greed. Fear of losing money in the stock market propels investors to hold more cash. Yet, once the market throws on its bullhorns, fear of missing out on future upside sends that cash back into the market.

Like most investment decisions, the choice of how much cash you hold is a personal one. It should be based on how long you expect to hold investments, the level of expenses you hope to pay out of investments, and your risk profile.

College tuition or a new house on your near-term horizon? More cash. Ten years until retirement and a substantial savings buffer? Less cash.

The good news for anyone is that cash is not the dirty word it used to be. Just two years ago, the three-month T-bill paid almost ZERO interest. A slow creep up since 2016 has accelerated into an all-out sprint with the current three-month T-bill paying 1.69%.

This means that holding "cash" can actually produce some well-deserved income to your portfolio.

For those willing to go further out in the investment horizon, the ten-year T-bill pays 2.8%. Many expect this rate to rise to almost 3%. That may not sound like a lot but comparing those rates against potential losses of capital in the market paints these rates in a whole new light.

Government T-bills are the most conservative "cash-like" investment to own. Despite the gigantic budget deficit the U.S. runs, our T-bills are still considered the gold standard of safe bets.

If you desire more risk to boost your potential return, you could certainly investigate corporate bonds. These require much more homework and consideration. Overall corporate debt is at decade-high levels. The rating firm S&P recently warned that almost 40% of its universe of corporations held debt levels that are bumping up against acceptable levels.

Extremely low rates and an abundance of capital available to corporations have overfed many companies with debt. If any of that debt carries variable rates, the company may be in for a bit of pain.

While it can be tempting to traffic in high-yield or junk debt, which offers much higher rates, the chance of default or a major drop in the bond price before maturity can be quite painful.

In the meantime, be nice to your mother, no matter how much you have saved up. And perform a litmus test on your portfolio. If your exposure to equities makes you squeamish, consider adding some comfort cash into your portfolio.

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See About the Analyst below.

About the Analyst

Linda McDonough is a veteran hedge fund analyst who loves to break down company financial statements and identify market inefficiencies to uncover big opportunities. She believes in a boots-on-the-ground approach that includes surveying customers, interviewing company executives, or doing whatever it takes to see what others don't. She's now brought her experience as a hedge fund analyst to subscribers of her *Profit Catalyst Alert* service. Her system identifies small- and mid-cap stocks that are about to move due to catalytic events that few others can identify…until it's too late. These events often times result in massive gains for her followers.