The cash conundrum – fight or flight?

Morningstar Investment Management South Africa

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For Financial Advisors and their Clients

Fight or flight refers to the instinctive physiological response to a threatening situation, which readies one either to resist forcibly or to run away. When markets are turbulent, we often see investors struggle with the same physiological response. They are left to choose between staying invested amid the volatility (i.e. fight) or fleeing (i.e. flight) to safe-haven assets and cashing out their investments. More often than not, the latter path is taken.

In early 2020, we saw the S&P 500 plunge from an all-time high due to market uncertainty regarding the looming pandemic. The opposite, however, was true for money market funds, which saw its assets under management jump by close to 20% (or as much as $685 billion in March of 2020) posting the highest monthly inflow in, at least, three decades.

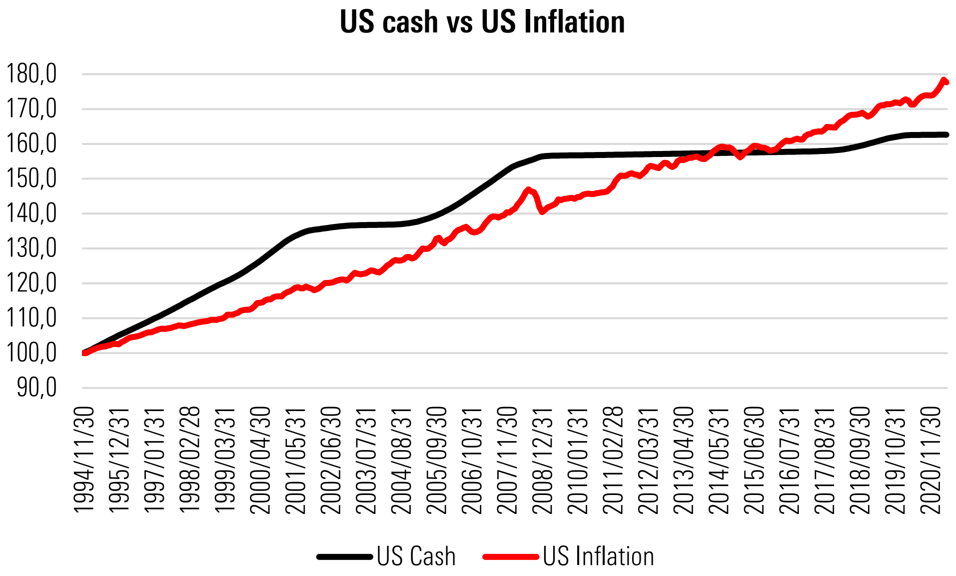
Is cash king?

While the saying "cash is king" has some truth to it, it is not without risk either. Cash is an important piece in the asset allocation puzzle and should be considered holistically when looking at a client's overall financial plan.

Cash has many advantages, a few examples include:

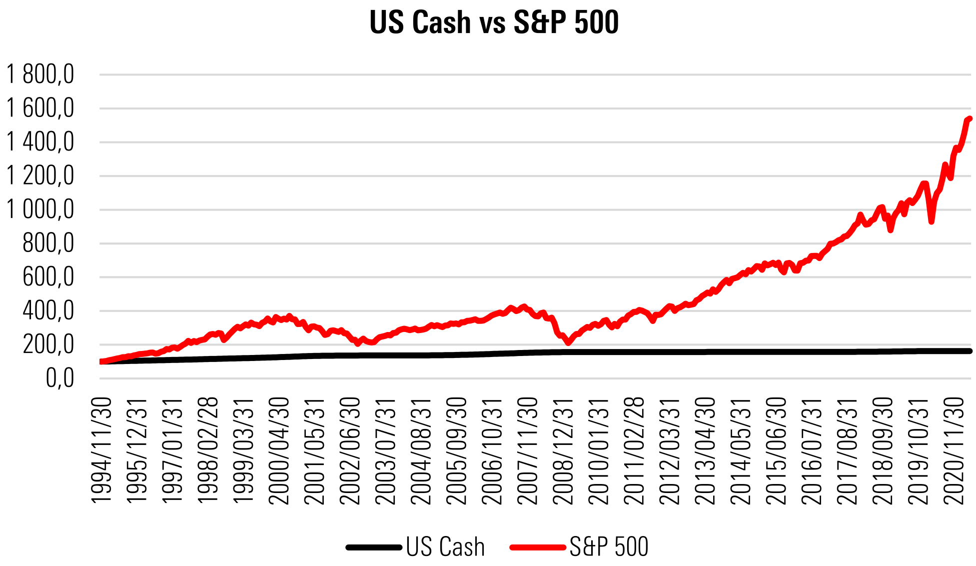
- It serves as a buffer by mitigating the total portfolio impact if other asset classes experience large drawdowns
- It provides liquidity and yield which is essential if you have income withdrawal needs.
- It can be used as a safety net in the event of a client needing immediate access to funds (for example, if they lose their job or need a lump sum withdrawal during tough markets).
- Cash can be kept in reserve and deployed when a good investment opportunity presents itself.

As with all investments, there will always be some element of risk as well. While cash serves as a buffer, it also introduces inflation risk. As can be seen in the graph below, in recent years the low interest rate environment has led to cash investments not keeping up with inflation and eroding the purchasing power of investment capital. This has resulted in a permanent loss of capital over time in some instances.



Source: Morningstar Direct. Data as of 31 May 2021. Past performance is not indicative of future results.

Opportunity cost is another risk to be aware of. The below graph shows that, when compared to the broader equity market over more than 25 years, investors are almost certainly better off remaining in the market. When reviewing data over the past 26 years for both US Cash and US Equities, on a calendar year basis, cash only outperformed in five of the 26 years. These instances of outperformance was mostly seen during a market drawdown or, what some investors would call, a "crisis" period.



Source: Morningstar Direct. Data as of 31 May 2021. Past performance is not indicative of future results.

So, investors should use their cash allocation wisely and remember that nobody ever got rich by simply remaining in cash.

What happens when we use cash as a flight mechanism?

Investment professionals may sound like broken records when they advise investors to sit tight when it comes to the topic of switching to cash, but the numbers simply don't lie. Let's take the financial crisis as an example.

If an investor switched their entire equity exposure to cash after the sharp sell-off we saw during the Global Financial Crisis, it would have had a devastating effect on their wealth, as presented in the graph below.

The value of staying invested

Holding the S&P 500 vs cash; initial $100,00 investment; Total returns

Source: Clearonomics, Standard & Poor's, Federal Reserve, Data as of May 2021; Past Performance is not indicative of future results.

If an investor with roughly $100,000 invested in US equities at the beginning of 2004 switched everything to cash when markets bottomed amid the Global Financial Crisis, he/she would be worse off by about $563 367 compared to if he/she remained invested throughout. It is much more difficult to recover losses caused by switching to cash, compared to the drawdown the investor would have suffered if he/she decided to remain invested.

Remain calm and don't get caught up in the so-called 'cash conundrum'

Many investors feel nervous when it comes to equity markets, especially when the downturn of March 2020 is still fresh in our minds and, understandably, the feeling of surrender and doing something "safe" and predictable is appealing.

There's an old adage among investors during downturns: "Don't catch a falling knife". Using cash as a flight mechanism when things get tough is detrimental to long term portfolio returns. Instead of chasing performance, investors should take this time to assess if their asset allocation is appropriate given their liquidity needs, time horizon and investment goals.

Remember, that cash can be a very valuable tool when it is used as part of a holistic financial plan but it can also carry a great amount of risk in the form of inflation risk or even the opportunity cost of not being invested in the market.

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