On The Mark

FourFront Group

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Risks of Excess Cash

Key Takeaways

- Investors sought safety in cash following the 2022 bear market driving a record of $6 trillion in cash.
- Investors holding excess cash missed opportunities in the 2023 market and could miss potential opportunities for greater return in the future.
- Dollar-cost averaging is a way to move your cash into the market in small amounts at a regular pace.

Investors took advantage of higher interest rates in the aftermath of 2022's bear market. Assets in money market funds soared to nearly $6 trillion[i] at the end of 2023.

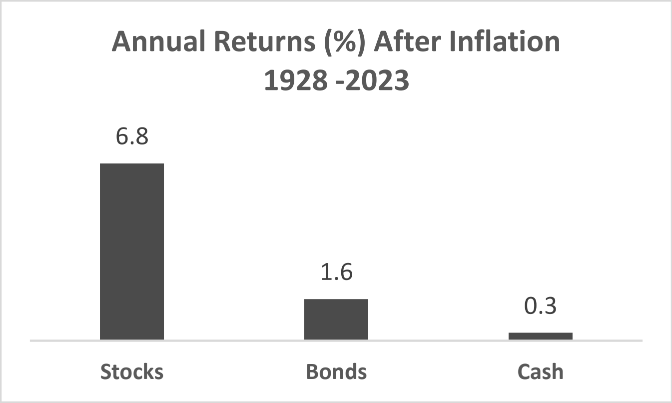
For investors, cash became a great place to park savings and earn roughly 5% interest. With cash accounts and related investments providing competitive yields not seen in the last decade, it can give investors a false sense of security as a no-risk investment choice.

Cash is often the best option for meeting near-term spending needs. But before declaring cash is king, holding too much cash beyond emergency or near-term needs comes with risks as well.

Inflation Risk

The objective for investments over the long term should be to generate returns above inflation. However, over the long term, cash has barely kept up with rising prices. On the other hand, stocks and bonds have historically delivered annual returns that have exceeded the rate of inflation.

In other words, overly relying on cash alone could be the equivalent of getting on an investment treadmill and not really going anywhere.



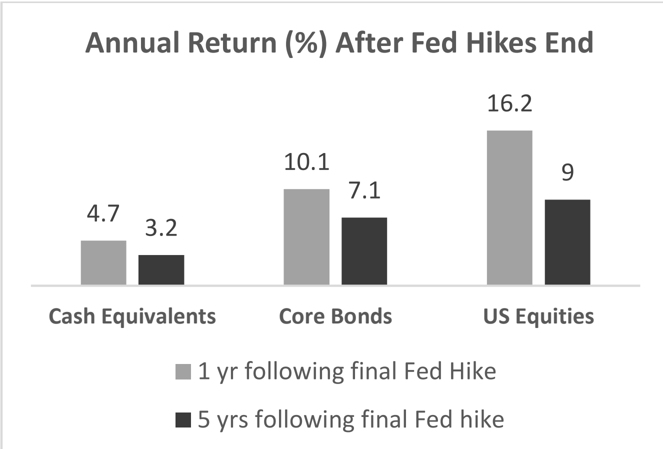
Source: NYU. Stocks: S&P 500. Bonds: 10 Year Treasury.
Cash: 3-Month T-Bill

Reinvestment Risk

Another potential risk to cash is 'reinvestment risk.' This happens when interest rates decline, and maturing investments are reinvested at a lower interest rate.

In today's landscape, with the Fed likely done raising interest rates and setting its eye on interest rate cuts in 2024, cash-like holdings may see little additional upside.

Looking at the last four interest rate hiking cycles from 1995-2018, when the Fed was done raising interest rates, long-term returns for both stocks and bonds outpaced cash, with the first year contributing the most.



Source: Capital Group. As rate hikes end, historic investor opportunity may begin.

How to Put Your Cash to Work?

In uncertain times, it's understandable for investors to hold on to excess cash. However, investors should be aware that holding excess cash isn't going to build wealth over time, comes with lost opportunity cost, and is unlikely to beat inflation over the long term.

Investors who are ready to put the excess cash to work but waiting for the "perfect time" to get invested could find the task daunting and may become stuck with indecisiveness. In reality, there is no perfect time to invest. Instead, consider dollar-cost averaging, which allows investors to take market timing out of the equation and invest that excess cash steadily over a regular time period.

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[i] https://www.ici.org/research/stats/mmf

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