



How much cash should a long-term portfolio hold?

At a time when financial markets are volatile and interest rates are rising, cash has greater appeal than it has done for some time. However, while it has a role for capital protection and optionality, it has limitations and there may be better options to enhance the risk/reward characteristics of a portfolio.

After more than a decade where cash returns were at or near zero, in 2022 rising interest rates saw cash rates lift again. At the same time, bond and equity markets fell in parallel. The long duration trade that had supported areas such as technology and long-dated government bonds reversed in a matter of months.

This gives cash a new appeal. As traditional diversification strategies come under strain, cash provides an uncorrelated source of return. When interest rates are higher it provides capital safety in a precarious world. Equally, it brings optionality, some “dry powder” to invest in opportunities as they emerge. Cash rates tend to rise when inflation goes up, which means that cash can actually be an effective inflation hedge, counter intuitively¹.

The inverted yield curve – where long-term rates are lower than short-term rates – is now a reality across many developed markets². An inverted curve eliminates the risk premium for long-term investments, meaning investors can generate better returns with short-term investments. This can make it more beneficial to hold cash. It means there is no real advantage to holding long-dated bonds.

Short-term versus long-term

This gives cash short-term attractions, but it has limitations as a long-term store of wealth. Its credentials as a ‘risk-free’ option need to be examined. The real return of cash is uncertain and depends on the macroeconomic environment at any given point. For example, at times of high inflation, savings rates at banks are likely to lag the pace of price rises and investors may lose capital in real terms.

In reality, cash hasn’t offered a positive real return since before the financial crisis. There is little evidence that this will change. Today, the market environment is likely to be one of high inflation and decelerating growth. In this context, the merits of cash as a risk-free asset are far from assured.

Cash rates have risen, but not as much as interest rates, as evidenced by the significant flows into money market funds. The recent banking turmoil was, in part, triggered by the unwillingness of banks to pass on higher interest rates to customers. A recent Bank of America note said investors had directed \$756 billion into cash funds this year in pursuit of higher yields³.

While it may be possible to lock in cash rates for a period of time, cash will need to be rolled over, and the rates are uncertain. As 2022 proved, cash rates are always vulnerable to changes in the macroeconomic environment and that environment can change very quickly. Prior to the war in Ukraine, there was little sense that inflation would become as great a problem as it has become.

¹ A. Ang “Asset Management: A Systematic Approach to Factor Investing”

² <http://www.worldgovernmentbonds.com/inverted-yield-curves/>

³ <https://www.reuters.com/markets/global-markets-flows-urgent-2023-05-26/>



Inflation rates have proved inherently unpredictable, as has policymakers' response to them. While cash looks superficially stable, both real and nominal return is variable for long term investors.

Balancing cash weightings

2022 showed the limitations of a portfolio comprising solely equities and bonds. At times of higher inflation, they may have greater correlation to each other and investor portfolios can be left vulnerable. This made the case for the inclusion of alternative options.

Cash is certainly part of the mix, but there are also options that deliver some of the characteristics of cash – zero or negative correlation to conventional financial markets, lower volatility and flexibility – without some of its limitations. For example, funds with a cash-plus target can provide diversification but crucially, also seek to deliver a higher return. If they succeed, that 3-5% return will compound over multiple years to deliver a meaningfully superior return to that of cash.

Including a diversified alternatives portfolio can help provide a specific hedge against inflation, but also against other risks. In blending a variety of specific asset classes, it is possible to manage a broader variety of risks, including stock market volatility, or interest rates, plus rising commodity prices or FX fluctuations. Volatility strategies, for example, will tend to do well when there are large movements in interest rates, as was seen in 2022. Harnessing these diverse strategies should give an investment portfolio greater resilience against shifting market conditions.

In contrast, cash can only do one job within a portfolio. It cannot adapt to a business cycle and macroeconomic environment, making it a crude option to manage specific risks. Its value in a portfolio is always vulnerable to interest rates shifts and to changes in inflation. In a recessionary environment, you would actually want to increase your bond weights, as they would typically do better than cash. A blended portfolio of assets can therefore be more flexible.

This may be particularly important today. There is a plausible scenario where interest rates fall before inflation starts to recede. Policymakers may see recession emerging and rein in future rate rises. This would leave cash investors nursing negative real returns on their cash holdings once again.

If alternatives have a low or negative correlation with an investors' benchmark portfolio, they can also reduce the volatility of the overall portfolio and improve the risk/return trade-off. It allows for greater nuance in the way risk is taken in a portfolio. Cash is non-correlated to stock markets, rather than being lowly or negatively correlated, but there will be times when investors want to take specific and targeted risks to improve returns.

Chosen judiciously, these assets can be highly liquid, which means investors get just the same optionality as they do with cash, but with a higher return in the interim. Incorporating alternatives also allows investors to target specific opportunities and sources of return opportunistically. Cash can only ever deliver a 'holding pattern' option, it is not an opportunity in itself.

Cash has a place, particularly as a short-term tool to create flexibility in a portfolio. However, the characteristics it offers can be replicated by other investments that offer more in terms of return and risk management. Ultimately, a diversified alternatives portfolio should provide a more nuanced and thoughtful option, with potential for a stronger long-term risk-reward profile.



Fulcrum Asset Management LLP. This document represents a marketing communication (non-independent research). It has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Fulcrum Asset Management LLP ('Fulcrum') defines marketing communication as market commentary consisting of illustrative, critically educational explanatory notes written to discuss or equally support an article or other presentation previously published. This document is also considered to be a minor non-monetary ('MNMB') benefit under Directive 2014/65/EU on Markets in Financial Instruments Directive ('MiFID II'). Fulcrum defines MNMBs as documentation relating to a financial instrument or an investment service which is generic in nature and may be simultaneously made available to any investment firm wishing to receive it or to the general public. The following information may have been disseminated in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service provided by Fulcrum.

Any views and opinions expressed are for informational and/or similarly educational purposes only and are a reflection of the author's best judgment, based upon information available at the time obtained from sources believed to be reliable and providing information in good faith, but no responsibility is accepted for any errors or omissions. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, Fulcrum does not guarantee the accuracy, adequacy or completeness of such information.

Redistribution or reproduction of this material in whole or in part is strictly prohibited without prior written permission of Fulcrum Asset Management LLP, authorised and regulated by the Financial Conduct Authority (No: 230683) © 2023 Fulcrum Asset Management LLP. All rights reserved.

Article written by Paul Seaton, Managing Director and Head of the New York Office

FC173 270623
(Thought Leadership)

17276635-NLD-08162023