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Interest Rates Should Not Drive How Much Cash You Hold

The highest interest rate environment in decades has led many investors to wonder how to best take advantage of the new-found yield from holding cash and cash-like investments.

While cash plays an important role in your financial plan, the level of interest rates should not be the driving force behind how much you hold. While it is easier to hold cash during periods when rates are high, it is still important to maintain your long-term asset allocation as over the long run, a diversified portfolio of stocks and bonds should outperform.

The amount of cash you hold should depend on your need to meet known upcoming expenses, provide an emergency buffer for unforeseen expenses, and allow you to sleep at night, particularly when your other investments are volatile. There is no one-size-fits-all answer to either of these questions – each depends on your life cycle phase, financial situation, risk tolerance, and goals.

Let's start with known upcoming expenses. If you have a planned expense coming due in the next year or two, such as a home purchase, tuition payment, or renovation, the funds being used to pay for that should be kept out of the market so they are not exposed to unnecessary investment risk.

While cash reserved for a larger purchase might feel like a strong cushion, it is not designed to help with unforeseen expenses, such as a loss of income. Here, an emergency cash fund allows you to continue with your current income stream without having to touch your longer-term invested assets. The appropriate size of this fund is unique to your circumstances, but having enough cash to cover 3-6 months of living expenses is a good start.

As you approach/enjoy retirement and prepare for portfolio withdrawals to cover living expenses, you may wonder if it makes sense to have a further cash cushion in case of market volatility ahead of your distributions. While stocks and bonds can rise and fall in the short term – and past performance is no guarantee of future returns – diversified portfolios of both assets have tended to rise and outperform cash over longer periods of time.

Moreover, if there is a down market during your retirement, we have choices regarding how we raise cash from your portfolio. For example, we may use bonds as a distribution source. By selling bonds, we can allow stocks to remain invested, giving them time to recover. As you consider your specific situation and how much cash is right for you, it is important to establish a goal that you are comfortable with and can stick to.

We hope you are all taking care and staying healthy. If you have any questions, please reach out to your Advisor.

Your O'Brien Team

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