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An Obsession for Determined Outcomes

NAVIGATING THE FINANCIAL OUTCOME PUZZLE

Cash is Not King

Saving for retirement is one of the most urgent tasks facing American households – and they take it very seriously. As of June 30, 2021, 401(k) plans held an estimated $7.3 trillion in assets and represented nearly one-fifth of the $37.2 trillion US retirement market, which includes employer-sponsored retirement plans (both defined benefit (DB and defined contribution (DC) plans with private- and public-sector employers), individual retirement accounts (IRAs), and annuities. In comparison, 401(k) assets were $3.1 trillion and represented 17 percent of the US retirement market in 2011.

Keeping an excessive share of assets in cash, let alone making cash the principal component of one's retirement savings, may be the most financially devastating decision your clients can make.

When your clients ask you how they can best maximize return and minimize the risk of ending a long working career with too little retire on, what can you tell them? Start with the basics; there are three ways to address risk.

1 ACCEPT IT   2 AVOID IT   3 TRANSFER IT

ACCEPTING AND AVOIDING RISK

Accepting risk means focusing solely on return: loading your portfolio with high-flying and speculative stocks in the hope of hitting the jackpot. The problems with this are clear; the bear market that began in October 2007 saw the Standard & Poor's 500 index lose more than half its value (56.4%[2]) before it ended almost a year and a half later. If you had clients who were planning to retire during those 17 horrific months, many of them would have been compelled to change their plans.

Avoiding risk means concentrating your assets away from the uncertainties of the stock market. For many people, this means keeping it in cash. Americans hold 57% of their assets in cash, according to a BlackRock 2017 Global Investor Pulse Survey[3].

An online survey commissioned by NerdWallet and conducted by The Harris Poll last year found that 39% of Americans don't invest at all; of these, 32% prefer to have their money in cash rather than investing, because it's easier to access, and 28% say they prefer to hold cash because they don't know how to invest. **On average, Americans hold $32,286 in cash[4].**

[1] Investment Company Institute: "Frequently Asked Questions About 401(k) Plan Research"
[2] NBC News: "11 Historic Bear Markets"
[3] BlackRock: "Investor Pulse: Money and Happiness"
[4] NerdWallet: "What Is a Brokerage Account and How Do I Open One?"

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What seems like prudent behavior—in case of bad times, who wouldn't want to be liquid?—is nothing of the sort, however. In fact, keeping an excessive share of assets in cash, let alone making cash the principal component of one's retirement savings, may be the most financially devastating decision your clients can make. NerdWallet calculated that over 30 years, $10,000 kept in cash instead of higher-returning investments results in some $44,000 of lost returns.

That's an enormous price to pay to ensure a degree of liquidity that most households will never need and that's accompanied by significant downsides. The less cash the individual keeps in stocks, the more the market needs to outperform to compensate for the slow appreciation of cash: an unrealistic expectation. And cash itself veers between extreme highs and lows; the U.S. Dollar Index (DXY) reached an all time high of 164.72 in February 1985, and hit a record low of 71.32 in April 2008.

Inflation has been a periodic problem for economies for generations. But if you hold a large percentage of your assets in cash, even a relatively low inflation rate can spell trouble. For the 12 months ended in April 2019, the inflation rate was a low 2%, but since 1914, it's averaged 3.28%[5]. Even at just 2%, however, that means if your clients are storing their assets in short-term CDs yielding 2.5% to 3%, much of the value of these holdings is being eaten away, leaving precious little growth to see them through their retirement.

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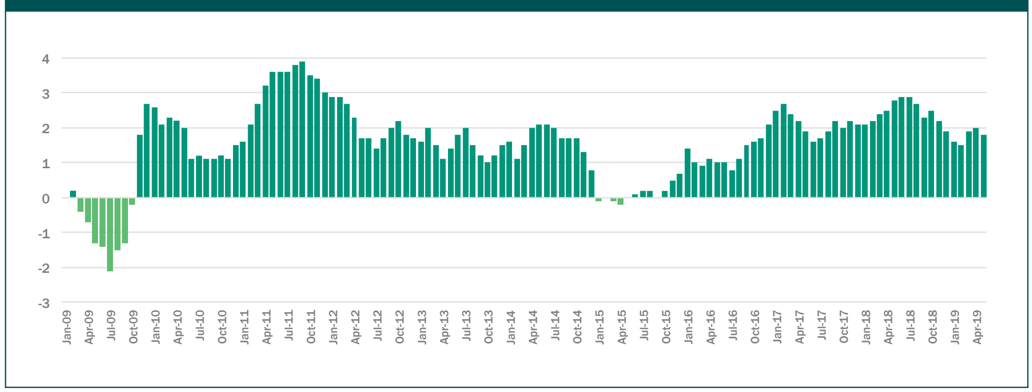
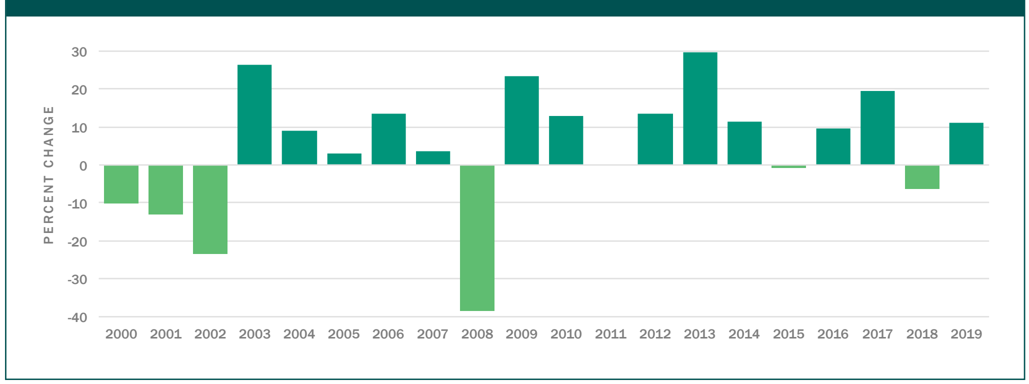
United States Inflation Rate: 10 Years



Source: https://tradingeconomics.com/united-states/inflation-cpi

Compare that with the performance of stocks, even taking some of the market's worst periods into account. If your clients had bought the S&P 500 index at its peak before the last major financial collapse, in October 2007, over the next 12 years they would have recovered their losses plus an additional 134%[6].

20-Year S&P 500 Historical Annual Returns



https://www.macrotrends.net/2526/sp-500-historical-annual-returns

[5] Lifehacker: "If Cash Is Your Only Savings Strategy, You're Losing Money"
[6] The Motley Fool: "4 Lessons From the Financial Crisis All Investors Should Remember Forever"

There's no doubt that working households need a prudent cash reserve covering some months of normal expenses. Institutional investors, private-equity and hedge fund managers, and other large money managers typically keep some cash on hand as well, so that they can respond to new investment opportunities or market downturns without having to reduce or liquidate existing valuable holdings. But any investor aiming to achieve a targeted return—as households saving for retirement certainly are—should never regard liquidity as an end unto itself.

> Warren Buffett, in his 2014 letter to Berkshire Hathaway investors, makes the point dramatically. Between 1964 and 2014, he noted, the S&P 500 grew from 84 to 2,059. With reinvested dividends, that generated an overall return of 11,196%. At the same time, the purchasing power of the dollar declined by 87%[7].

Why? Because wealth is built on economic growth, and cash doesn't generate economic growth. People, and their businesses, do. "The one thing I will tell you," Buffett said recently, "is the worst investment you can have is cash. Everybody is talking about cash being king and all that sort of thing. Cash is going to become worth less over time. But good businesses are going to become worth more over time[8]." Why, then, do so many people value cash over investments? A misunderstanding of risk is a contributor, Buffett says. While currency-denominated assets are riskier over time, "that lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk. Popular formulas that equate the two terms lead students, investors, and CEOs astray[7]."

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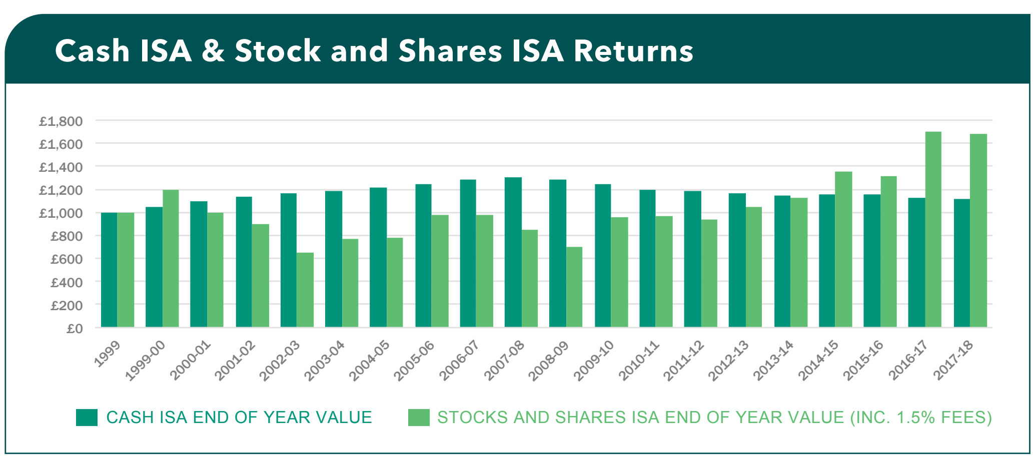
>
> ***WARREN BUFFETT***
> CEO, Berkshire Hathaway

Another reason, of course, is the emotional scarring people carry with them from the last stock market collapse. News organizations typically highlight dramatic movements in stocks, while oftentimes, sharp movements in currencies, which are more frequent and harder to interpret, get less attention. A recent study by Schroders illustrates this.

The study looked at Individual Savings Accounts, a tax-advantaged vehicle introduced in the UK in 1999 that now holds more than £600 billion in assets. Initial subscriptions to ISAs were £28.4 billion, of which 57% went into stocks and shares. Since then, however, more new ISA money has gone into cash than stocks in every year except one. And that year was 2000-01, which was the peak of the tech-fueled 1990s bull market.



https://www.schroders.com/en/insights/economics/what-is-an-isa-cash-vs-stocks-and-shares-isa/

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[7] Berkshire Hathaway: "Berkshire's Performance vs. the S&P 500"
[8] The Motley Fool: "What Warren Buffett Thinks About Stocks, Bonds, Gold, Cash, Real Estate [...]"

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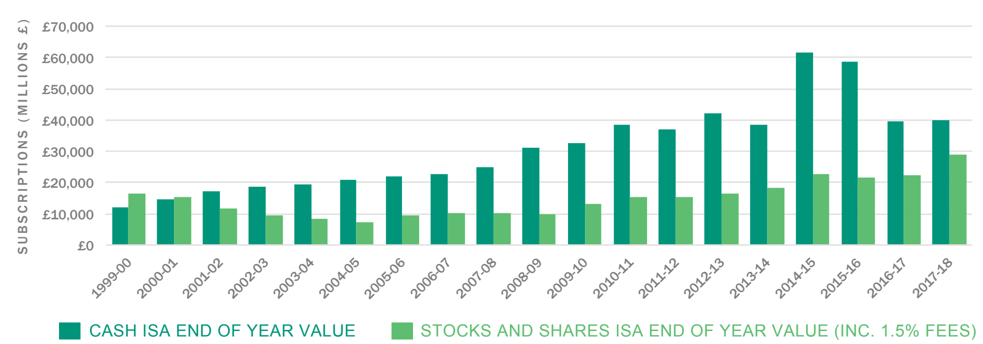
Since then, demand for cash in ISAs has only grown. In 2008-09, the year of the global financial markets collapse, 76% of new ISA money went into cash accounts. And in 2017-18—long after the global economic recovery had kicked into gear, bolstering a long stock-market advance—58% of new money still went into cash ISAs[9].

This in spite of the fact that, according to Schroders's calculations, a £1,000 deposit in a cash ISA in 1999 would have produced a return of 0.6% per year while the same investment in an ISA composed of stocks would have returned 2.9%: almost five times as much.

> Life expectancies are going up; about one out of every three 65-year-olds today will live past age 90, and roughly one out of seven will live past age 95.
>
> U.S. SOCIAL SECURITY ADMINISTRATION

Cash ISA vs. Stocks and Shares ISA Subscriptions



https://www.schroders.com/en/insights/economics/what-is-an-isa-cash-vs-stocks-and-shares-isa/

The story of ISAs dramatizes two lessons about investor behavior:

1. The shock waves from a stock market collapse can last for many years, prompting investors to flee to safety and stay there even when they ought to be focused on building rather than preserving assets
2. Investors have a high propensity to buy high and sell low.

The first lesson underscores the danger of staying in cash. Life expectancies are going up; about one out of every three 65-year-olds today will live past age 90, and roughly one out of seven will live past age 95, according to the Social Security Administration[10]. Retirement, for these individuals, will last almost as long as some of their working careers, and they will need the assets to support them through that period. Avoiding risk, for them, amounts to taking risk, and a long-term preference for liquidity works against the imperative to accumulate assets.

The second lesson highlights the difficulty many individuals have formulating and sticking to a long-term investment plan. Buying low and selling high, and rebalancing along the way, is one of the cardinal rules for investors like Buffett. But working households don't have the infrastructure—technology, analytics, portfolio managers—that provide them with perspective on the markets and the risks they are running, when they need it.

For these people, the best course of action is the third of the three approaches we enumerated above: **to transfer risk**. We'll discuss this in our next Bonsai POV Paper.

[9] Schroders: "Cash Isa vs stock market Isa: which has returned the most?"
[10] Social Security Administration: "Benefits Planner | Life Expectancy"