UNDERSTANDING THE ROLE OF CASH IN YOUR PORTFOLIO

It's easy to understand why investors may be wary of stocks. The stock market has suffered two major pullbacks in recent memory: January 2000 to July 2002 and December 2007 to June 2009. Since the Great Recession officially ended in 2009, the stock market has continued to reach record highs. Despite the run-up in stocks, people have actually been adding to their cash balances, regardless of their age or amount of wealth.

Why is this happening? Chalk it up to fear. The fear of another market correction. Or the fear of making the wrong decision at the wrong time. Although cash may feel safe, you can actually lose purchasing power over the long term after accounting for inflation and taxes.

Whether you are keeping money in cash while waiting for opportunities to enter the market, or out of simple fear of the investing climate, holding too much cash can be costly. If you're invested for the long term, returns on cash probably won't keep up with the alternatives.

ROLES OF CASH

Having a better understanding of the role cash plays in your portfolio is critical in helping you reach your financial goals.

1 Liquidity

Apart from day-to-day expenses, the need for liquidity generally falls into two categories:

- Emergencies (e.g., health expenses, job loss, etc.)
- Known obligations or likely expenses in the next one to three years

Liquidity is extremely important here — don't invest money reserved for near-term obligations in the stock market. Instead, keep it in cash, cash investments, or shorter-term investments with minimal principal risk between now and when you need to spend the money.

For retirees who may have special liquidity needs, such as increasing medical costs, it may make sense to set aside some money to cover unexpected expenses and limit the potential need to sell from the portfolio at an inopportune time.

2 Flexibility

Having some percentage of your portfolio in cash can allow you to take advantage of investment opportunities as they arise. A cash allocation may come in handy if you wish to overweight or underweight certain asset classes in your portfolio based on your outlook for the markets. In addition, a cash allocation can provide flexibility when it's time to rebalance your portfolio and/or pay investment fees.

Give yourself a firm deadline for reinvesting the money because people who set aside cash to invest opportunistically widely report never making the decision to get back into the market.

3 Diversification

Bonds are the traditional go-to asset for diversifying a stock portfolio and reducing your overall risk of losses. These days, many investors are using a combination of bonds and cash to help stabilize investment portfolios over time. For this role, cash investments are meant to be the most defensive part of a portfolio.

4 Peace of mind

Besides your ability to handle losses, there's also your willingness to do so. Investors who are especially risk-averse might be tempted to hold more cash than necessary so they can sleep better at night. If volatility in the market causes you angst, talk with your advisor to determine if you have the right portfolio mix for your risk profile and your goals.

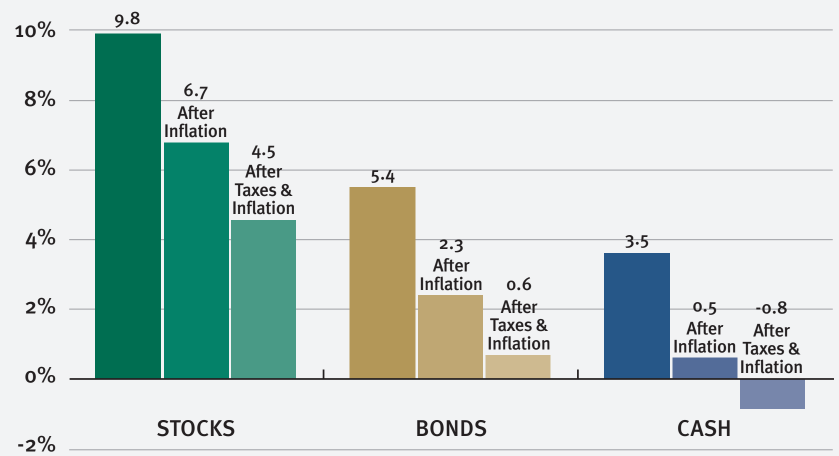
> **RETIREMENT CONSIDERATIONS**
> Market crashes and their aftermaths can cause investors to become too conservative or even to abandon stocks altogether. Those approaching or in retirement can be especially susceptible to this reaction.
>
> Investors may wish to reduce some of the equity risk inside their portfolio during retirement. A portfolio that is too conservative, however, may leave an individual without the financial assets needed to support the lifestyle he or she envisioned, especially given the effects of inflation. With longer life spans, a portfolio may need to last 20 or more years in retirement.

RISKS OF TOO MUCH CASH

Investors who shift to cash simply replace the risk of loss with the risk of not achieving their financial goals. While cash provides liquidity and stability, it is not intended to be the primary holding in your investment portfolio because of low real returns, which is the investment return achieved after accounting for the effects of inflation.

As the chart below shows, cash had an average annual return of only 0.5 percent after inflation between 1926 and 2012. When taxes are factored, cash has a negative return of 0.8 percent. In comparison, stocks have an average return of 4.5 percent and bonds 0.6 percent after taxes and inflation.

CASH HAS AVERAGED A NEGATIVE REAL, AFTER-TAX RETURN
Compound Annual Returns (1926 – 2012)



Source: Blackrock

THE APPROPRIATE LEVEL OF CASH

The appropriate level of cash really depends on your situation — that is your investment strategy and time horizon. Work with an experienced advisor who can help you understand what is a reasonable amount of cash to hold — and why — because it is an important decision when designing an investment portfolio in the context of your overall financial plan.

Contact a Commerce Trust advisor today to review your investment goals and discuss the role of cash in your portfolio.

1-800-892-7100 x17329 | commercetrustcompany.com