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The investment cachet of cash

The ultimate portfolio diversifier, cash has been a relatively good performer

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Improving employment, reduced capacity overhang and a bubbly residential real estate market have dramatically increased the odds that the Bank of Canada will initiate a new rising interest rate cycle.

Three-month Government of Canada treasury bill yields hit a decade-low of 0.16% in February; barring deflation, rock-bottom rates such as these cannot be maintained for long. In order to understand better the role of cash in a portfolio, my firm, Tacita Capital Inc. of Toronto, analyzed the historical returns and volatility of the DEX 91-day T-bill index and its correlation to other major asset classes.

Cash has been a better investment than many advisors might believe. Over the 54 years from March 1956 through February 2010, 91-day T-bills had an annualized nominal return of 6.4%. Although lower than the 8% and 9.3% annualized returns of the DEX long-term bond and S&P/TSX composite indices, respectively, this return was achieved with an annualized standard deviation of 1.1% — an oasis of stability compared with the 8.9% and 17.3% standard deviation of long-term bonds and stocks, respectively.

Despite minimal volatility, cash has provided investors with a real return. Over the 54-year history, 91-day T-bills achieved an annualized real return of 2.3%. In contrast, long-term bonds and stocks had annualized real returns of 3.9% and 5.1%, respectively.

On a nominal basis, T-bills have been the ultimate risk-free asset — they never had a negative return in the 54-year period. However, on a real basis, this isn't the case. T-bills have had negative returns when

yields have lagged inflation. This occurred briefly in the 1950s and for a prolonged period in the 1970s, as well as in 2002 and 2010. Recent negative real returns are indicative of how stimulative monetary policy has been in the face of the recent global meltdown.

Cash is the ultimate portfolio diversifier. T-bill returns had a negative correlation of 0.01 with Canadian stocks and only a 0.1 correlation with long-term bonds. Because of this correlation pattern, seen in a series of portfolio optimization runs, cash has earned a significant role in the portfolios of conservative investors, as well as a modest role in the portfolios of moderate investors. Younger investors with conservative to moderate risk tolerances also would do well to have some cash allocations in their portfolios.

Older investors who face a stream of retirement expenditures, however, will find cash has a minor role in a portfolio. Cash as an asset class has massive reinvestment risk. The decline of 91-day T-bill yields to 0.16% in February 2010 from 4.62% in August 2007 illustrates this risk. High-quality bonds are much more suitable vehicles for matching investment cash flows with future long-term expenditures.

During periods of rising inflation, however, the extremely short maturities of cash instruments such as T-bills makes this asset class an excellent inflation hedge. The correlation of the DEX 91-day T-bill index and the Canadian inflation rate was 0.41. Annualized T-bill returns climbed to 19.2% in September 1981 from 1.7% in March 1956 as inflation gradually accelerated.

Financial advisors concerned with the expansiveness of monetary policy worldwide and the potential for rising inflation once cyclical deflationary pressures wane should take note.

Returns from money market funds have evaporated over the past year, as management expense ratios overwhelmed the low yields of T-bills, bankers' acceptances and commercial paper.

Fortunately, high-interest savings accounts offered by several banks and trust companies, which pay higher rates than money market funds, are available on FundSERV Inc. in both A- and F-class units.

Critically, individual investments should be kept to a maximum of $100,000, in order to qualify for insurance from the Canada Deposit Insurance Corp. **IE**

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