

CONVERSATION GUIDE NO. 1

SETTING THE STAGE: EDUCATING CLIENTS ON THE OPPORTUNITY



Helping Clients Reinvest Cash Now

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

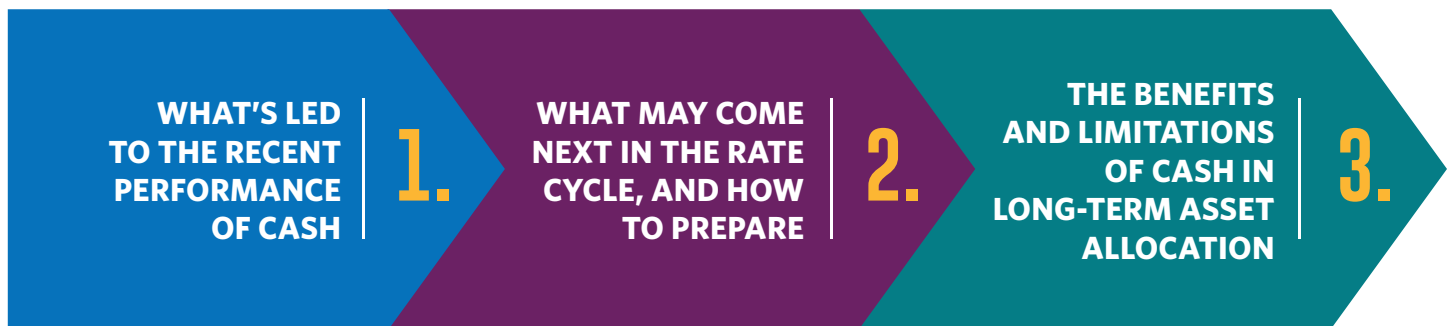
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INTRODUCTION

High cash yields following a vigorous rate hiking cycle have led many clients to hold on to excessive cash balances. Advisors will face conversations about the current environment, staying diversified, and putting a client’s cash to work again. This guide, the first in a three-part series, will help advisors discuss:



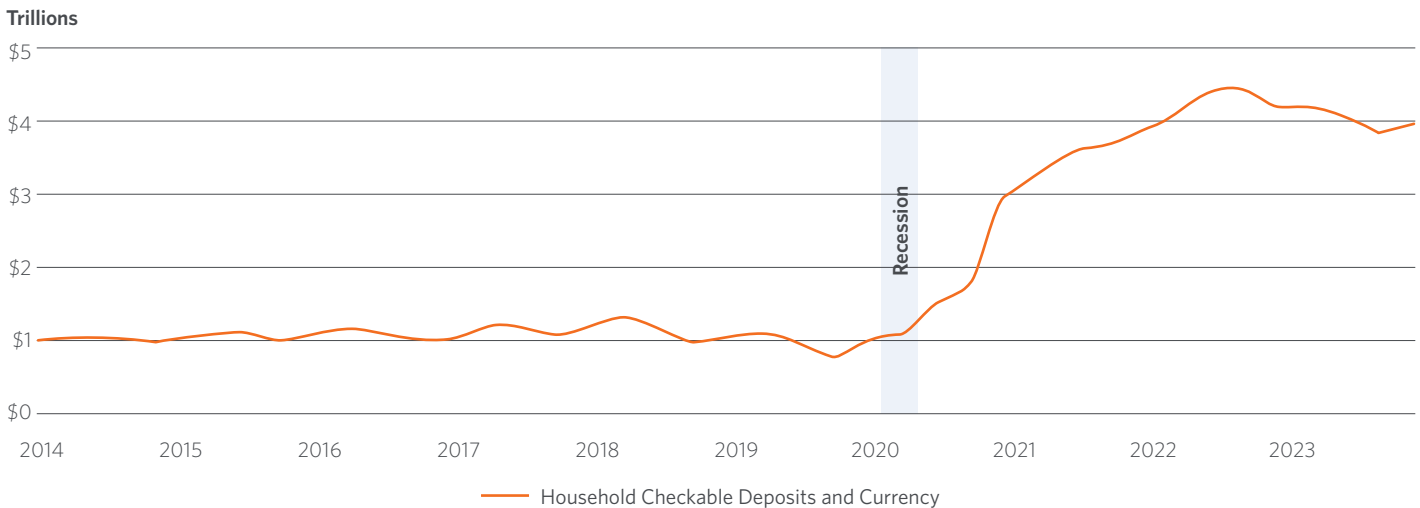
1.

WHAT'S LED TO THE RECENT PERFORMANCE OF CASH

Cash has performed well as a safe haven with solid yield

- Higher rates have bolstered yields on bank deposits and money market funds to levels we haven't seen since before the **2008** financial crisis.
- Generous yields with protection of principal found in cash and cash equivalents can provide a sense of security during economic uncertainty.

DEPOSITS HAVE SWELLED SINCE THE PANDEMIC



As of 12/31/2023. Sources - Checkable Deposits and Currency: Federal Reserve Board of Governors; Recessions: National Bureau of Economic Research.

- The accumulation of “dry powder” may be due to the lack of apparent entry points or opportunities in fixed income. Fixed income performance and specific bond market shocks have caused some investors to question the value of bonds as a generator of absolute return and equity hedge, a short-term perspective influenced by recent market conditions.

2.

WHAT MAY COME NEXT IN THE RATE CYCLE, AND HOW TO PREPARE

The end of rate hikes is introducing uncertainty

- The Fed has steadily signaled **the rate hiking cycle is at or near its peak**, though it has also continued to focus efforts on taming inflation, which has yet to return to the target level of **2%**, adding some uncertainty to the future rate direction.
- As the economy's growth has exceeded expectations, **the timing of the Fed's next rate move is not clear**, making it unwise to attempt to time the markets regarding asset allocation.
- A soft economic landing is still a possible outcome, but **some recessionary signals warrant our attention**. The yield curve, for instance, has been inverted since **2022**, a condition that often signals recession. The yield curve has been normalizing recently, but whether it flattens in the short term is uncertain.

3.

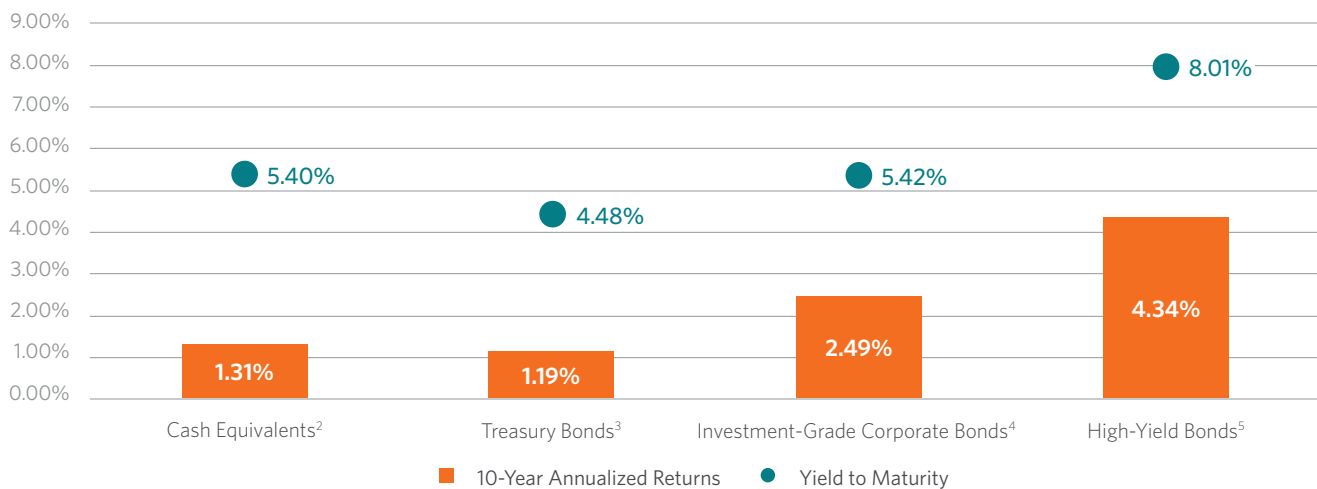
THE BENEFITS AND LIMITATIONS OF CASH IN LONG-TERM ASSET ALLOCATION

The long-term role of cash in a portfolio in the current cycle

While cash is often seen as a risk-free asset and defensive position, carrying too large of a cash allocation has risks.

- Falling inflation should not distract investors from the reality that even **relatively benign levels of inflation erode the long-term purchasing power of cash.**
- While we cannot be sure when the Federal Reserve will cut interest rates, rate cuts are likely in **2024**, and **returns on cash holdings will decrease** as a result.
- Deploying cash too late can have consequences, specifically by increasing reinvestment risk. By the time yields on cash fall, bond prices will have climbed, and **investors sitting on the sidelines may miss a favorable entry point to bonds.** Beginning a systemic reallocation plan may help reduce the risk of moving into bonds late.
- Research has shown that **investors tend to overestimate the incremental risk of extending the duration within their fixed income allocation.**¹ Caution may lead to excessive cash allocations in place of bonds without a meaningful reduction in portfolio risk.
- **Over a full market cycle, cash tends to underperform bonds.** Even considering the recent outperformance and current high yield of cash, looking back at its 10-year annualized return illustrates cash’s lower return potential compared to other fixed income options:

FIXED INCOME ASSET CLASSES 10-YEAR RETURNS AND YIELDS



As of 2/29/2024. Source: Bloomberg.

Past performance is not indicative of future results. It is not possible to invest directly in an index, which also does not include the application of fees.

It’s also important to keep in mind that, even though certain deposit products and money market funds are providing decent yields, the average CD rate remained **below 2%** at the start of **2024**.⁶ While cash certainly plays a role in a well-diversified portfolio, current market conditions may signal a historic opportunity to reduce levels in favor of higher-yielding fixed income assets. While cash may look attractive to some given a yield that is higher than it has been in recent years, there is an opportunity cost of holding cash. As we move into the next cycle, investors may want to take advantage of higher-yielding fixed income options that can help diversify portfolios — and may even deliver upside potential if interest rates move lower.

If the goal remains to keep risk low, or the time horizon is short, short-term bonds and even municipal bonds may create a more favorable risk profile in a portfolio while still picking up yield from cash as rates fall. Additional yield can be captured with intermediate-duration bonds, as well as high-yield and emerging market bonds if an investor’s risk tolerance permits.

¹ “Asset Allocation, Decoupling, and the Opportunity Cost for Cash,” The Journal of Portfolio Management, July 2003

² Bloomberg U.S. Treasury Bill: 1-3 Months Index

³ Bloomberg U.S. Long Treasury Index

⁴ Bloomberg U.S. Corporate Bond Index

⁵ Bloomberg U.S. Corporate High Yield Bond Index

⁶ “National Rates and Rate Caps,” FDIC, Feb. 20, 2024

Diversification cannot ensure a profit or protect against loss in a declining market. It is a strategy used to help mitigate risk.



KEY TAKEAWAYS

Cash has performed well recently, but **cash yields will decrease if and when rates fall.**

Cash tends to **underperform bonds** over a full market cycle.

Holding cash may not **meaningfully reduce portfolio risk** relative to holding bonds over the long term.

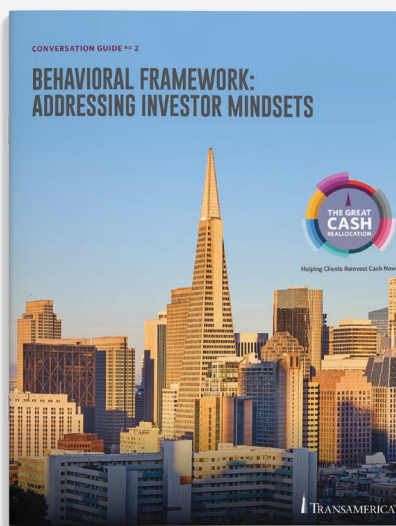


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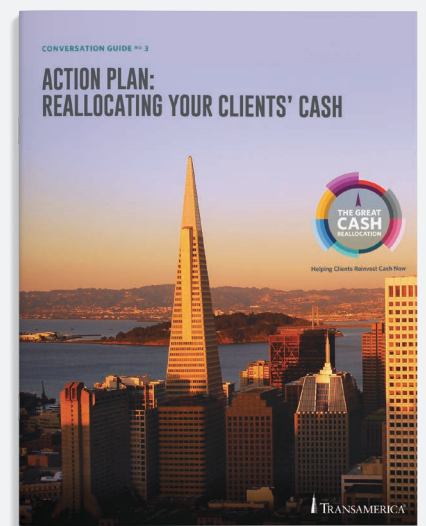
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Setting the Stage:
Educating Clients on the Opportunity



Behavioral Framework:
Addressing Investor Mindsets



Action Plan:
Reallocating Your Clients' Cash



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