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The Place for Cash

RECONSIDERING 'CONSERVATIVE' IN LIQUIDITY AND RISK-BASED PORTFOLIOS AFTER 2022

By William Olinger, CIMA®, and Benjamin Doty, CFA®

Until 2022, the investment community reliably had seen investment-grade bonds act as ballast to the volatility of stocks, especially for individuals nearing retirement or those individuals and institutions with the dual goals of capital preservation and income. Until then, it was easy to remain ignorant of the twin risks inherent to bonds: interest-rate risk and default risk. The latter, however, was fairly well-managed because past bear markets in stocks also hit non-investment-grade bonds hard. For example, the Bloomberg U.S. High Yield Corporate Index declined 26 percent on the heels of the S&P 500's fall of 37 percent in 2008.[1] Asset allocation products and model portfolios developed by the investment committees at the largest asset management firms reflected portfolios that minimized default risk in bond portfolios. Yet, durations were about as long or close to that of the Bloomberg U.S. Aggregate Bond Index, which carried a duration of close to 6.6 at the start of 2022 when the 10-year U.S. Treasury note had a yield of about 1.6 percent, off a July 2020 low of almost 0.5 percent.[2]

So-called "conservative" portfolios suffered in similar magnitude to losses across stocks and bonds. Conservative portfolio products, for example, represent what happened when interest-rate risk became a harsh reality after decades of falling interest rates and inflation. The anchor of many bucketing strategies, dividing assets into different liquidity and risk portfolios, gave way. Many retirees, especially, witnessed dramatic drops in their so-called safe assets.

This has prompted us to rethink what a "conservative" portfolio should look like. What can be a better anchor for the bucketing strategy? First, we want to observe two things: (1) the likelihood of multi-asset portfolios from the past to endure and (2) the viability of liquid alternatives to fill the void. We then focus on cash and its equivalents as the best anchor for the long run—what we might call the missing bucket. We believe the solution always was under our noses: emergency funds for individuals or working capital accounts for institutions. In the realm of conservative portfolios, cash is king, as the saying goes.

Table 1

CATEGORY PERFORMANCE OF LIQUID ALTERNATIVES (%), SELECT YEARS

	2022	2008	Max Drawdown (2008)	10 Years (through 12/31/22)
Morningstar U.S. Fund Conservative Allocation	−11.10	−16.26	−18.68	2.52
Morningstar U.S. Fund Commodities Broad Basket	15.96	−37.65	−49.70	−0.92
S&P GSCI Gold TR USD	−0.74	3.91	−27.07	0.01
Bloomberg U.S. Agg Bond TR USD	−13.01	5.24	−3.83	1.06
Bloomberg U.S. Treasury Bill 1-3 M TR USD	1.52	1.77	0	0.73

Sources: Morningstar, Bloomberg, S&P Global

MULTI-ASSET CLASS PORTFOLIOS

We all know in hindsight that inflation has broken recent multi-decade records, forcing rates higher and causing bonds to have high positive correlations with equities. The majority of conservative portfolio products had negative double-digit returns. This was largely due to dependence on investment-grade bonds for ballast in the portfolio. These bonds, proxied by the Bloomberg U.S. Aggregate Bond Index, returned -13.0 percent in 2022 (see table 1).

Although commodities did post positive returns in 2022, we note the dismal record of commodity returns in the long run, the episodic nature of their outperformance when they do shine, and their sensitivity to the economic cycle—all of which create challenges for incorporating commodities into a long-term allocation with economically significant outcomes. Although the subject is too great to explore in detail here, we note what happened in 2008 when even the S&P GSCI Gold Total Return Index experienced a drawdown of 27.1 percent between March and October of 2008, despite ending the calendar year modestly positive.[3]

We also don't cover private investments, which on paper showed gains in many places. We believe liquidity issues make these mostly inappropriate for consideration. We would not recommend them in personal or organizational working capital accounts (even interval funds and so-called evergreen funds operate with significant redemption limits).

In contrast to many diversifying asset classes, cash and its equivalents—

proxied by the Bloomberg 1–3 Month U.S. Treasury Bill Index—had modest but positive returns in both 2022 and 2008.

LIQUID ALTERNATIVES

Largely in response to the Great Financial Crisis, liquid alternatives emerged as an additional answer to how public market portfolios could be diversified. At best, we would say the performance of liquid alternatives in various categories is mixed (see table 2). In 2008, all seven categories experienced negative drawdowns, and in 2022, five of the seven categories experienced negative returns for the calendar year. Even though their 10-year performance bested investment-grade bonds during the period, no category had returns to write home about.

Although we recognize that some managers may have had positive returns during their categories' bad years, we don't believe an allocation to liquid alternatives should be made on the performance record of managers with no consideration of the average performance of the category. Such decisions miss the high likelihood of future returns that reflect the average return of the category. In other words, buying a good house in a bad neighborhood doesn't make much sense. Avoid bad neighborhoods.

HISTORY OF CASH AND ITS FUTURE

Two things to note about cash and its equivalents, which we typically proxy with short-dated U.S. Treasury bills: (1) cash, at times, outperforms investment-grade bonds and (2) the return experience with cash in the next 10 years should be more favorable than the past decade. In table 3, we use index data from the SBBI Yearbook[4] rather than the index data from Bloomberg because the SBBI Yearbook provides almost 100 years of historical data for use.[5]

After the recent experience with double-digit negative bond returns, the period over which intermediate-term investment-grade bond returns turned positive extended to greater than five years. Until 2022, the lowest five-year return of intermediate bonds had been 0.65 percent. That slipped to a slightly negative return with the inclusion of 2022 (−0.15 percent). The cash equivalent of a U.S. Treasury bill, in contrast, had no losses substantially different from zero in all shorter-dated rolling periods. The opportunity cost of not being in on longer-dated bonds, however, was between 160 and 170 basis points per year.

Not surprisingly, due to the slightly negative correlation of intermediate-term bonds to stocks over time, a conservative allocation with 30-percent invested in U.S. large-cap equities had better downside experiences with intermediate-term bonds than U.S. Treasury bills, which have little to no duration.

Despite the recent period of near-zero short-term interest rates and ultra-low interest rates across the yield curve, we note that U.S. Treasury bills have returned about 3.25 percent over various rolling periods since the mid-1920s. We do not believe that we will return to near-zero rates on short-dated financial instruments again. In its "Summary of Economic Projections" from its June 2023 meeting, the Federal Open Market Committee projected a long-term federal funds rate of 2.5 percent.[6] For both reasons, we believe that cash equivalents will provide a positive nominal rate of return for the foreseeable future. An era of such dramatic central bank easing couldn't last forever.

'CONSERVATIVE' BUCKET

The year 2022 schooled investors in remembering that bond portfolios carry risks too, especially portfolios that have been hibernating for decades in lower interest rates. Extreme left-tailed events can touch any asset class. Those with short-term needs, especially retirees, who segment their assets into shorter-dated and longer-dated portfolios for liquidity needs, may want to reconsider cash and its equivalents, whether in money market funds or other financial instruments, as a better foundation for short-term spending than conservative asset allocation portfolios. Ideally, this could mean immunizing the short end of liquidity needs up to five years; for example, think of a five-year ladder of

Table 2

CATEGORY PERFORMANCE OF LIQUID ALTERNATIVES (%), SELECT YEARS

	2022	2008	Max Drawdown (2008)	10 Years (through 12/31/22)
Morningstar U.S. Fund Event Driven	−1.32	−15.55	−17.79	3.56
Morningstar U.S. Fund Relative Value Arbitrage	−3.86	−13.59	−15.49	2.61
Morningstar U.S. Fund Equity Market Neutral	6.04	−3.23	−6.52	2.05
Morningstar U.S. Fund Multistrategy	−3.00	−16.33	−17.25	2.41
Morningstar U.S. Fund Macro Trading	−2.28	−22.12	−24.06	2.49
Morningstar U.S. Fund Systematic Trend	14.53	10.19	−10.77	2.46
Morningstar U.S. Fund Options Trading	−9.55	−26.54	−30.57	3.13
Average of Liquid Alternative Categories	0.08	−12.45	−17.49	2.67
Bloomberg U.S. Agg Bond TR USD	−13.01	5.24	−3.83	1.06
Bloomberg U.S. Treasury Bill 1–3 M TR USD	1.52	1.77	0.00	0.73
S&P 500 TR USD	−18.11	−37.00	−37.66	12.56

Sources: Morningstar, Bloomberg, S&P Global

Table 3

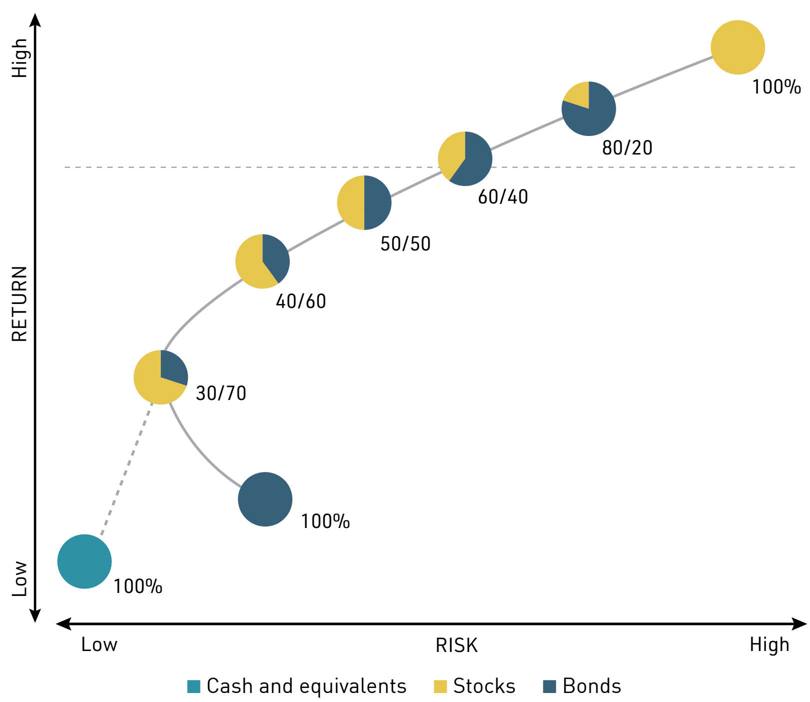
LONG-TERM RETURNS: U.S. TREASURY BILLS AND INTERMEDIATE-TERM GOVERNMENT BONDS

	1-Year	2-Year	3-Year	5-Year
Percentage—Negative Returns				
U.S. Treasury Bills	2%	0%	0%	0%
U.S. Intermediate-term Gov. Bonds	10%	6%	4%	0%
Lowest Annual Return				
U.S. Treasury Bills	−0.04%	0.00%	0.00%	0.03%
U.S. Intermediate-term Gov. Bonds	−11.82%	−7.27%	−3.79%	−0.15%
Average Annual Return				
U.S. Treasury Bills	3.25%	3.25%	3.24%	3.24%
U.S. Intermediate-term Gov. Bonds	4.87%	4.86%	4.90%	4.87%
Difference	−1.62%	−1.61%	−1.66%	−1.63%
Years Covered	December 1926–June 2023	December 1927–June 2023	December 1928–June 2023	December 1930–June 2023

Sources: Morningstar, Ibbottson (U.S. Treasury bills proxied by IA SBBI US 30 Day T-Bill TR USD index, and U.S. Intermediate-term Gov. Bonds by IA SBBI US IT Govt TR USD index).

Figure 1

LIQUIDITY PORTFOLIOS AND EFFICIENT FRONTIER



Past performance is no guarantee of future results. Risk is measured by standard deviation. Return is measured by artithmetic mean. Portfolios are only illustrations.

investment-grade bonds that match annual cash needs. At a minimum, individual and institutional investment advisors must be very clear about what conservative means with clients (because it doesn't mean you won't lose capital). There is a naivete here that fiduciaries need to dispel.

Although cash and its close cousins are not without risk, as the local currency experiences of many other countries have shown, they still may act like the one-eyed man in the land of the blind. There are no better options for immediate liquidity needs as cash.

Whether embedded in a larger portfolio or alone in its own account, cash and its equivalents are, for a lack of better phrasing, the first pillar of an efficient frontier or bucketing strategy. Conceptually, it's very much like drawing a line from the minimum risk portfolio on an efficient frontier to the risk-free asset (see figure 1). The rest of your bucketing framework still exists, but the better ballast, or front end of the barbell, may be cash and its equivalents.

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ENDNOTES

1. Morningstar, accessed June 23, 2023.
2. Bloomberg, U.S. Department of Treasury, accessed June 28, 2023.
3. See endnote 1.
4. R. Ibbottson, *Stocks, Bonds, Bills and Inflation* (SBBI®) *Yearbook*, Duff & Phelps (2022).
5. Admittedly, even 100 years of historical data is not much in terms of the 5,000 years or so of recorded human history. Just imagine the trove of historical financial data that financial analysts of the future will have to use centuries from now.
6. "Summary of Economic Projections," Board of Governors of the Federal Reserve System (June 14, 2023), https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230614.pdf.

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