3 Reasons to Examine Your Cash Allocation

Investors are finally getting paid for holding cash, but there are risks in holding too much of it.

For the first time since 2007, investors are finally getting an attractive interest rate on their cash holdings. With a little searching, you can find money-market funds and one-year CDs that pay 5% or more. Loading up on cash may seem like a good strategy, but like your favorite dessert, is there a downside to having too much of a good thing?

Here are three reasons why investors should be careful about holding too much cash:

1. Cash has usually delivered negative returns after inflation and taxes
2. Cash hasn't historically helped investors grow their wealth
3. Today's attractive interest rates may not be available tomorrow

Insight from Hartford Funds

Key Points

- Even with today's generous interest rates, the real return on 12-month CDs is barely positive.
- Feeling safe by holding excess cash comes with an opportunity cost.
- Attractive yields on cash can disappear quickly, so investors should consider ways to lock in those attractive yields.

1. Cash Has Usually Delivered Negative Returns After Inflation and Taxes

Cash has a key role in every portfolio. Everyone needs cash on hand for recurring expenses such as mortgage payments, college tuition, and credit-card bills. It's also prudent to have an emergency fund because life is unpredictable. But it's important for investors to realize that cash investments such as CDs typically don't generate a positive return after factoring in taxes and inflation (**FIGURE 1**). Even with a historically generous 12-month CD rate of 5.32%, the real after-tax return (i.e., the return after factoring in inflation and taxes) is still less than 1%.

FIGURE 1: Inflation and Taxes Have Had a Significantly Negative Effect on CD Returns

Real Return on 12-month CDs (2004-2023)

Year	12-Month CD Yield (%)[1]	Taxes (%)[2]	Inflation (%)	Real Return After Taxes & Inflation (%)
2004	2.58	25	3.34	-1.41
2005	4.22	25	3.34	-0.18
2006	4.91	25	2.52	1.16
2007	4.43	25	4.11	-0.79
2008	2.65	25	-0.02	2.01
2009	1.44	25	2.81	-1.73
2010	0.96	25	1.44	-0.72
2011	0.77	25	3.06	-2.48
2012	0.69	25	1.76	-1.24
2013	0.67	25	1.51	-1.01
2014	0.70	25	0.65	-0.13
2015	0.62	25	0.64	-0.18
2016	0.59	25	2.05	-1.61
2017	0.80	25	2.10	-1.50
2018	1.29	22	1.92	-0.91
2019	1.14	22	2.26	-1.37
2020	0.39	22	1.28	-0.98
2021	0.28	22	7.10	-6.88
2022	2.35	22	6.42	-4.59
2023	5.32	22	3.40	**0.75**

Past performance does not guarantee future results. CD rates are proxied by Bankrate's 12-month CD national average; the CD rate for 2023 is the average of the 12-month CD rates offered on Bankrate. CDs are short-term investments that pay fixed principal and interest, are insured by the FDIC up to $250,000, and are subject to changing renewal rates and early withdrawal penalties. The chart uses the highest marginal federal income tax rate based on $100,000 of taxable income for a married couple filing jointly for each calendar year. The tax rate is not representative of the experience of every investor. A lower tax rate would have a favorable effect on the real return. Data Sources: Bloomberg, FactSet, and Hartford Funds, 1/24.

2. Cash Hasn't Historically Helped Investors Grow Their Wealth

One of the most fundamental decisions we make as investors is how much money to allocate among stocks, bonds, and cash. Cash is certainly safer than stocks or bonds in terms of daily volatility. The tradeoff for that feeling of safety, however, is much less long-term growth potential. Cash is the proverbial parking spot for your money, but it probably won't help you get where you want to go over the long term—and holding too much of it could cause you to miss out on significant gains.

Holding too much cash could cause you to miss out on significant gains.

FIGURE 2

Stocks and Bonds Created Significantly More Wealth Than Cash Over Most Decades

Average Annual Returns for Stocks, Bonds, and Cash by Decade

Decade	Avg. Stock Return (%)	Avg. Bond Return (%)	Avg. Cash Return (%)
1970s	5.90	7.00	6.30
1980s	17.60	12.40	8.90
1990s	18.20	7.70	4.90
2000s	-1.00	6.30	2.80
2010s	13.60	3.80	0.50
2020s*	12.04	-0.72	1.70
Return from 1/1/70-12/31/23	**10.70**	**6.77**	**4.42**

Growth of $10,000 for Stocks, Bonds, and Cash From the Beginning to the End of Each Decade

Decade	Stocks	Bonds	Cash
1970s	$17,685	$19,607	$18,438
1980s	$50,384	$32,266	$23,433
1990s	$53,278	$20,001	$16,171
2000s	$9,090	$18,475	$13,125
2010s	$35,666	$14,445	$10,536
2020s*	$15,759	$9,717	$10,698
Growth of $10,000 1/1/70-12/31/23	**$2,425,538**	**$344,363**	**$103,346**

*Through 12/31/23. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Please see page 4 for representative indices. Data source for charts and infographic: Morningstar, 1/24.

SINCE 1970...

A STOCK INVESTOR GAINED **142%** **MORE THAN** A CASH INVESTOR

&

A BOND INVESTOR GAINED **53%** **MORE THAN** A CASH INVESTOR

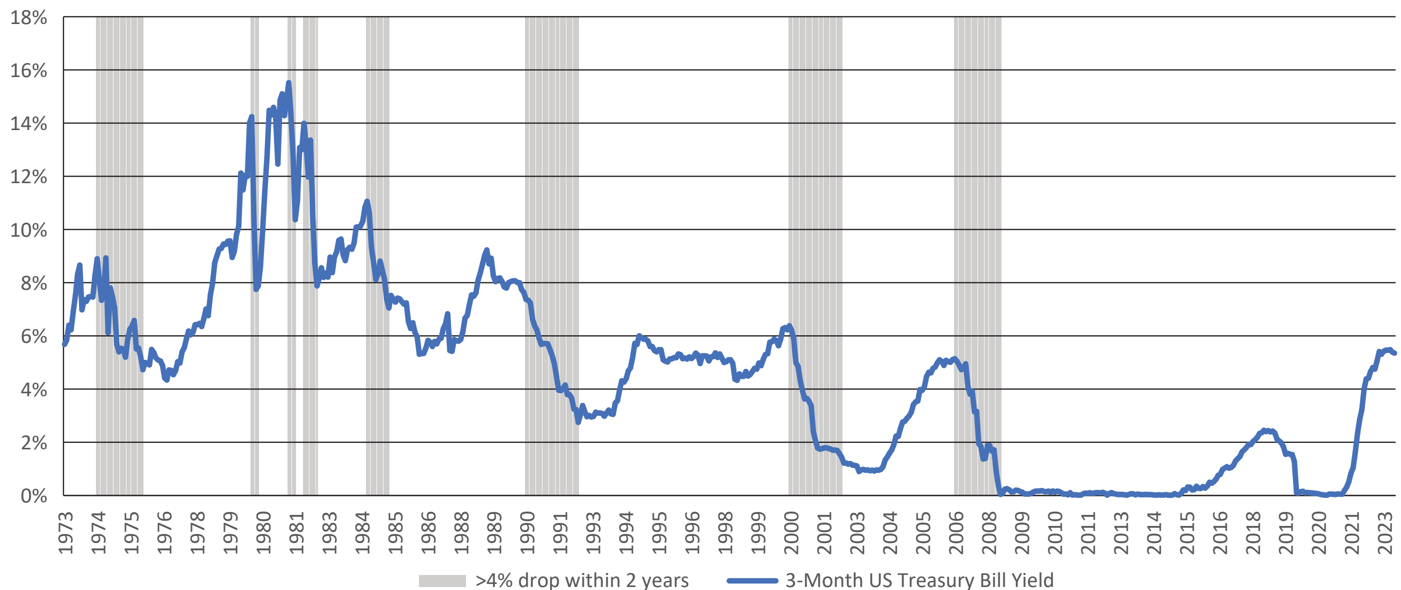
3. Today's Attractive Interest Rates May Not Be Available Tomorrow

While earning 5% interest on your cash is extremely attractive, history shows that this generous interest rate may not last. In fact, over the last 50 years there have been eight times when yields on cash fell by 4% or more over periods ranging from three months to two years (**FIGURE 3**). The reinvestment risk for cash and short-term CDs is one of the biggest risks investors face today.

FIGURE 3

Cash Can Be Volatile: Yield Drops of 4% or More Within Two Years or Less

3-Month US Treasury Bill Yield % (1/31/73–12/31/23)



Date Range	Beginning Yield	Ending Yield	Total Yield Drop
4/74-1/76	8.90	4.73	4.17%
3/80-6/80	14.24	7.88	6.36%
8/81-11/81	15.52	10.37	5.15%
3/82-9/82	13.99	7.88	6.11%
8/84-6/85	11.06	7.05	4.01%
9/90-9/92	7.37	2.75	4.62%
10/00-10/02	6.38	1.44	4.94%
2/07-12/08	5.14	0.04	5.10%
Average Yield Drop			5.06%

Data Source: Factset, 1/24.

Takeaways

The amount you allocate to stocks, bonds, and cash can be a major factor in your portfolio's long-term performance, so choose wisely. If you allocate too much to cash, you may not generate high enough returns to fund your retirement or other investment goals. But if you allocate too little to cash, you may have to sell some stocks or bonds at an unfavorable time to pay for an emergency. Your financial professional can take a holistic view of your finances and help you decide how much to allocate among stocks, bonds, and cash.

If you believe yields on cash, CDs, and money markets could fall in the not-too-distant future, consider buying intermediate-term bonds or CDs that mature further out. Your financial professional can help you create a bond or CD ladder[1] so your money comes due and is reinvested at different times, which helps reduce reinvestment risk. You could also consider purchasing an actively managed intermediate-term bond fund or ETF to let professional money managers decide how to navigate changing interest rates.

The Risk of Owning Stocks and Bonds vs. Cash

As with any investment, there are relative risks to be considered. Cash, CDs, and money-market funds generally involve the least amount of risk but also offer the least potential return.

Stocks can be volatile, especially over short periods of time. Companies could fail to execute their business plans or lose value due to increased competition. Stock investors could lose part or all of their principal.

Bonds tend to carry greater risk than cash equivalents, including the risk that a bond's lender may be unable to make interest or principal payments on time. Bonds with longer maturities (e.g., 10 years or more) can offer higher returns but can lose value when interest rates rise. Bonds are also subject to the risk that the lender may choose to pay off the bond early, which could deprive investors of potential interest income. When rates are falling, lenders sometimes choose to pay off bonds ahead of maturity in order to reissue bonds at lower prevailing rates.

Talk to your financial professional to help you decide the amount of cash holdings that are right for you.

[1] When you create a bond or CD ladder, you divide the total amount of money you want to invest into equal amounts and invest those amounts in bonds or CDs with different maturity dates.

Bonds are represented by the IA SBBI LT Government Index, which measures the performance of a single issue of outstanding US Treasury notes with a maturity term of around 5.5 years.

Cash is represented by IA SBBI US 30 Day T-Bill Index, which tracks 30-day Treasury bills. CD rates are based on 3-Month CD rates from the Federal Reserve Bank of St. Louis. Data begins June 1964.

Stocks are represented by the S&P 500 Index, which is a market capitalization-weighted price index composed of 500 widely held common stocks, using data calculated by Ibbotson Associates.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall.

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