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Opportunities for Income Investors: Going Beyond Cash

Cash has become more appealing due to higher interest rates. But while it clearly has merits, there are also drawbacks.

There's no avoiding that current cash yields are attractive. However, while cash can play an important role, it's not quite the low-risk asset that many believe it is.

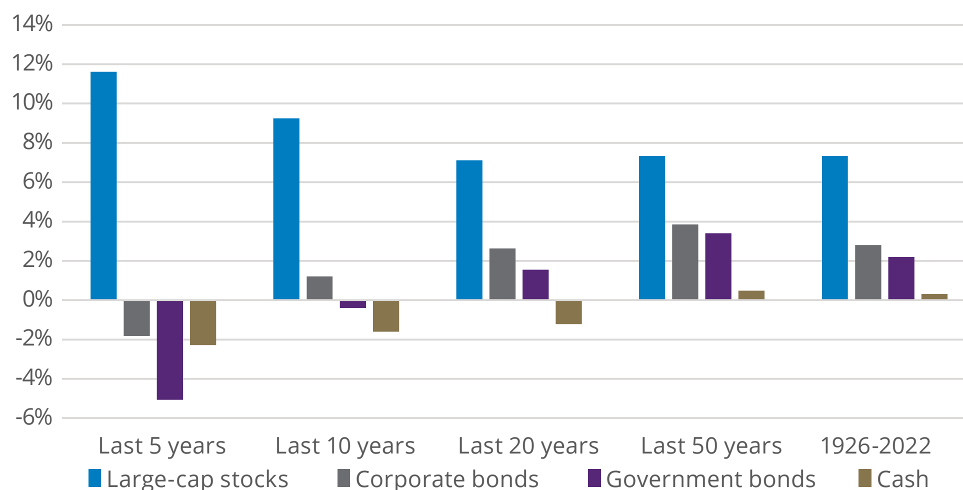
In my view, there are three main risks to cash that may make other asset classes worth considering instead: inflation risk, reinvestment risk, and volatility/fundamentals risk.

1. Inflation Risk

A 5% cash rate may look appealing right now, but with inflation, the real value of that cash holding falls. The longer the investment time horizon, the worse that impact becomes. For example, a US dollar invested in cash in 2014 would be worth $1.12 in nominal terms in 2024, but only $0.85 in real terms.[1]

In the long run, equities have beaten bonds, which have generally beaten cash. Equities have generated the highest real returns (which are returns adjusted for inflation) across historical periods, whether that be in the last 5 years or 50 years (**FIGURE 1**). Over longer periods, such as 20 or 50 years, bonds have also tended to deliver a real return that's outpaced inflation. Within bonds, corporate bonds have tended to beat inflation to an even greater degree than government bonds.

FIGURE 1
Equities Have Historically Outperformed Better than Both Bonds and Cash Against Inflation
Historical Real Returns (Returns in Excess of Inflation) Since 1926



As of 12/31/23. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. Stocks represented by Ibbotson® SBBI® US Large-Cap Stocks, Corporate bonds by Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds, Government bonds by Ibbotson® SBBI® US Long-term (20-Year) Government Bonds, and Cash by Ibbotson® US (30-day) Treasury Bills. Source: Morningstar Direct, accessed via CFA Institute and Schroders.

Insight from sub-adviser Schroders Investment Management

Harry Goodacre
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Key Points

- Though cash is attractive right now, rates may come down sooner rather than later.
- Once cash yields are lower, owning too much cash could introduce inflation risk and reinvestment risk to portfolios.
- Equities and bonds both have their own sets of risks, but when combined with cash, a diversified mix may help investors better navigate the income landscape.

[1] Cash represented by 30-day Treasury Bills as of 5/31/24.

2. Reinvestment Risk

Reinvestment risk is when the investment horizon is longer than the period for which the income is locked-in. This means proceeds will need to be reinvested at the prevailing market rate further down the line, which may be worse (or better) than the initial rate. The longer the maturity of the investment, the lower the reinvestment risk.

For long-term investors, cash doesn't provide a stable or predictable income stream because interest rates on cash aren't constant over time. Since the Federal Reserve is expected to move into a rate-cutting cycle, 5% rates aren't expected to last much longer. In previous rate-cutting cycles, cash has generally underperformed equities and bonds (**FIGURE 2**).

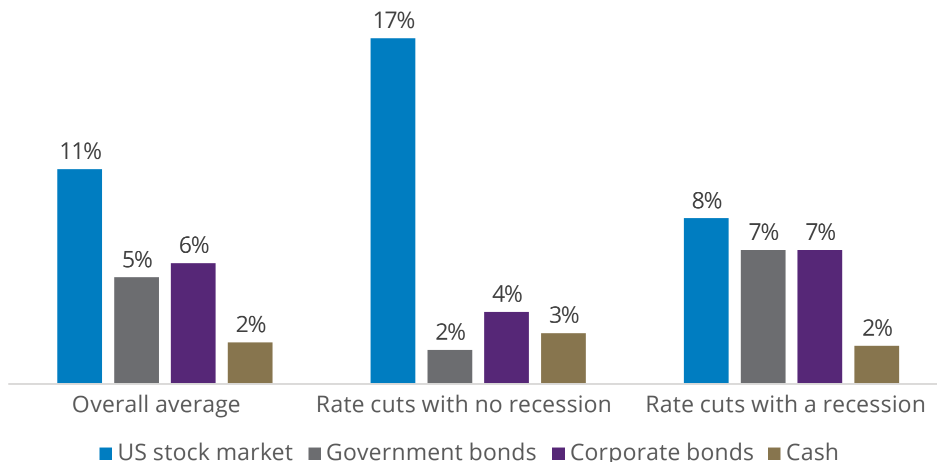
Investment-grade corporate bonds are currently yielding around 5%-6% with an average maturity of nine years, which could make them an attractive alternative to cash to help lock in yields for longer. And given extremely low historical default rates, corporate bonds may be appealing for long-term income investors who may be less concerned about short-term price movements.

Given extremely low defaults, corporate bonds may be attractive for long-term income investors.

FIGURE 2

Stocks Have Outperformed Bonds and Cash During Rate Cuts, on Average

Average 12-month Real Returns from the Date of First Federal Reserve Rate Cut



As of May 1928–December 2023. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. Stocks represented by Ibbotson® SBBI® US Large-Cap Stocks, Corporate bonds by Ibbotson® SBBI® US Long-term (20-Year) Corporate Bonds, Government bonds by Ibbotson® SBBI® US Long-term (20-Year) Government Bonds, and Cash by Ibbotson® US (30-day) Treasury Bills Source for return data: CFA Institute, SBBI® database, and Schroders. Source for Fed Funds data: Post-1954 is direct from Federal Reserve Economic Data (FRED). Earlier data is based on the Federal Funds rate published in the New York Tribune and Wall Street Journal, also sourced from FRED. See methodology on last page.

3. Volatility Risk/Fundamentals Risk

For those investors with a longer-term perspective, reinvestment risk can be reduced through investing in bonds that lock in higher yields for longer. But many investors also care about volatility risk and the risk that falling prices will lead to losses.

Investors with a longer time horizon that aim to hold bonds until they mature may be less concerned with any change in bond prices and more concerned with potential defaults, in which coupon income (the annual interest rate paid on a bond) and/or principal (amount of money to be repaid to the bondholder by the issuer at

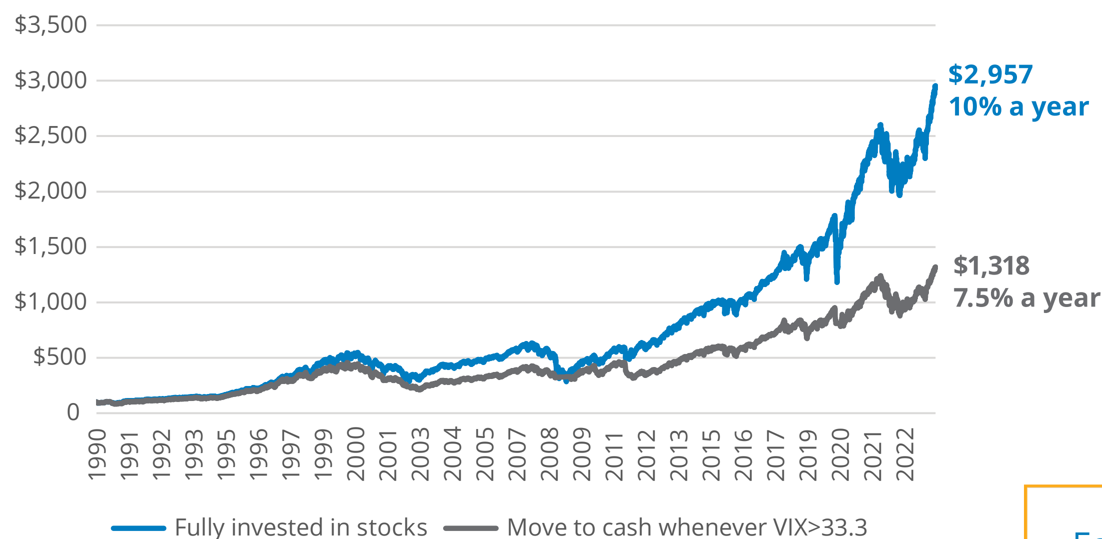
maturity) losses are incurred. But historically, investment-grade defaults have been very rare: On average, 99.9% of investment-grade issuers and 96% of high-yield issuers have not defaulted in any given year. [2]

And though equities are generally more volatile than bonds, which in turn are more volatile than cash, long-term investors should beware of making knee-jerk reactions to increasing equity volatility. Historically, staying invested has proven to be a better strategy (**FIGURE 3**).

FIGURE 3

Investors Should Beware of Making Kneejerk Reactions to Equity Volatility

Growth of $100 Fully Invested in Stocks vs. Switching to Cash When VIX Is High



As of 3/31/24. **Past performance does not guarantee future results.** Stocks represented by the S&P 500 Index, a market capitalization-weighted price index composed of 500 widely held common stocks. Indices are unmanaged and not available for direct investment. VIX, commonly referred to as the "Fear Index," is the ticker symbol for the Chicago Board Options Exchange (Cboe) Volatility Index and measures the market's expectation of 30-day volatility. VIX levels below 20 reflect complacency, while levels of 40 or higher reflect extremely high levels of volatility. Levels in excess of 33.5 represent the top 5% of experiences for the VIX. Portfolio is rebalanced on a daily basis depending on the level of the VIX at the previous close. Figures do not take into account any costs, including transaction costs. Data Source: LSEG and Schroders calculations.

Conclusion

As with all investing, there's a trade-off between risk and returns. Current high interest rates may help cash appear attractive for now, but over the long term, investing too much in cash may have drawbacks. While cash can provide certainty of nominal value, it's exposed to more reinvestment risk than assets such as bonds, which can lock in current elevated interest rates for longer. And while past performance isn't a guide to future performance, over the longer term, equities have done better than cash at mitigating against inflation risk. So, for long-term income investors that are willing to see some price volatility, a diversified mix of assets may be a more attractive alternative to cash alone.

For long-term income investors that are willing to see some price volatility, a diversified mix of assets may be a more attractive alternative to cash alone.

Talk to your financial professional about the right mix of stocks, bonds, and cash for you.

[2] Average annual defaulted corporate bond recoveries have averaged around 43% between 1983–2023 as measured by trading prices. Recovery rates vary across time and type of bond (e.g. unsecured bonds tend to have lower recovery rates than secured bonds). Source: Moody's Investors Service, 2024 annual default study.

Figure 2 Methodology: Recession periods include instances where recession occurs within 12-months of the date of first rate cut. These are the dates of the first rate cut in each cycle, the ones with an * are recession instances: 9/30/1929*, 12/31/1931*, 3/31/1933*, 11/30/1953*, 10/31/1957*, 5/31/1960*, 11/30/1966, 2/28/1970*, 9/30/1971, 9/30/1973*, 7/31/1974*, 4/30/1980*, 1/31/1981*, 7/31/1981*, 4/30/1982*, 8/31/1984, 5/31/1989, 6/30/1995, 9/30/1998, 12/31/2000*, 7/31/2007*, 7/31/2019*. An approach consistent with that outlined in A New Daily Federal Funds Rate Series and History of the Federal Funds Market, 1928-54, St. Louis Fed, has been followed. To lessen daily volatility for the earlier data, a 7-day average was used, so each month-end figure is the average for the 7 days leading up to last day of the month.

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. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Diversification does not ensure a profit or protect against a loss in a declining market.

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