MORNINGSTAR®

The role of cash in a portfolio

Morningstar Investment Management South Africa

June 2020

Debra Slabber, CFA®
Business Development Manager
Morningstar Investment Management
South Africa

For Financial Advisors and their Clients

Popular headlines such as "the dash for cash", "don't give up on equities just yet" and "is switching to cash the right move?" have left many investors questioning their exposure to cash. During times of market volatility, cash is often questioned first, leaving investors wondering whether they should be jumping on or off the cash-bandwagon. In the following article, we take a step back and examine the role of cash in a portfolio.

The role of cash in a diversified portfolio is so often misunderstood. One of the least covered topics when it comes to investing is how cash plays a role in your portfolio. The saying that cash is king has some truth to it but it's not without its risks either.

Investors often use cash as a flight mechanism. As the saying goes "when the going gets tough, the tough get going", but when it comes to cash this is rarely the case. More than often, investors will run to cash for safety instead.

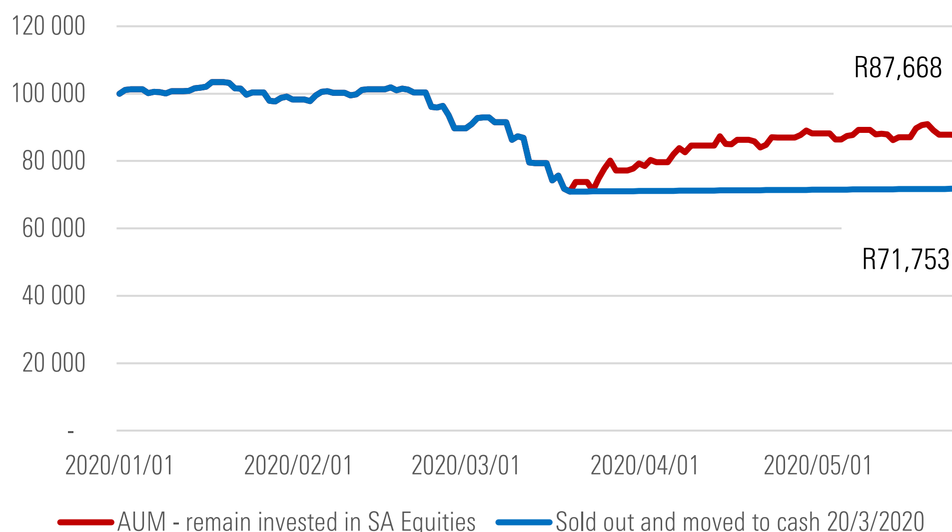
Trying to time when to get in and when to get out of the market is a never-ending battle, especially when there are big shocks to the system as we have seen recently. It's often because of their short-term risk profile and reaction to sudden market moves that investors want to change their investment plan by switching to cash for its so-called safe-haven appeal. This move is then justified with phrases like "it is just temporary" or "I just want to miss some of the volatility" and "I will get back into the market when things have settled".

The fact that investors enjoyed better returns from cash than other investments such as South African equities over the past couple of years makes the argument to run to cash even more appealing. They have also enjoyed the benefit or real returns (returns in excess of inflation) by being in cash instead.

What happens when we use cash as a flight mechanism?

Investment professionals may sound like broken records when they advise investors to sit tight when it comes to the topic of switching to cash, but the numbers simply don't lie. Let's take recent market events as an example.

If an investor switched their entire equity exposure to cash after the sharp sell-off in March, it would have had a devastating effect on their wealth, as presented in the graph below.



Source: Morningstar Direct, 25 May 2020

If an investor with roughly R100,000 invested in South African equities at the beginning of the year switched everything to cash when markets bottomed in the middle of March, he/she would be worse off by about R16,000 compared to if he/she remained invested throughout the bumpy period. It is much more difficult to recover losses of 28% (caused by switching to cash), compared to the 12% drawdown the investor would have suffered if he/she decided to remain invested.

When confronted by fear, the first step is to ask whether an investor's actions are causing them to completely change their investment plan. Any good investment strategy is already built to protect their money. When investors veer off course and sell out of fear, they put other areas of their portfolio at greater risk. So their plan shouldn't be abandoned at the first sign of distress. With this as a backdrop, cash should not be the enemy either.

Reminding investors about the role of cash in their long-term investment plan

Asset allocation is a complex puzzle that requires constant solving as well as a deep understanding of each client's unique circumstances, their risk tolerance, return objectives, time horizon, liquidity requirements and tax position. Cash is an important piece in that puzzle and should be considered when looking at a client's holistic financial plan.

Cash has many advantages: it serves as a buffer by mitigating the total portfolio impact if other asset classes experience large drawdowns, and it provides liquidity and yield (an essential when you have income withdrawal needs). It can be used as a safety net in the event of a client needing immediate access to funds (for example, if they lose their job or need a lump sum withdrawal during tough markets) and, cash can be kept in reserve and deployed when a good investment opportunity presents itself.

©2020 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited. Morningstar Investment Management South Africa is a subsidiary of Morningstar, Inc. All data sourced from Morningstar Direct as at May 2020 unless stated otherwise.

MORNINGSTAR®

There are many ways in which cash exposure can be obtained. Historically most investors opt to keep their cash investments in their bank savings accounts or a money market account. More recently, income funds have become popular as well. Multi-asset funds also hold a decent allocation to cash instruments. Cash is, therefore, probably already part of your portfolio to begin with. Investors must also be cognizant that the term "cash" covers a variety of instruments, each unique in term of characteristics and riskiness.

It does not come without risk

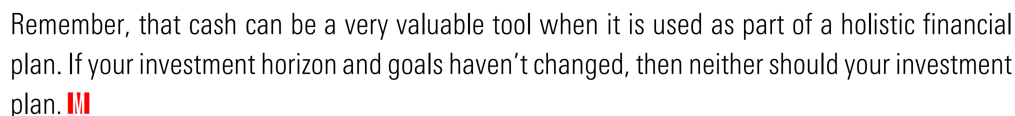
While cash serves as a buffer, it also introduces inflation risk. Recent aggressive interest rate cuts by the South African Reserve Bank resulted in the returns from money market funds being slashed by 40% compared to a few months ago. To put his into perspective, this time last year, you could easily keep your investments in your money market account and generate a before-tax return of between 6% - 7% per annum. Fast forward to the present and you will be lucky if you receive a 4% return on that same investment over the next 12 months.

It is also important to note the tax differential on returns from cash compared to returns from equities. Opportunity cost is another risk to be aware of. So, investors should use their cash allocation wisely. Remember, nobody ever got rich by just remaining in cash.

Remain calm and don't get caught up in the so-called 'cash conundrum'

Many investors are feeling disappointed with equity markets and their investment portfolios at the moment. It has after all been an incredibly tough five years for South African investors. Add the global pandemic to our already long list of woes and, understandably, the feeling of surrender and doing something "safe" and predictable is appealing.

There's an old adage among investors during downturns: "Don't catch a falling knife". Using cash as a flight mechanism when things get tough is detrimental to long term portfolio returns. Instead of chasing performance, investors should take this time to assess if their asset allocation is appropriate given their liquidity needs, time horizon and investment goals.



Remember, that cash can be a very valuable tool when it is used as part of a holistic financial plan. If your investment horizon and goals haven't changed, then neither should your investment plan.

©2020 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited. Morningstar Investment Management South Africa is a subsidiary of Morningstar, Inc. All data sourced from Morningstar Direct as at May 2020 unless stated otherwise. MORNINGSTAR®

Risk Warnings

This commentary does not constitute investment, legal, tax or other advice and is supplied for information purposes only. Past performance is not a guide to future returns. The value of investments may go down as well as up and an investor may not get back the amount invested. Reference to any specific security is not a recommendation to buy or sell that security. The information, data, analyses, and opinions presented herein are provided as of the date written and are subject to change without notice. Every effort has been made to ensure the accuracy of the information provided, but Morningstar Investment Management South Africa (Pty) Ltd makes no warranty, express or implied regarding such information. The information presented herein will be deemed to be superseded by any subsequent versions of this commentary. Except as otherwise required by law, Morningstar Investment Management South Africa (Pty) Ltd shall not be responsible for any trading decisions, damages or losses resulting from, or related to, the information, data, analyses or opinions or their use.

This document may contain certain forward-looking statements. We use words such as "expects", "anticipates", "believes", "estimates", "forecasts", and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially and/or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason.

Morningstar Investment Management South Africa Disclosure

The Morningstar Investment Management group comprises Morningstar Inc.'s registered entities worldwide, including South Africa. Morningstar Investment Management South Africa (Pty) Ltd is an authorised financial services provider (FSP 45679) regulated by the Financial Sector Conduct Authority and is the entity providing the advisory/discretionary management services.

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.

©2020 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited. Morningstar Investment Management South Africa is a subsidiary of Morningstar, Inc. All data sourced from Morningstar Direct as at May 2020 unless stated otherwise.

MORNINGSTAR®