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Financial resilience for entrepreneurs and investors part 1

Executives & Entrepreneurs

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- We believe 2023 will be a year with turning points for inflation, interest rates, and growth. However, given considerable uncertainties as to the timing, speed, and extent of these inflections, entrepreneurs and investors may want to consider their financial resilience—that is, their ability to withstand events that negatively impact income or assets.
- In the first of a three-part series, we explore why it may be worth revisiting cash management strategies to bolster financial resilience today, but without compromising business and personal wealth goals in the future.
- We aim to help entrepreneurs and investors to decide how much cash to hold, how to put excess cash to work in other financial assets, and which tools can be used to build a Liquidity strategy.

Entrepreneurs and investors all have objectives they want to achieve—goals that inevitably require capital. They may adopt different investment approaches to achieving their goals. But what if the assumptions underpinning an approach prove to be wrong?

As outlined in our outlook, we believe 2023 will be a year with turning points for inflation, interest rates, and growth. However, given considerable uncertainties as to the timing, speed, and extent of these inflections, entrepreneurs and investors may want to consider their financial resilience—that is, their ability to withstand events that negatively impact income or assets.

In this three-part series, we'll look at three potential tools entrepreneurs and investors can use to bolster their financial resilience:

1. Managing cash for an uncertain world
2. Building a diversified financial portfolio
3. Using alternative approaches such as life insurance

As we outline some of the potential merits and drawbacks of these tools, it is important to stress that each entrepreneur and investor may favor a different mix of tools—as part of a holistic financial plan—to best meet their objectives and goals.

Below we explore why it may be worth revisiting cash management strategies to bolster financial resilience today, but without compromising business and personal wealth goals in the future.

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Tool 1: Managing cash for an uncertain world

Why hold cash?

Bear markets and recessions can arrive without much warning. They can result in sharp declines in the value of commercial and financial assets. However, these disruptions tend to be short-lived, with diversified investment portfolios recovering within about 3–5 years.

To build resilience against bear markets—and provide cash flow for unexpected expenses—we recommend setting aside 3–5 years of cash flow needs in a "Liquidity strategy." This approach should be funded with resources that are insulated from stock market and credit risk: cash, high-quality bonds, and reserved borrowing capacity.

This Liquidity strategy approach can help individuals and families to maintain their lifestyle during a bear market or during a temporary drop in their employment income.

Similarly, business owners can build up Liquidity strategy resources within their companies for use in cases of extraordinary expenses or to cover overhead in periods when demand wanes.

Potential advantages of precautionary savings include the ease of availability, flexibility, and cash's ability to hold its *nominal* value (although negative interest rates challenged this until recently for many euro and Swiss franc depositors).

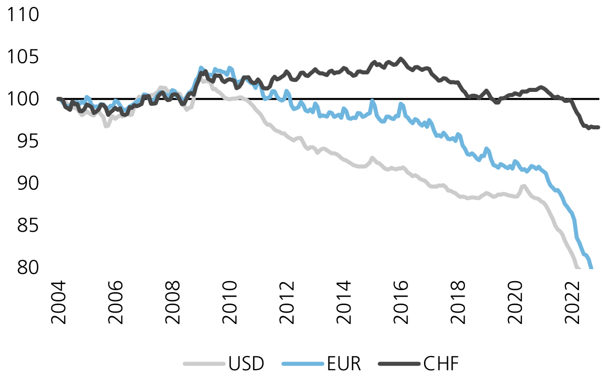
Why *too much cash* can hurt

Investors and business owners who don't evaluate the appropriate *size* of their savings for the next 3–5 years may undermine their long-term financial resilience. While cash may have outperformed other investment approaches in 2022, holding excessive savings rather than investing for the long term can entail opportunity costs. One cost could be the inflation-adjusted erosion of an entrepreneur's or investor's wealth.

Figure 1 demonstrates how rising general price levels eat into the spending power of cash held in major developed market currencies. Cash is a useful tool for meeting short-term expenses. But for satisfying long-run objectives or as a means of meeting unexpected bills farther in the future, cash is a foe—not a friend.

Figure 1: In the long run, cash is a foe for meeting goals

Inflation-adjusted value of 100 in select currencies invested in cash, including interest income, since 2004



Source: Bloomberg L.P., UBS, as of January 2023

As such, sizing the amount of cash to be held in the short and long term is critical. The level of precautionary savings that best supports a financial resilience strategy depends on personal and commercial goals, circumstances, and a variety of other factors.

How much cash is enough?

We believe that the best investment strategy for achieving an entrepreneur's or investor's goals should reflect their unique resources and needs. Therefore, our approach segments wealth into three investment strategies that are purpose-built to meet unique goals:

- A **Liquidity strategy**, to maintain a lifestyle regardless of short-term market volatility;
- A **Longevity strategy**, to improve a lifestyle by replacing working-age regular income in retirement and to fund spending for the rest of an entrepreneur's/investor's life; and
- A **Legacy strategy**, to grow assets in excess of lifetime needs to improve the lives of others, including future generations of the family or society at large.

In this context, cash is a poor long-term investment. Short-term interest rates are usually low relative to inflation, so uninvested cash tends to lose its purchasing power over time. Therefore, we generally advise against a large cash allocation in Longevity and Legacy strategies.

On the other hand, cash is a valuable "risk-free" asset for day-to-day expenses. There is very little risk that the currency in one's wallet—unlike assets in financial markets—will suddenly lose a lot of value. Therefore, a Liquidity strategy with cash and other high-quality safe assets should be part of a holistic investment approach.

Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

How much does one need in a Liquidity strategy?

There is no catch-all answer. Personal circumstances will determine how much an entrepreneur or investor will need to pull from their invested assets over the next three to five years. After this, it may be possible to fund a Liquidity strategy with enough cash, high-quality bonds, and borrowing capacity to finance that spending.

Why three to five years? This amount of time should be long enough for most diversified portfolios to fully recover from even the worst market losses. The presence of a Liquidity strategy can help to confidently invest the rest of one's wealth, knowing that one can satisfy business, personal, and family obligations while generally avoiding the risk of forced asset sales that lock in otherwise-temporary losses on long-term investments.

All-in or drip feed? How to allocate excess cash

To be clear, returns on cash in most developed markets are still below headline inflation rates. However, the return outlook for Liquidity strategies has not been as bright as this in years. With central bank credibility at stake, global interest rates will likely rise moderately higher until official measures of inflation slow more meaningful toward targets. We project policy interest rates to peak in the first half of 2023 around 5%, 3%, and 1.5%, in the US, Eurozone, and Switzerland, respectively.

Locking in today's interest rate levels for the longer-dated part of a Liquidity strategy makes sense. This rests on our view that inflation is likely to move closer to central bank targets toward the end of the year, improving real returns and offering some central banks scope to cut policy rates.

Given our outlook, entrepreneurs and investors will likely need to balance a desire for higher cash levels to weather volatility, against the desire to generate income and capital appreciation for meeting long-term objectives. While nominal returns on cash may be at levels not seen in years, and equities appear vulnerable to potential short-term headwinds from earnings disappointments, the longer-term outlook for balanced portfolios has brightened considerably thanks to more attractive bond yields and stock market valuations.

After the recent decline in stocks and bonds, balanced portfolio returns are set to significantly dwarf cash returns over the next few years.

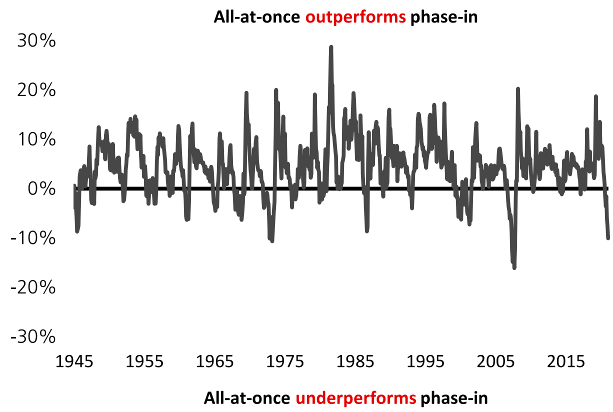
The return advantage for diversified portfolios versus cash is set to be even more impressive over the long term. Over multiple market cycles, we expect global equities to deliver average annual returns of between 7% and 9%, while higher yields on USD and EUR investment grade corporate bonds suggest an annual return potential of between 3.5% and 4.5%.

Figure 2 aims to show the relative merits and disadvantages of full investment versus 12-month drip-feed commitment into a balanced portfolio of equities and high-quality bonds. Statistically, an all-at-once approach has outperformed the 12-month phase-in approach in 81% of instances since 1945, by an average of 4.5 percentage points. Counterintuitively, this historical analysis shows that the bad timing risk of being out of the market—in the hope of putting to cash during a market pullback—tends to be more costly than the bad timing risk of putting cash to work just before a market decline. With these historical odds in mind, an all-at-once approach is usually the best approach—on average—for putting cash to work.

But there is some nuance for investors to ponder. An all-at-once approach for everyday deposits (regular dividends from a privately-held business, concentrated stock position, or portfolio of private equity investments) may be optimal, where the potential benefits of compounding and regular investment allow investors to capture the general long-term uptrend in asset market pricing. But when deposits are fewer, more "lumpy," and the pain of potential mark-to-market losses is greatest, the cost-benefit analysis may shift. The potential risk of bad market timing becomes more prominent, and there can be psychological benefits of phasing into markets.

Figure 2: It generally pays *not* to wait

Relative performance of 12-month phase-ins to a 60/40 stock/bond portfolio, versus an all-at-once approach



Source: MorningstarDirect, Bloomberg L.P., UBS, as of December 2022

Strategies are subject to individual client goals, objectives and suitability.

In our presentation *10 reasons to put cash to work*, we outline five potential ways to enhance the value of a phase-in strategy:

1. Put bonds to work in a lump sum, and only phase-in the equity allocation
2. Have a phase-in plan and stick with it—we recommend phasing cash into the market within 12 months
3. Accelerate a phase-in after a 5% or 10% market sell-off
4. Consider strategies—such as structured investments—and options—such as call buying and put writing—that can shield against the opportunity cost of phasing into the market
5. Address specific concerns and customize a financial plan to account for changing commercial, financial market, and family circumstances (all of which can impact the need for liquidity versus saving for our lifetimes and beyond).

How to manage your Liquidity strategy

Once an entrepreneur or investor has established the right Liquidity strategy size for their commercial or personal circumstances, it makes sense to allocate these resources using a mix of strategies that align with their cash flow needs over the next three to five years.

Not all "cash" is created equal. For more details on the various cash, cash-equivalent, or cross-asset building blocks beyond the scope of this paper, please see "*Cash alternatives: Liquidity solutions.*"

Core holding

The most straightforward way to align your Liquidity strategy assets with your planned expenses is to build a "ladder" of bonds, certificates of deposit, and term deposits so that the interest and principal payments perfectly match the size and timing of your planned spending. A bond/CD ladder arrangement helps businesses and investors insulate their known spending against the risk that interest rate fluctuations will cause them to fall short of the cash flow that they need for known spending.

A satellite approach to cash flow management

However, not every expense is known in advance. For spending needs that are more uncertain in timing and quantity, we recommend three satellites that can act as complements to the core bond/CD ladder approach. These strategies will help to further protect purchasing power in the Liquidity strategy, allowing investors to tap into growth and yield opportunities in exchange for taking on more liquidity, credit, currency, or counterparty risk (as appropriate for the investor's risk tolerance).

Tier I: Everyday cash

Everyday cash should be earmarked for everyday expenses such as operating expenses, personal living expenses, and potential "rainy day" funds. Regular expenses are known with some degree of certainty and need to be liquid and flexible for deployment at short notice. Precautionary savings may require the same flexibility —unforeseen circumstances cannot be planned for by definition—but excess amounts of emergency funds come at a cost in terms of lost returns, as more liquid cash offerings tend to offer lower prospective returns than longer-term offerings.

Given the need for immediate access, Tier I solutions should be limited to instant access banking facilities. Even with higher central bank interest rates, it is improbable that everyday cash will deliver positive real returns throughout the market cycle.

Everyday cash should typically comprise around 6–12 months of cash flow needs.

Tier II: Savings cash

This pool of capital is earmarked for known expenditures with unknown timing, but for which there will be some warning. Without needing instant access to these funds, they can be invested in less-liquid strategies and generate potentially higher returns than Tier I solutions. Tier II solutions include savings solutions, call deposits, or money market options. These can offer a blend of returns, diversified counterparty exposure, and different liquidity windows that match payment needs, and have limited interest rate or credit exposure.

Tier II typically comprises around 1–2 years of cash flow needs.

Strategies are subject to individual client goals, objectives and suitability.

Tier III: Investment cash

The last satellite approach is for funds that are likely deployed in three to five years' time—perhaps for a business investment, private market capital calls, or as a buffer to draw on in the later stages of a bear market.

Because of the longer time horizon, Tier III solutions can include a broader potential investment universe. Liquidity considerations may be less pressing, allowing solutions that are more likely to deliver returns that at least keep pace with inflation. However, we stress the importance of managing credit, duration, and counterparty risks—Tier III solutions should represent asset classes that perform well (or at least provide capital preservation) during a bear market or a credit crisis.

It may be possible to deploy cash for this approach across a combination of highly rated fixed income (government bills and bonds, municipal and agency debt, shorter-dated investment grade debt). Well-diversified, risk-managed fixed income portfolios—even if they include a small allocation to higher-yielding credit (such as emerging market or high yield debt)—can also be an appropriate solution to increase yield potential.

Similarly, certain market-linked structured solutions may allow entrepreneurs and investors to generate additional yield with potential capital preservation features, albeit with the associated risks of such approaches whose return is contingent on uncertain capital market outcomes.

Tier III typically comprises 1–3 years of cash flow needs—usually for spending in 3–5 years' time.

Deploying the toolkit

Having grown accustomed to more than a decade of low or sub-zero interest rates, entrepreneurs and investors may be unaware of the potential yields now available for managing their Liquidity strategy portfolio.

Figure 3 highlights some Liquidity strategy solutions for each tier, with estimates of expected returns and risk levels for each. With interest rates having also climbed in Switzerland, the Eurozone, and other areas, it may pay to revisit cash management approaches in 2023.

Figure 3: Tools for the tiers of a Liquidity strategy

An indicative toolkit for the tiers of a Liquidity strategy

	Liquidity strategy solution	Indicative return	Market risk	Liquidity risk	Credit/ counterparty risk
Tier I	Bank deposit / current accounts/	+	•	•	•
Everyday cash	sweep account				
Tier II	Call deposits	+	•	•	••
Savings cash	Core Savings*	++	•	•	•
	Money Market Funds	++	••	•	•
Tier III					
Investment cash	Fixed deposits (3rd party)	++	•	•••	••
	Certificates of deposit/T-bills/sovereign bonds/commercial paper, highly-rated corporate bonds < 1 year maturity)	++	•••	••	••
	Extendible money market certificate	+++	••	••	••
	Short-duration bond funds	+++	•••	••	••
	Diversified fixed-income asset allocation	+++	••••	•	••
	Market-Linked CDs (MLCDs)	++++	•••	•••	•••
	Market-linked structured solutions with 100% capital protection	++ - ++++	••••	••	••

*Available only in the US.

Source: UBS, as of January 2023. For illustrative purposes only. Not all indicative tools may be available to all entrepreneurs/investors, in all jurisdictions.

Legend: + indicates return potential, • indicates risk potential. For illustrative purposes only. Market risk refers to the volatility of the price of the investment—the extent to which its market value will deviate from your initial purchase price. Liquidity risk indicates the ability to sell the investment quickly and without exchange costs. Credit / counterparty risk reflects the possibility that the issuer(s) associated with that solution will fail to meet their obligations under the terms of the contract.

Borrowing in the context of cash management

When implemented prudently, borrowing strategies can be an effective complement to asset-based Liquidity strategy solutions. Borrowing against assets to meet cash needs may allow longer-term investments earmarked for retirement or post-lifetime goals to continue growing. This approach, when savvily managed, can reduce the amount of cash drag from safe-haven assets during a bull market rally.

While borrowing costs have risen over the last 12–18 months, they remain low by historical standards. Moreover, the forward-looking return outlook for diversified portfolios has improved dramatically. Last, but not least, inflationary environments tend to be beneficial for borrowers, who benefit from low real yields and are able to repay their loans with depreciated currency.

Strategies are subject to individual client goals, objectives and suitability.

Although entrepreneurs and investors may be hesitant to consider taking on debt—whether through a fear of ceding control to creditors or a perception that all liabilities are "bad"—it may be worth considering both sides of the balance sheet when reviewing long-term goals and their funding sources. Commercial and personal wealth advisors can help guide challenging conversations about taking on debt, as well as supporting with quantitative analysis to ascertain the disadvantages or merits of borrowing versus selling assets.

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