Put cash to work

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- **Why?** (1) Cash's long-term underperformance compared to other asset classes is a structural phenomenon. (2) Global quality bonds (Bloomberg Global Aggregate) historically outperformed USD cash (one- to three-month T-bills) in the 12- to 24-month period after rate peaks. (3) Since 1945, cash has underperformed a strategy of phasing into a diversified portfolio of US stocks and bonds on around 83% of five-year horizons.
- **Why now?** (1) In our base case, the Fed would cut interest rates by a further 75bps by the first quarter of 2026, prioritizing labor market weakness over a likely temporary increase in inflation. (2) Investors should review cash allocations and deploy excess cash in globally diversified portfolios. (3) Holding excess short-term US dollars may expose investors to negative after-inflation returns and reinvestment risk.

With the Fed cutting interest rates, investors should consider alternative ways to earn portfolio income.
Source - Unsplash

Cash provides security and income, but over the long term, excess cash holdings tend to be detrimental to portfolio growth. As part of our Liquidity. Longevity. Legacy. framework, we typically advise that investors limit liquidity holdings to those needed for near-term expected portfolio withdrawals, and deploy excess liquidity for longerterm growth.

A period of high interest rates in recent years has made it easier to hold excess cash, but with income potential from cash now low in much of Europe and Switzerland, or falling as we expect a further 75bps of Fed rate cuts by end January, the imperative to put cash to work is increasing. We recommend the following three steps:

Optimize liquidity strategy

Liquidity can be divided into three segments:

Everyday cash, for spending needs up to one year, should be readily available and take little to no interest rate, credit, or market risk. Deposit programs, money market funds, or certificates of deposit offer relative stability in exchange for modest yields.

Core liquidity, covering known expenses or emergencies over a one- to three-year horizon, should balance flexibility and yield. A bond ladder—a portfolio of individual bonds or fixed maturity bond funds with staggered maturities—can provide predictable cash flows and manage interest rate risk. Structured strategies with capital preservation features may also be considered, aiming to capture market gains while curtailing losses so the original capital is returned at maturity.

Investment cash, earmarked for needs up to five years out, shifts the focus from immediate access to optimizing returns while accepting some price fluctuation and lower liquidity. This allocation is best built using medium-term government or investment grade bonds, as well as diversified multi-sector bond investment approaches.

Quality bonds have historically outperformed cash after rate peaks. Our analysis of prior rate hiking cycles shows that average 12-month forward returns for global high-quality bonds (Bloomberg Global Aggregate) outperformed US dollar cash (one- to three-month T-bills) in the 12- to 24-month period after the peak in rates by between 2.7% and 4.1%. Quality bonds should also deliver appealing returns in an adverse growth scenario.

Select regional credit opportunities may offer higher returns. Within the US we prefer quality corporate bonds across a range of defensive sectors and also select rising star candidates. In Europe, a core allocation to more defensive and domestically oriented issuers is recommended, with subordinated bonds of established investment grade issuers and instruments from rising star candidates as complements. In Asia Pacific, Asian bank credit continues to offer good value due to solid capitalization profiles and benign asset quality. Bonds from Korean and select Indonesian issuers are also attractive.

Diversified active fixed income strategies can also add value to a liquidity strategy, providing exposure to higher-returning bond segments like high yield debt and emerging market bonds in a risk-controlled way. Multi-asset strategies may also invest tactically across assets, with positions in equities and equity-derivative strategies to supplement income.

Phase excess liquidity into diversified portfolios

Deploying cash or liquidity holdings in excess of those needed for near-term expected portfolio withdrawals into diversified portfolios can allow investors to benefit from likely longer-term appreciation of financial assets relative to cash.

Between 1960 and October 2024, USD 1 of cash would have grown to USD 15.71 (one- to three-month T-bills) versus USD 43.69 for government bonds (Bloomberg US Treasuries Intermediate) and USD 672.43 for equities (US large caps). And since 1945, cash has underperformed a strategy of phasing into diversified portfolio of stocks and bonds on around 74% of one-year horizons and around 83% of five-year horizons.

Approaches to phasing in can vary, but common strategies include investing equal amounts at regular intervals—such as monthly or quarterly—over a defined period. This method, often called dollar-cost averaging, can help reduce the impact of market volatility.

Consider income replacement strategies

Investors who have relied on regular income from cash and are seeking income replacement in light of lower cash interest rates can consider complementing a diversified portfolio with equity income strategies or yield-generating structured strategies. Such approaches can deliver comparable or even higher returns than some cash and fixed income strategies, albeit with higher associated risk.

Equity income strategies are available in various markets. In CHF, Swiss dividend-paying equities are attractive, with an average dividend yield around 3.0%, higher than Swiss franc bond yields. Robust balance sheets and profitability suggest that market-wide distributions are sustainable. Attractive yields in Southeast Asian (ASEAN) markets stand out for investors focused on income and portfolio resilience, with ASEAN markets offering an average dividend yield of 4.6% this year. In the US, while dividend yields are generally relatively low, for dividend-seekers within US equities we do see select opportunities in stocks with attractive dividend yields. For details, see our "Yield & Income" publication.

Yield-generating structured strategies, including reverse convertibles, may grow in appeal when interest rates are low. Reverse convertibles combine a bond with a put option, offering yields that depend on the market's perceived volatility of the underlying asset. By monetizing market volatility, reverse convertibles may deliver a unique return stream, often less correlated with traditional investments. Systematic allocation to reverse convertibles has historically improved portfolio returns with similar risk, particularly in sideways or gently declining markets. Steady coupon payments provide predictability, while features like barriers and autocalls can tailor risk and reward. However, reverse convertibles carry specific risks, including market, credit, liquidity, and complexity risks. Understanding these features is essential before considering an allocation.

Financial planning considerations

Investors may also be able to find ways to reduce reliance on excess cash in the context of a broader financial plan. For example, annuities can secure a reliable stream of income that can last for the rest of an investor's life. Meanwhile, opening up borrowing capacity can reduce the need to hold excess cash for unlikely events.

Appendix

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