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INVESTMENT TALKS

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The Reinvestment Risk of Cash

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Executive summary

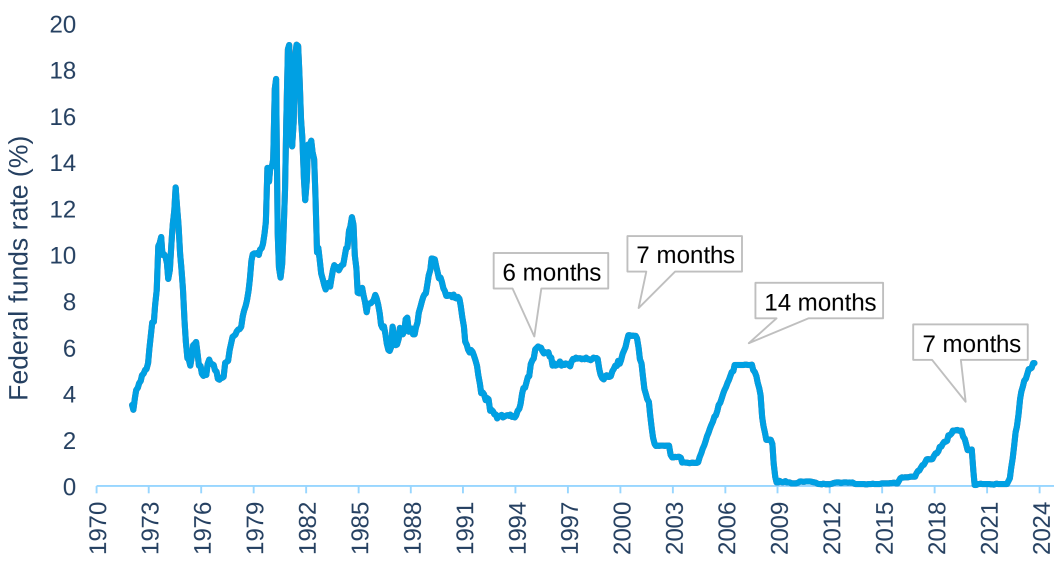
- *With cash rates elevated, why own longer-maturity fixed income securities that may offer a lower yield and higher volatility?*
- *Against the interest rate risk inherent in most fixed income securities, investors should consider the reinvestment risk inherent in cash.*
- *Moving into longer-maturity fixed income securities may help investors lock in today's attractive income levels before they disappear.*

For the first time in many years, savers can earn a reasonable return in cash. Naturally, this era of plenty comes on the heels of a nearly three-year selloff in the US bond market, with periods of positive correlation between equities and bonds serving as salt in the wound. In such an environment, it is understandable that some investors have found comfort in cash.

But how long can compelling cash rates last? Historically, the answer has been: not very long. In every rate hike cycle since the 1970s, the US Federal Reserve has "paused at the peak" federal funds rate for a matter of months, not years. Furthermore, once the Fed starts cutting the funds rate, cash rates can move hundreds of basis points lower in a short period of time.

How long can compelling cash rates last? Historically, the answer has been: not very long.

Exhibit 1: How long does the Fed "pause at the peak?" Historically, once the Fed pauses, the interest rate cuts start in a matter of months, not years. And when it cuts, it tends to cut big.



Source: Bloomberg, 10/16/2023. Federal funds effective rate.

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This history suggests cash investors today may be taking on substantial reinvestment risk at a time when interest rates in fixed income appear unusually attractive versus history (see Exhibits 2 and 3). How many other asset classes are nearly the cheapest they have been in 20 years? What investment decisions would be made if the same could be said today about the equity market or housing market? Of course, such valuations do not arrive without reason, and recent bond market volatility may continue in the near-term.

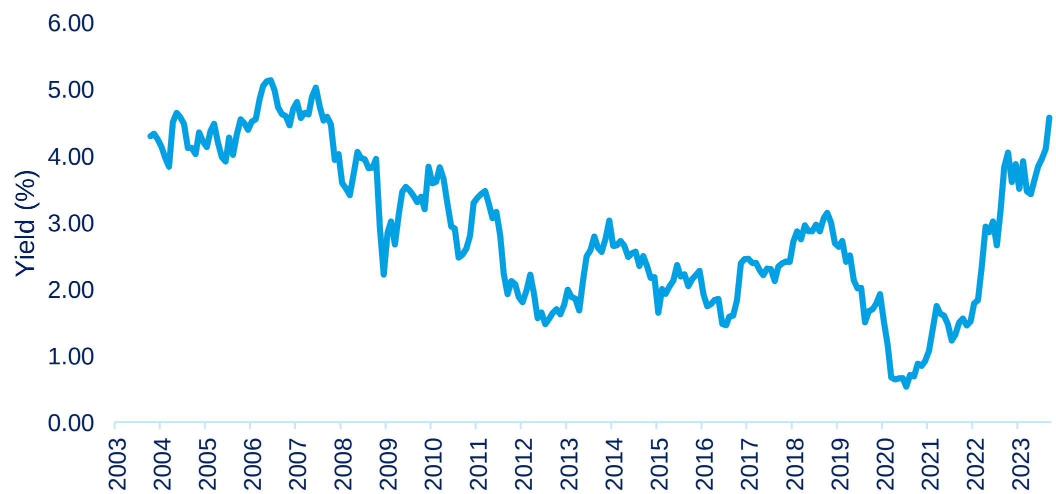
Conclusion

While cash interest rates may be relatively high today, those elevated levels may not last very long. For investors whose objectives can be measured in months or years rather than days, we believe today's historically elevated interest rates may call for allocating at a point on the yield curve that controls for volatility risk without ignoring reinvestment risk.

Exhibit 2: US Treasury 2-year yields are near the widest levels seen in the past 20 years.

Source: Bloomberg, 10/16/2023. Notably, the currently elevated rate levels are not explained by inflation. The US Treasury Inflation Protected Securities (TIPS) market likewise indicates real yields are attractive versus history (not pictured).

Exhibit 3: US Treasury 10-year yields are elevated versus the past 20 years of history.



Source: Bloomberg, 10/16/2023. Notably, the currently elevated rate levels are not explained by inflation. The US Treasury Inflation Protected Securities (TIPS) market likewise indicates real yields are attractive versus history (not pictured).

Index and Term Definitions

- **Correlation:** Measures the degree to which two variables move in relation to each other. A positive correlation signifies similar movements; negative correlation indicates opposite movement.
- **Reinvestment risk:** The chance that cash flows received from an investment will earn less when put to use in a new investment.
- **Treasury Inflation-Protected Securities (TIPS):** Marketable US Treasury securities whose principal and interest payments are adjusted for inflation.
- **Volatility risk:** The risk of a change in the price of a portfolio or holding.

Important information