Is cash burning a hole in your pocket — or worse, in your portfolio?

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"Sometimes I am two people. Johnny is the nice one. Cash causes all the trouble. They fight."

— Johnny Cash

Just like Johnny's troublesome alter ego, the role of cash can, at times, be at odds. When it comes to stashing your cash, you might wonder whether it belongs in your investment portfolio, or if it's better off on your balance sheet. The answer is not as binary as it may seem. As you assess your cash needs and investment goals, keep in mind you don't need to make a tradeoff between holding or investing cash — with the right planning, you can do both.

In this publication, PNC's resident experts Amanda Agati and Jonathan Kessler face off on the timely topic of cash and share their thoughts on asset allocation for investors who want to put excess capital to work through their multi-asset investment portfolios and balance sheets.

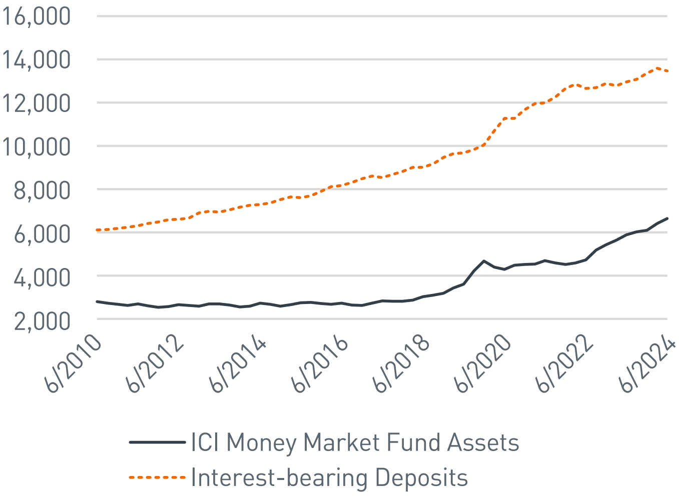
Why is cash such a hot topic right now?

AA We just turned the corner on the fastest, most aggressive Federal Reserve (Fed) monetary policy tightening cycle in 40 years, and short-term interest rates are finally expected to decline. Due to the extreme rise in inflation during the pandemic, the Fed raised the fed funds target rate by 525 basis points (bps) from March 2022 through July 2023, and investors piled into money market funds and interest-bearing deposits to capture that yield (**Figure 1**). Remember, this followed a period of more than 15 years of near-zero interest rates, so investors were hungry for higher-yielding liquidity options.

Given the expected decline in short-term interest rates, we think investors should reassess how they're putting their cash to work. While cash can offer relatively high risk-adjusted returns during high-interest-rate environments, over the long term, cash tends to yield much lower returns than stocks or bonds. As a result, holding too much cash can limit portfolio growth over time, leading to increased shortfall risk.

Figure 1. ICI Money Market Fund Assets, FDIC Interest-Bearing Deposits $ billions

Money market and interest-bearing deposit flows continue to grow



As of 6/30/2024. Source: Bloomberg L.P.

The importance of examining all options for excess cash is heightened by current market dynamics. In a twist from what one might expect, since the Fed's first rate cut in September, longer-term yields have been on the rise. Although the policy rate is lower by 75 bps, as of this writing, the 10-year U.S. Treasury is up 50 bps. Many investors may have been assuming the yield curve would shift down; however, we believe what's happening reflects the bond market's concerns about deficits and debt levels. It's no time to leave cash on the table!

Furthermore, the start of the new year will bring the end of the debt ceiling suspension, unless a compromise is reached beforehand. Consensus estimates the Treasury will have a cash balance of approximately $700 billion come January 1. At an average year's spending pace, the Treasury will exhaust these funds by August 2025. While debt ceiling uncertainty creates a headwind for markets, should the Treasury be forced to rely on funding from its general account, it would add liquidity to financial markets and serve as a tailwind. Overall, this uncertainty is likely contributing to rising yields; we expect yields to experience some relief once a resolution is reached.

Is investing excess cash the only way to go?

JK While it's prudent to consider deploying cash into longer-term, return- and income-oriented investments as the Fed guides rates lower, we believe there is also value to having immediate access to cash for short- and medium- term needs.

We think investors can benefit from first segmenting their cash pool into three buckets: operating, reserve and strategic cash (**Figure 2**). Operating cash is generally earmarked for short-term expenses and requires quick, easy access. Reserve cash is for medium-term needs and unexpected expenses. Strategic cash has the longest investment horizon of the three and is typically set aside for known, but future, liquidity needs such as next year's tuition payment or a downpayment on a home. With each option, there are various considerations in terms of risk tolerance, return and income expectations, and the timely ability to access liquidity.

Figure 2. Cash Segments and Solutions

Pro tip: Earmark your cash balances based on your needs and goals

	Solutions
Operating Cash Short-term operating expenses Zero tolerance for loss and interest rate risk Easy access (same-day settlement)	Checking account Money market deposit account
Reserve Cash Intermediate-term obligations & unexpected expenses Low risk tolerance, sensitive to realized gains and losses Access to majority of cash with timely settlement	Money market mutual funds High-yield savings accounts
Strategic Cash Intermediate-term obligations Moderate risk tolerance Access to cash determined by liquidity needs	Certificates of deposit Short-term bonds

As you evaluate your options, consider how much cash you may need to cover the cost of everyday living, reserves for unplanned expenses and "rainy day" funds for extended periods of unexpected needs.

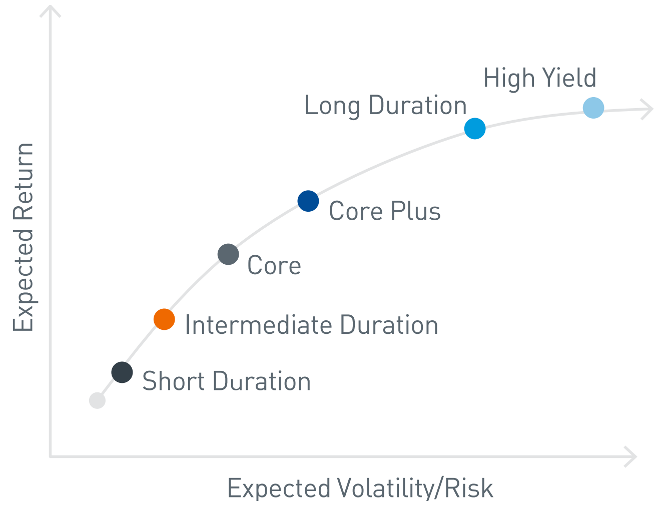
How should I allocate my uninvested cash?

JK A checking account is a great option for quick and easy access to cash but offers little in the way of return. Consider keeping it filled with just enough cash to support spending needs to avoid missing potential return opportunities. For infrequent but substantial expenses, savings or money market accounts can provide easy-to-access liquidity while also being able to generate returns commensurate with money market mutual funds, with additional security in the form of FDIC coverage, up to allowable limits.

Investors seeking to maximize returns on cash while remaining flexible enough to potentially fund medium- or longer-term liquidity needs typically turn to term deposits, such as certificates of deposit (CDs). Whether it's an upcoming tax payment, planned investment in a business, a future tuition payment or other planned expense, term funding can generate an attractive yield while also offering principal protection through FDIC coverage (again, up to allowable limits).

Figure 3. Fixed Income Strategies Across the Efficient Frontier

Cash alternatives have varied expected risk, return and income considerations



For illustration only. Source: PNC

Is there a "go-to" option for investing excess cash?

AA If you're seeking to reallocate excess cash, it's important to first review your overall investment policy statement, as well as your current goals and objectives, to better understand any potential gaps in your portfolio positioning. Fixed income is often the first place investors look when redeploying cash, given its generally low-to-moderate expected risk and potential for income generation.

> As short-term interest rates are expected to come down, we are encouraging investors to look further out the yield curve if it fits their investment profile."

While near-cash fixed income options at the shortest end of the yield curve grew in popularity as interest rates rose, as short-term interest rates are expected to come down, we are encouraging investors to look further out the yield curve if it fits their investment profile (**Figure 3**). We believe employing a wider spectrum of sectors and security types helps improve risk-adjusted outcomes, based on historical return volatility and correlations.

For example, moving from cash into short-term (that is, 1-3 years to maturity) investment-grade fixed income can offer greater portfolio diversification by broadening the investment universe. Additionally, as the yield curve normalizes, this segment of the curve should offer the ability to capture the appreciation of a security as it moves from a higher-yielding point on the curve to a lower-yielding point on its way toward maturity.

For investors with a slightly longer-term horizon, core and core plus fixed income (5-7 years to maturity, on average) may also be a relatively attractive option given the movement in rates. Core fixed income tends to be the primary ballast in multi-asset portfolios given its broad diversification across Treasury, Corporate and Securitized markets. We expect correlations between stocks and bonds to also begin falling as the Fed keeps cutting its policy rate and the yield curve steepens, which would add to this segment's diversification benefits.

Further out the risk spectrum are high yield bonds. Over the course of a business cycle, we expect high yield (HY) to outperform core fixed income. Historically, HY has a stronger correlation with equity markets than the direction of interest rates. Thus, we believe the diversification benefit of HY is an important consideration for fixed income investors. With the economy showing signs of achieving a soft-landing, HY issuers appear to have a better fundamental backdrop in which to roll over maturing debt. However, valuations continue to richen as HY spreads sit near cycle lows.

Outside the United States, we like emerging market (EM) debt, which tends to offer better fundamentals and higher yields than developed markets. We also prefer U.S. dollar-denominated EM debt, which should provide an additional tailwind in periods of dollar strength. In this shifting interest rate environment, EM debt offers an attractive yield pickup; it has U.S.-high-yield-like characteristics, but with stronger underlying fundamentals relative to the slower growth prospects across the developed world. However, valuations now appear rich relative to other fixed income asset classes.

In terms of implementation, we tend to favor active managers within fixed income as we believe they benefit from certain structural advantages. For example, among multisector fixed income managers, we focus on managers with scale and experience in off-benchmark sectors and securities. Scale is important since the economics of trading costs and retaining top talent favor large asset bases. Off-benchmark experience enables skilled managers to access areas within fixed income that are off the beaten path, which could enhance diversification.

Are there any investment alternatives to fixed income?

AA Depending on your circumstances, equities or alternatives might also be worthwhile options. Relative to fixed income, these options tend to come with more investment risk, but also more capital appreciation potential as well.

In terms of an income-generating option within equities, one of the most conservative sub-classes is high-quality, dividend growers, which should benefit as their yields become more attractive amid decreasing short-term interest rates. Easing financial conditions are also a tailwind for equities in general. Quality companies, in our view, have high rates of recurring revenue; strong, defendable profit margins; reliable cash flow generation and low leverage. Quality equities have underperformed the mega-cap tech leaders in the current bull-market environment, creating an attractive relative valuation entry point.

> “Quality companies, in our view, have high rates of recurring revenue; strong, defendable profit margins; reliable cash flow generation and low leverage.”

In addition to these public-market options, there are private-market options as well. For qualified investors seeking equity market exposure, certain hedge fund strategies, such as long-short or multi-strategy, that focus on low volatility and generating excess returns relative to their benchmark, may be an attractive option. In our view, they generally come with a moderate level of risk and expected return but aren't good options for income generation. From a timeliness perspective, we believe these funds are generally well-positioned to benefit from the global central bank easing cycle.

Private credit is another option. This asset class is the fastest growing within private markets, as traditional lending markets remain restrictive since the banking industry challenges in March 2023. While credit quality is typically below investment grade, most direct lending is senior secured, making it high on the capital structure. However, it's important to keep in mind, selecting a high-quality private debt manager is essential; their skill at investment selection is critical for performance. Furthermore, because the asset class has experienced rapid growth in new assets, investors should be cautious of overly exuberant sentiment.

Another fast-growing area of private markets is secondary offerings, which provide liquidity to

primary investors in private companies. Secondary investors, in our view, benefit from a shortened capital distribution period and shorter investment durations. Investing in secondaries also tends to mitigate the common J-curve pattern associated with private equity, in which an initial period of negative returns inflects and turns positive. A slowdown of merger & acquisition activity this year and the lack of distributions by private equity funds has created a symbiotic environment where company owners are seeking liquidity through private equity solutions and investors are seeking liquidity through primary-investor-led secondaries. This demand for liquidity is contributing to a "buyer's market" in secondaries.

Can investors who have already allocated their cash generate additional liquidity if needed?

JK Investors who want to support their liquidity needs, keep their cash reserves intact and stay invested in the market may be able to tap into their diversified portfolios as a source of liquidity through a securities-based line of credit. Interest rates on these facilities are typically floating in nature and linked to short-term indices such as the Secured Overnight Financing Rate. As short-term rates fall, securities-based lending may be an attractive option for investors who want to manage their cash flow and meet their liquidity needs.

Investors who have larger, illiquid investments, such as primary residences, second homes or residential investment properties, may be able to use these illiquid assets as a source of liquidity. By using cash-out refinance mortgages or home equity lines of credit (HELOC), investors can potentially fund investment or business opportunities, home renovations, or even large expenses. Tapping into home equity can also provide tax benefits as interest on certain transactions is tax deductible (up to allowable limits) and may provide an investor the ability to execute tax-efficient borrowing strategies to support taxable investment strategies.

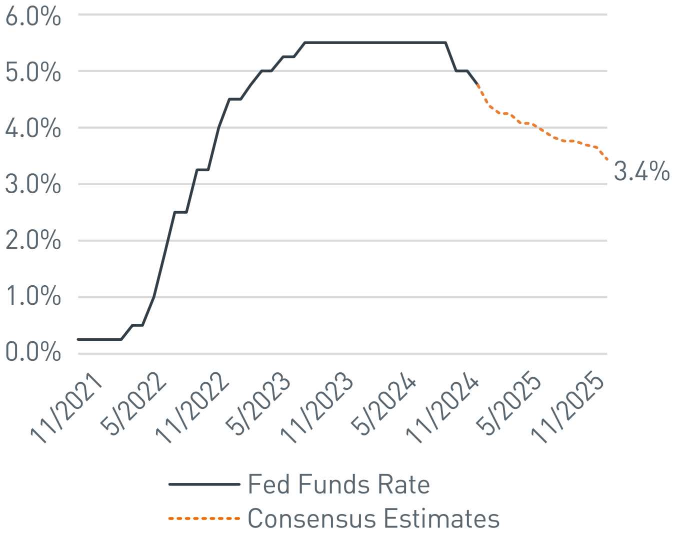
What does the path forward for interest rates mean for cash?

AA We share the consensus view that the Fed will continue lowering interest rates through 2025 (**Figure 4**). However, the path to get to the Fed's long-term target — the so-called "terminal rate" — will likely not be a straight line. The Fed has made it clear that future decisions will be rooted in economic data, which will naturally fluctuate over time and potentially be impacted by fiscal policy uncertainty. As we assess our clients' long-term asset allocations, we believe the journey to the Fed's terminal rate holds less influence than its final destination. Although Fed rate cuts have begun, the journey is not over as the Fed continues to cut its policy rate well into 2025, so investors should consider whether it still makes sense to hold large allocations of cash.

> "We believe the journey to the Fed's terminal rate holds less influence than its final destination."

Figure 4. Fed Funds Rate

As the Fed cuts rates, cash yields should fall



As of 11/30/2024. Source: Bloomberg L.P.

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