Why Cash Could be a Killer For Your Portfolio

Description

Deciding how much cash to hold in a portfolio is a tough choice for any investor to make. On the one hand, some cash is a necessity. It is required to take advantage of inefficient short-term pricing of assets which could lead to profitable investment opportunities for the long run. However, cash also reduces the overall returns of a portfolio, since it offers a modest return in comparison to shares.

Looking ahead, cash may become an even less efficient asset. Global inflation is expected to rise, and with world stock markets making gains there could be a valid argument to reduce cash levels to extremely low levels over the medium term.

Inflationary outlook

While the world has experienced a decade of deflationary forces, higher inflation looks set to take hold in future. Deflation has generally been avoided since the financial crisis because of the ultra-loose monetary policies pursued across the developed world. They have helped to keep the price level rising, albeit at a relatively slow pace. As such, the real return on cash has generally been negative, but has not been poor enough to discourage investors from holding sizeable chunks of their portfolios in the asset.

Now though, the prospect of higher spending and lower taxes in the US may create higher inflation. This could be exported across the globe and lead to an even worse real return on cash over the medium term.

Rising share prices

While global stock markets have enjoyed a major Bull Run in recent years which has increased the opportunity cost of holding cash, further share price gains could be ahead. There seems to be a cautious standpoint from Central Banks across the developed world regarding the pace of monetary policy tightening. This may lead to low interest rates and stimulus packages being left in place for longer than they perhaps should be. The result of this could be rising share prices.

Certainly, some stocks appear to be overpriced after their gains in recent years. However, a number of industries such as oil and gas, mining and the banking sector may still offer high levels of upside potential. They could prove to be the catalysts for further stock market gains. Holding too much cash within a portfolio may therefore have an increasingly negative effect on overall returns versus a more efficient portfolio.

Takeaway

Holding some cash within a portfolio is prudent. Share prices are usually volatile, and having cash on hand can create the opportunity to take advantage when high quality companies are trading at relatively low prices. However, holding too much cash reduces overall returns. With inflation forecast to move higher and stock markets still on a major Bull Run, the opportunity cost of cash as an investment may increase over the coming years.

Therefore, focusing on shares through a buy-and-hold strategy could be a sound move for Foolish investors to make at the present time.

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peterstephens