THE GLOBE AND MAIL

April 22, 2011

When inflation comes knockin', cash starts rockin'

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From Saturday's Globe and Mail

Money market funds, T-bills and high-interest accounts let you safely park your investment dollars when prices are on the rise

When financial markets crashed in 2008, cash was king.

Today, cash is trash.

Prediction for the not-too-distant future: Cash will be cool again. The hotter inflation gets, the cooler cash will be.

Cash is the catch-all phrase to describe a safe parking place for your investment dollars. Cash can be uninvested money sitting in your investment account, it can be a money market fund, a high-interest savings account or a Treasury bill. The common threads are, first, that you don't have to worry about cash investments losing value and, second, that your returns are tied to short-term interest rates.

Those rates are puny right now, which is why cash is trash. Quietly, though, cash is making a comeback.

For one thing, short-term rates have quietly increased over the past year. The yield on a one-year Government of Canada T-bill has been around 1.4 per cent lately, up from about 0.45 per cent a year ago. Bank of Canada data show that one-year T-bill yields averaged 2.74 per cent over the past 10 years, so there's obviously lots of potential for higher returns as the economy gains momentum.

It's hard to find consensus among economists and money managers about the pace of growth ahead, but concern about inflation is on the rise. Earlier in April, before this week's surprisingly high inflation reading for March was released by Statistics Canada, the money managers at Baskin Financial Services gave a presentation titled Taking Shelter From the Inflation Storm. "From being off the radar screen last year, suddenly inflation looks like an oncoming, perhaps unstoppable, freight train," the firm said.

The worse inflation gets, the more you'll want cash in your portfolio. In a recent study of the inflationary period from 1965 through 1980, the investment firm Nomura Securities found that cash outperformed stocks, bonds and commodities in the U.S. market. This was a period in which the annual inflation rate rose as high as 15 per cent in the United States.

A study by academics at Seattle University found that between 1954 and 2007, T-bills were outperformed on average by stocks and bonds, after inflation. "However, there were years when Treasury bills did relatively better," this study says. "Specifically, in years when inflation levels were high, the average real returns on bonds and stocks tended to be lower than those on Treasury bills."

T-bills and the rest of the cash family of investments are so good in inflationary times because their yields quickly reflect interest rate increases initiated by central banks to cool the economy. But it's important to note that the Seattle University study looked at returns on a pretax basis. In a non-registered account, where cash returns are treated like regular income, the performance of cash would likely have lagged inflation slightly.

Cash generates nowhere near the amount of analysis that stocks and bonds do in terms of portfolio building, but there are still wide differences of opinion on how and where it fits. One view is that your investing goals and risk tolerance dictate a set amount of cash for a portfolio, maybe 5 to 15 per cent. In some cases, the cash weighting is lumped in with bonds, a.k.a. fixed income. In others, it's a separate asset.

Another view is that you strategically build up cash in your portfolio at times when you foresee a market decline. That's what they're doing at Montreal-based Lorne Steinberg Wealth Management, which this week sent out a market update with a cautious tone. "The only way to preserve capital is to hold cash when the risk-to-reward ratio is unfavourable," the firm said. "At present, we believe this ratio makes it prudent to hold a significant cash position."

A cash-first approach to investing is the barbell strategy suggested by economist Nassim Taleb, author of the influential book, *The Black Swan: The Impact of the Highly Improbable*. Here, you invest most of your portfolio, say 80 to 90 per cent, in risk-free cash investments like T-bills and the remainder in assets of your choice that offer a high level of risk and potential reward.

There are also people who don't see a permanent role for cash in portfolios. Financial planner Rona Birenbaum said she holds cash in client accounts for only two reasons - the money will be needed in 12 to 24 months for such purposes as a home renovation or car purchase, or the client is making gradual investments over a period of 12 to 18 months through a dollar-cost averaging program. "We do not hold cash for market-timing purposes," Ms. Birenbaum said in an e-mail.

Now to the question of how best to hold cash. Let's look at some options:

Money market mutual funds

Pro: The traditional choice because all fund companies offer them, and they can usually be bought and sold without fees.

Con: Fees have been cut, but they're still high enough to leave returns in the 0.4-to-0.8-per-cent range.

Verdict: Convenient, but a bad choice

High-interest savings products

Pro: Simple to use because they're bought and sold like mutual funds, and the returns are much higher than money market funds (see chart); Canada Deposit Insurance Corp. covers holdings up to $100,000

Con: Not always available from your investment dealer; fees may apply at some firms when you make a withdrawal.

Verdict: The No. 1 option. Much better than money market funds

Claymore Premium Money Market ETF CMR-T

Pro: A money market mutual fund operated in an ETF format, which means a low management expense ratio of 0.22 per cent;

Con: You have to pay brokerage fees to buy and sell this fund and that will undercut the fee advantage.

Verdict: Better than a traditional money market, but watch those brokerage commissions.

Horizons AlphaPro Floating Rate Bond ETF HFR-T

Pro: This exchange-traded fund holds high-grade corporate bonds and uses a derivative instrument called an interest rate swap to deliver returns that float up and down with interest rates; the after-fee yield right now is about 2.5 per cent.

Con: Would fall in value in an environment where investors are worried about corporate bond defaults.

Verdict: The complex structure suggests it's suitable to diversify cash holdings rather than being a core cash product.

Claymore Short Duration High Income ETF CSD-T

Pro: Offers a very high yield of roughly 5.5 per cent after fees through holdings in short-term U.S. high-yield bonds, which are issued by companies with less than sterling financials; the bonds in the portfolio mature in less than a year and thus are less sensitive to interest rates than other bonds; monthly distributions are taxed as capital gains and return of capital, not interest, and returns are hedged to protect against currency fluctuations.

Con: The risk of high-yield bonds, which were crushed in 2008.

Verdict: Another complement to traditional cash holdings.

Five investment advisers explain the tools they use to hold cash in client accounts.

Winnie Go, portfolio manager and senior wealth adviser, ScotiaMcLeod

"Generally we look for the highest yielding money market/investment savings fund, or a cashable GIC for short term money."

Warren MacKenzie, president of Weigh House Investor Services

"I would say that more than half of the people I see just have cash sitting in cash in their brokerage account. Not even in a T-bill. My recommendation for most people is to open an ING account. Their rate is about the same or higher than a 12-month T-bill and you don't have to renew it when it expires."

Lori Livingstone, portfolio manager, ScotiaMcLeod

"I have been using savings accounts offered by Dundee, Manulife, etc. Generally I find them to be the highest-paying vehicle for cash. They all tend to follow each other as to the yield."

David Baskin, president of Baskin Financial Services

"In normal times, we keep client cash in brokerage accounts and get paid something like prime minus 2.25 percentage points, which is equal to 0.75 per cent right now. As this is so low we are using money market products sold by major institutions such as Manulife. They currently pay 1.25 per cent."

Rona Birenbaum, financial planner with Caring For Clients

"I use the following: ING Direct, National Bank Cash Performer and Dundee Bank Savings. I will also tell a client about Ally since the rates are higher (2 per cent)."

High Interest Savings Accounts: A Rundown

Product	Yield (%)	Fund Code	Min. Investment
Altamira High-Interest CashPerformer	1.2	AIS100	$1,000
B2B Trust High Interest Investment Account	1.3	BTB100	none
Dundee Investment Savings Account	1.2	DYN500	none
Manulife Bank Investment Savings Account	1.2	MIP510	none
Renaissance High Interest Savings Acct	1.2	ATL5000	$1,000

Note: These savings accounts are bought and sold like mutual funds. The fund code is needed when placing an order.

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