

# The Week

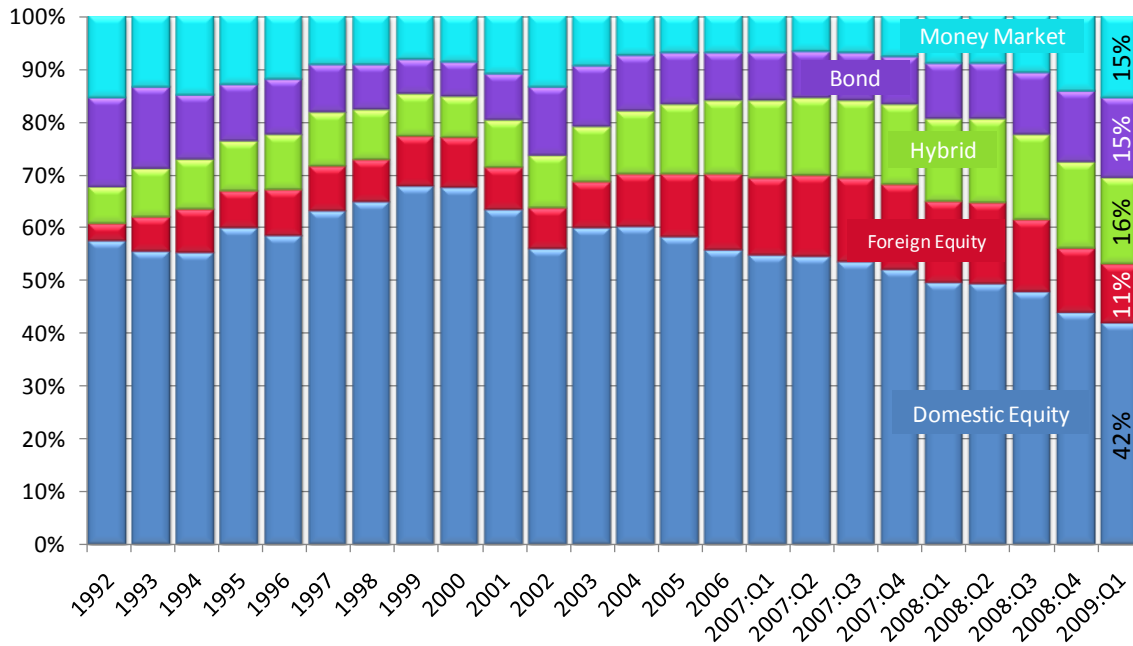
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Tom McManus, Chief Investment Officer

## Too Much Cash on the Sidelines?

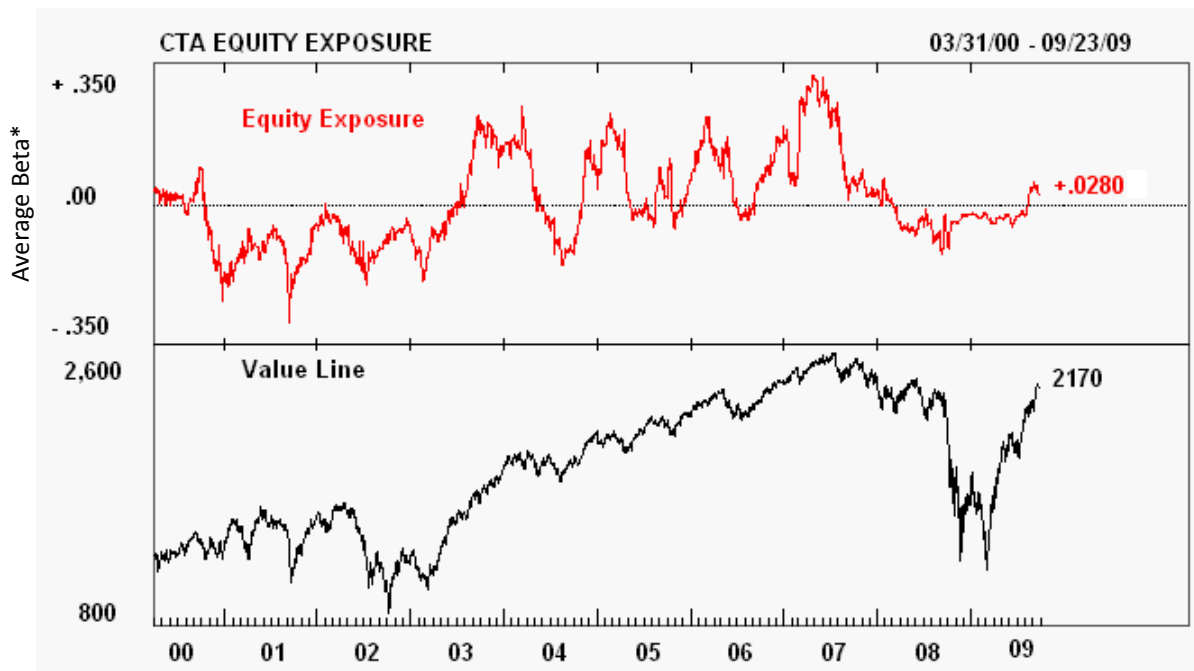
- Despite the sharp rally for stocks and portions of the bond market seen from the depths of the market lows in March, large sums remain invested in short-term reserves like cash, bank deposits and money market funds. “Money of Zero Maturity” (abbreviated “MZM”) — an index which includes each of these forms of deposit, stands at \$9.6 trillion, according to the Federal Reserve Bank of St. Louis. By comparison, the aggregate equity market capitalization of the companies comprising the Standard & Poor’s 500 index is \$9.2 trillion.
- The growth rate of MZM has stalled since the market lows after rising sharply (about +10% per year) over the prior 4 years. Some households appear to be using their savings balances to reduce their outstanding debt. Even if they accelerate their “de-leveraging” process, some of this excess liquidity appears to be helping the rally in risky assets.
- After all, the yield on reserve balances is miniscule, while riskier asset classes have made impressive gains so far in 2009. The S&P 500 (dominated by large-capitalization stocks) is up almost +16% this year, while the Value Line index (which includes stocks of all capitalizations on an equal-weighted basis) is up +50%. Corporate bonds have likewise performed well. But according to Bloomberg (citing Crane Data), the 100 largest taxable US money-market funds returned an annualized +0.12% during the latest week.
- Assets of money-market mutual funds surged to nearly \$4 trillion early this year, according to the Investment Company Institute (ICI), a trade organization. Since peaking in January, that amount has already fallen –\$440 billion or –11%, as some investors have apparently regained their appetite for riskier asset classes. Domestic equity mutual funds have registered net new cash inflows of nearly +\$16 billion since March, according to the ICI.
- Some market observers expect that the balances in money-market funds will continue to fuel further advances for the stock market and other assets, as more and more investors jump in from the sidelines. Any small amount of cash seems like too much when stocks are climbing, and experience shows that many investors will race for the relative safety of money-market funds when — and if — the market swoons again. If investors could adopt a strategy of committing their reserves to the markets when fear is highest, and rebuild their defensive allocations when optimism returns, they may get more enjoyment from their experience.
- Of course, some of the cash in money market funds should not be invested in riskier assets, because it is needed for current liabilities. The first chart overleaf ignores these balances by focusing only on mutual funds that are dedicated to retirement investing — e.g. IRA and 401(k) accounts. The most recent data (near the March market lows) show that investors had a combined 46% in money-market funds, bond funds, and hybrid funds (which hold a mix of stocks and bonds). This is a big change from 2007, when only 31% was invested in these three categories. Many investors appear more defensively positioned than in 2007.
- The second chart shows that actively managed hedge funds that can shift their asset allocation by trading futures contracts are employing a higher equity exposure now than at any time since late 2007. Apparently, these funds were more defensively positioned when stocks were near their lows (but not nearly as much as during the bear market of 2000-02).
- Earlier this year (see *The Week*, May 18) we increased our exposure to riskier asset classes like equities, commodities and REITs in most of our strategic asset allocation models, based on higher expected returns from what was a depressed valuation level. We are currently re-evaluating our expected risk, return and correlation estimates in light of the recent rally.

### Sharp Correction Puts Mutual Fund Retirement Assets Back Near 60%/40%



Note: Shows asset allocation of retirement assets in mutual funds. Source: Investment Company Institute.

### Hedge Fund Equity Exposure: Rising, But Still Not at "Bull Market" Levels



Note: \*Beta is a measure of the sensitivity of the portfolios to equity market moves. The Value Line index (on a log scale) is shown for comparison purposes; it is comprised of 1,700 equally-weighted companies. An index is not managed and is unavailable for direct investment. Source: [www.CarpenterAnalytix.com](http://www.CarpenterAnalytix.com), Value Line.

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**An investment in money market mutual funds is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money by investing in the fund.**

*Technical analysis is based on the study of historical price movements and past trend patterns. There is no assurance that these movements or trends can or will be duplicated in the future.*

*An index is not managed and is unavailable for direct investment.*

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*There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions. Distributions from REIT investments are taxed at the owner's tax bracket.*

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*Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

*Futures trading is for individuals willing to accept a higher level of risk for the opportunity of greater returns.*

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