BOND CONCEPTS

# **Cash vs. Bonds:** Which is Better?

For much of 2023 and 2024, investors could earn the same, if not a higher yield by staying in cash than what much of the bond market offered. Many investors did just that – replacing traditional bond investments with money market or other very short-term cash instruments. Coming into 2025, bond yields had reverted back to normal, yet an uncertain economic environment kept many investors in their cash allocations. While both cash and bonds are perceived to be "safe," investors should consider two important factors when determining which is best for their portfolio: **total return potential** and **reinvestment risk.**

As the Federal Reserve (Fed) orchestrated a historic increase in interest rates to combat inflation, fixed income investors finally saw income return to their portfolios. The 10-year Treasury bond, which yielded 0.6% in August 2020, traded in a range of 3.7% to 4.7% throughout 2024. Short-term rates also shot up, with the 3-month Treasury bill trading above 5% at the peak of the Fed's tightening before falling to 4.3% following the 100 basis points of cuts to the Fed Funds rate.

As indicated by the Fed Funds futures markets, many investors believe more rate cuts will occur in 2025. With the potential for an economic slowdown and uncertainty in markets, the essentially risk-free asset of cash tempts many investors with yields still meaningful at above 4%. Some may be questioning the role of fixed income when cash can yield the same amount or more.

Having experienced the impact of interest rates rising, let's examine what investors may face if rates continue to move in the other direction. Understanding this phenomenon is essential when deciding whether to invest in cash or bonds.

## The Basics: Cash, Money Market Funds, and Bond Funds

Cash – including high-yield savings accounts, short CDs – money market funds, and bond funds, are all perceived as relatively "safe" investments but differ in terms of their risk level and return potential. Cash is the least risky of the three but offers the lowest potential return. Money market funds, considered cash equivalents, are a type of mutual fund that invests in short-term, low-risk securities such as treasury bills and commercial paper and offer a slightly higher return than cash. Bond funds invest in various fixed-income securities and offer a higher potential return than money market funds but also come with greater risk.

Short-term bond funds typically invest in bonds with maturities of five years or less. Intermediate bond funds invest in bonds with maturities out to ten years, while long-term bond funds can invest in bonds with maturities of thirty years or more. Longer-term bonds are more sensitive to interest rate movements than short-term bonds.

## Duration

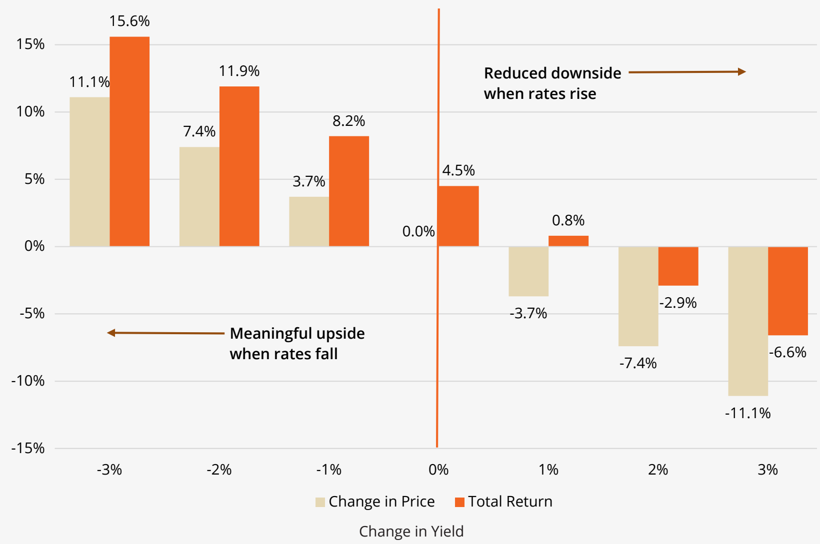
Duration is a measure of the expected change in a bond's price for a given change in yields. When interest rates rise, duration becomes a tangible measure of a bond's decrease in value. However, duration also offers the potential for capital appreciation. When interest rates fall, the price of a bond increases, leading to capital gains for investors should they decide to sell the bond before maturity. The greater the duration, the greater the price appreciation (falling rates) or depreciation (rising rates).

## Total Return Potential

### Income +/- Change in Price = Total Return

The total return on a bond or portfolio of bonds is a function of the income it generates plus or minus any change in price. For most bonds, the level of income is set when it is bought. It is simply the coupon adjusted for the price paid for the bond. Change in price is a function of the duration of a bond and the amount of change in the bond's Yield to Maturity (YTM). The total return potential in today's market is far more appealing for bond investors than just a short time ago when interest rates were low and credit spreads were tight. It is common for a high-quality, intermediate bond portfolio to offer a starting YTM well over 4.5% today versus under 1% just a few years ago.

As the illustration shows, today's yields add value, whether rates rise or fall. If rates rise, the higher level of income acts as a cushion, offsetting some of the expected price declines. If rates fall, having some duration in a portfolio provides a meaningful upside. An investor not only enjoys a higher level of income but also the potential for capital appreciation. If an investor anticipates interest rates will fall, having exposure to longer-duration securities like bonds can provide a bump for the return of a portfolio. With cash and money market funds, if interest rates fall, there is little opportunity for price appreciation.




*Assumes a beginning YTM of 4.5% and a duration of 3.7.*

## Reinvestment Risk

Another important consideration related to the movement in interest rates is the yield at which the proceeds from an investment are reinvested. Interest and principal payments are reinvested at whatever going rate the market dictates when they are received, not at a constant rate. As rates fall, maturing bonds with higher yields are replaced with lower-yielding bonds, reducing income. Conversely, as rates rise, a portfolio's income rises as low-yielding bonds are replaced with higher-yielding ones. Reinvestment risk is a function of interest rate volatility and the maturity structure of the underlying investment.

With longer-term bonds, in return for taking on the interest rate risk (duration), investors are exposed to less reinvestment risk. With cash or other short-term investments, an investor takes very little interest rate risk but is exposed to extreme reinvestment risk. For example, investor A invests in a money market account yielding 4%, and investor B invests in a five-year bond yielding 4%. After one year, if interest rates decline and the money market account now yields 2%, investor A will earn a lower yield. Alternatively, investor B will still earn 4%, as the bond was locked into that rate for five years. In addition, assuming the five-year yield also fell, the investor would enjoy appreciation of the underlying bond.

Of course, rates could also rise from here, and the locked-in 4% bond yield for investor B would become a lower yield than cash. But if the Fed is to be believed and the market's expectations are correct, the most likely path for rates over the next 12-24 months is lower. While cash or an equivalent investment may provide an attractive yield today, that yield, and therefore the income generated, may evaporate with little to no potential for capital appreciation if rates decline. A portfolio of intermediate bonds, on the other hand, will maintain most of its income-generating ability while also providing attractive total returns as holdings in the portfolio appreciate.

For some investors, locking in a longer-term cash flow may be important; for others, capital stability may be important. The type of investment that is right for you will depend on your investment goals, risk tolerance, and current market conditions.

## Why Outlook is Important

The outlook for interest rates is critical when allocating an investment portfolio, especially when cash and longer-term bonds offer similar yields. Cash can be an important tool when navigating periods of rising interest rates, but only after considering reinvestment risk and the potential opportunity cost of capital appreciation should rates fall. When constructing a bond portfolio, an active fixed income manager can implement views on interest rates, the market, and the economy. Decisions such as yield curve positioning, credit quality, and duration exposure can work to reduce risk and take advantage of developments in interest rates.



Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve), and flat. Yield curve strategies involve positioning a portfolio to capitalize on expected changes.

Principal preservation statements relate to investment objectives and assume all bonds are held to maturity with no defaults.  Market value between purchase and maturity may vary.

Yield to Maturity (YTM) measures the annual return an investor would receive if they held a particular bond until maturity as of the end of a report period In order to make comparisons between instruments with different payment frequencies, a standard yield calculation basis is assumed This yield is calculated assuming semiannual compounding.