Extending Duration: Balancing Interest Rate and Reinvestment Risk

Risk in an investment context is often oversimplified to a linear spectrum. The typical discussion of investment risk centers around the relative proportions of equity and fixed income securities in a portfolio. Traditionally, equities are considered "riskier" than fixed income and fixed income is considered "riskier" than cash equivalents. If you conflate volatility and risk to mean the same thing, then you'd be correct in that understanding. However, this is an oversimplification. Risk is a multi-dimensional concept, and that linear spectrum solely speaks to one of those dimensions: volatility. Volatility is just a measure of the smoothness of the ride, whereas holistic risk involves other elements. Some of these include liquidity, longevity and reinvestment risk.

For now, I'd like to focus on the tradeoffs between cash (including near-cash instruments such as money market funds) and fixed income, which centers on the concept of reinvestment risk. Since the Fed entered a rate hiking cycle in 2022, cash and near-cash investments have offered relatively attractive interest rates. Many investors have jumped at the opportunity to earn attractive short-term rates without taking on market risk. These instruments are appealing due to their liquidity and lack of duration risk. Duration risk is simply the sensitivity of an investment's value to interest rate movements. A duration of 5, for example, means that a bond will decline in value by approximately 5% for every 1% increase in interest rates. This concept is reversed for a decline in interest rates (value increases by approximately 5% for every 1% decline in interest rates, assuming a duration of 5).

Is Cash a Risk-less Asset?

While holding outsized amounts of cash or money market instruments may feel safe, it comes with its own peril – reinvestment risk. If short-term rates decline, those cash yields are the first to drop. Cash offers no protection from reinvestment risk. Reinvestment risk is critical if you are investing for the long term, as the prices of longer-term bonds typically move inversely with interest rates. It's easy to think solely about the risk that most recently impacted your portfolio and for many fixed income investors that is interest rate risk. However, interest rate risk (duration) works both ways. When rates decline, higher levels of interest rate risk (i.e. duration) can be additive to total return. Historically, investors that move from cash to fixed income before rate cuts occur earn better returns over the ensuing 5-year period than those who wait for rates to decline.

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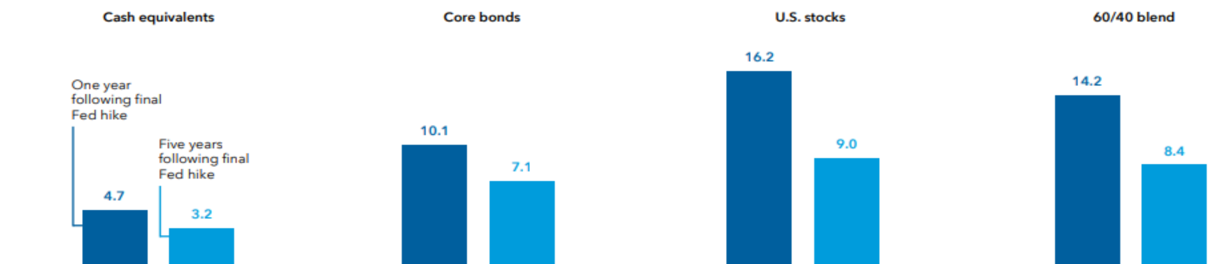
Source: Capital Group, Morningstar. Based on an average of the four most recent hiking cycles, which began in 1995, 2000, 2006 and 2019. Chart represents the average returns across respective sector proxies in a forward extending window starting in the month of the last Fed hike in the last four transition cycles. Benchmarks represent US 3-month T-bill (Cash), Bloomberg US Aggregate Index (Core Bonds), S&P 500 Index (US Stocks), and a blend of 60% of the S&P 500 Index and 40% of the Bloomberg US Aggregate Index (60/40 Blend).



Conclusion & Takeaways

The main takeaway is to examine risk holistically when composing your investment allocation. Sitting in cash instruments paying attractive yields is safe from a volatility perspective but also carries a high degree of reinvestment risk. When the Fed cuts interest rates, yields tend to fall and bond prices have historically risen. At Journey Wealth, we view cash in the context of your financial plan and not as a tactical investment tool. It is prudent to hold onto some level of cash to cover any short-term needs and to have a reasonable cash reserve for emergencies, but not to excess. If you're holding cash to avoid volatility and earn some yield, be conscious of reinvestment risk. One of the arguments against shifting from cash to fixed income was the yield discount. As the yield curve has normalized, yields on core bonds have essentially achieved parity with money market yields. For the five-year periods after the Fed stops hiking rates, core bonds have historically outperformed cash equivalents substantially. At Journey Wealth, we believe in planning and investing for the long-term. When determining an appropriate level of cash, the most relevant factors include income volatility, future cash outlays and cash flow uncertainty. Attempting to use cash as a tool for market timing has historically proven to be a poor investment strategy.

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