MEDIA CONTACT:
Emily Willms
ewillms@themilwaukeecompany.com
414.238.3232

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When it Comes to Risk Management, Cash Is Still King For Individual Investors

Wall Street's financial engineers have developed an array of sophisticated risk-management tools in recent decades, but for most investors cash is still king.

"Cash became a dirty word during the long bull market for stocks, but recent events are a reminder that a dedicated allocation to safe, liquid assets can play a critical role in managing investment risk," says Andrew Willms, president and chief executive officer of The Milwaukee Company, a wealth management firm in Thiensville, Wisconsin.

Willms notes that allocations to cash and cash equivalents reduces returns in a bull market, but the net effect over a full business cycle can be positive. "If a cash buffer helps an investor maintain a long-term focus and prevents her from selling out at the bottom of a market correction, the indirect return can be quite high."

As a simple example, consider a portfolio that tracks the U.S. stock market vs. the same investment in equities that's tempered with a 10% allocation to cash – a 90%/10% asset allocation. On paper, the 100% allocation to the stock market probably has a higher expected return, thanks to the tendency of equities to outperform cash and cash-equivalents over time. But when you factor in behavioral risk, the 90%/10% strategy may actually generate a higher performance for an investor by generating a moderately smoother portfolio ride during market corrections.

"Human nature being what it is, some investors are prone to sell during bear markets," explains Willms. If the investor stays out of the market, or jumps back in at a price that's higher than the selling price, the portfolio's performance will take a hit.

In those cases, an all-stock portfolio's performance may be lower vs. a 90%/10% strategy." Why? A dedicated cash allocation reduces the short-term portfolio losses, which in turn can provide some investors with a higher level of confidence to hold tight during a bear market.

"By avoiding emotional selling decisions triggered by short-term losses, some investors can earn higher returns with a permanent cash allocation," Willms says.

“Every investor is different and so investment strategies should be customized to match risk tolerance, investment horizon and other factors,” Willms adds. Accordingly, investors should consult with a financial adviser to determine if holding cash in their investment portfolio is appropriate.

“For some individuals, cash is definitely not a dirty word,” he notes. “Depending on the investor, it can be a tool that ends up boosting performance after adjusting for behavioral risk.”

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About The Milwaukee Company
The Milwaukee Company (TMC) is a wealth management firm based in Thiensville, Wisconsin. TMC offers investment-related services to individuals, trusts, investment entities, and charitable organizations. The company also provides insights and advice on how to reduce income taxes on investment portfolios, as well as plans to successfully transfer wealth to family members and charitable organizations. For additional information, visit: themilwaukeecompany.com