Robert Michaud

Chief Investment Officer

Robert Michaud is the co-holder of four U.S. patents in portfolio optimization and asset management and is the Chief Investment Officer at New Frontier. He holds a Masters in Mathematics from Boston University and pursued a PhD in finance from the Anderson School of Management at the University of California at Los Angeles before joining New Frontier. His research interests include risk models, empirical asset pricing, and international finance. He is the co-author of Efficient Asset Management: A Practical Guide to Stock Portfolio Optimization and Asset Allocation, (2nd ed. Oxford University Press, 2008) and research articles in refereed journals.

When Cash Isn't King: The Advantages of an Optimized Portfolio

Key Highlights:

1. Rising interest rates have led some investors to shift to cash, seeking a risk-free 5% return. Yet, a more effective strategy combines cash with ETFs within an optimized portfolio.
2. An optimized portfolio is engineered to achieve the highest expected return for a given level of risk, making it a superior choice for achieving financial goals compared to holding cash in isolation.
3. Timing the market by holding cash to avoid potential market downturns is rarely successful in practice. The data indicates that investors should expect to be compensated for staying in the market, even during periods of economic uncertainty.
4. Cash, while attractive currently, has insufficient inflation-adjusted return to meet most long-term investment goals. A multi-asset solution including stocks is more likely to be appropriate.
5. Market conditions change, and cash's attractiveness will diminish over time. A continuously optimized portfolio can capitalize on cash in the short term and shift to other asset classes on its own.

The dramatic rise in interest rates has led some investors to pull money out of investment accounts and into cash, often in the form of Treasury Bills and money market funds. After a difficult year for investing, a risk-free return over 5% is compelling for many. However, a portfolio that optimally allocates cash alongside Exchange-Traded Funds (ETFs) of multiple asset classes remains a more sophisticated approach that can harness the power of interest rates. This well-structured portfolio captures the current benefit of increased cash exposure today and systematically adjusts should the benefits of cash diminish in the future, eliminating any guesswork.

The Appeal of Cash

When the Fed raised interest rates, but banks didn't follow with their clients' savings accounts, many individuals wisely moved money from low interest savings accounts into market rate cash. That's basic efficiency, bordering on arbitrage — swapping an individual asset to something with the same risk (virtually zero) and a higher return, where the only cost is convenience.

However, the appeal of cash in isolation should not be taken too far. Some unenthusiastic investors similarly moved investment accounts into high yielding cash. But switching investment styles or portfolios is another matter. One cannot extrapolate the superiority of T-Bills over savings accounts to the superiority of T-Bills over a portfolio. Holding too much cash, whatever the interest rate, is inefficient.

Portfolios can do what individual investments cannot. Portfolios can use all available investment opportunities, assess their risks and return potential and optimize them together to maximize the combined investments' ability to meet an investor's financial goal.

Benefits of an Optimized Portfolio

Optimized portfolios have two distinct benefits—efficiency and suitability. When a portfolio is properly optimized for investment goals, whether they be after tax wealth appreciation with moderate volatility, or a sustainable income source growing with lifetime needs, the investor benefits with a greater chance of meeting the goal and a likelihood of lesser disappointment should markets not work out.

To achieve efficiency, optimization can take advantage of the varying risks, returns and correlations among investable assets to find the right combination of assets to maximize the chance of meeting an objective. An optimized portfolio is called "efficient" because it is engineered to achieve the highest expected return for a given level of risk. In other words, choosing to invest in anything other than an optimized portfolio is akin to leaving money on the table.

An optimized portfolio should also be suitable for the investment goal—a portfolio that's a great choice for one investor may be a poor choice for another. Start from best-in-class investment instruments (typically ETFs) and then construct an efficient portfolio while considering how factors such as taxes, income needs, risks, and uncertainty about the future affect the specific investment goal. The result is an optimized portfolio with the added benefit of customization for different investors' needs.

> ***Think of an optimized portfolio as an "efficient" one.... Investing in anything less efficient is akin to leaving money on the table.***

Holding Cash Alone May Not Be Ideal

While cash can be an attractive asset class, especially in a high-risk, high-uncertainty environment, holding cash separately from your investment portfolio is likely not the most optimal choice. Two key reasons support this notion:

Better Return Opportunities: Economic risks and the inverted yield curve make cash especially appealing now. But cash is unlikely to be the highest return asset available in the coming months as markets anticipate the end of the hiking cycle, and over time, this will turn into a statistical certainty as markets evolve. Putting this in simple terms for today's market—if the economy does well (no recession or a mild one), stocks will likely beat cash, but if the economy fares poorly (a worse-than-expected recession), bonds will likely beat cash—either way, there are better return opportunities.

Portfolio Inefficiency: Portfolio efficiency is always relevant, and it can only be achieved when managing the portfolio as a whole. Cash is an asset, just like stocks or bonds, and should be considered within the context of your overall portfolio. Isolating cash will lead to a portfolio with suboptimal risk characteristics and inefficiencies, as it doesn't factor in the interaction with other assets you may be holding.

Timing the Market Rarely Works

Another common reason investors opt for cash is to avoid potential market downturns, particularly during times of economic uncertainty. However, this strategy often falls short in practice. Those who held onto cash this year, for instance, missed out on robust market performance. Market dynamics demand that investments are priced to provide returns that compensate for the associated risks, so staying invested typically remains the smarter choice.

The Data Speaks: Interest Rates and Returns

Consider the historical data in the table below, which showcases future one-year average returns for various interest rate regimes:

Interest Rates	Average 1 Year Stock Return	Standard Deviation	Observations
Less than 5%	7.9%	15.2%	464
5% to 6%	11.5%	14.3%	114
Greater than 6%	8.3%	18.0%	239

Source: FRED and New Frontier. Interest rates are defined using the Fed Funds Effective Rate. 1-year returns are calculated using S&P 500 total return on the 12-month period following the observation of the interest rate from July 1954 through July 2022. The mean and standard deviation is calculated for all 1-year returns grouped according to their corresponding interest rate.

The table shows that stock returns have been attractive across a range of interest rates. Although historical returns have been highest on average when rates were between 5% and 6%, we do not expect this tendency to necessarily persist in the future. Rather, in our view, the data does not support the notion that higher interest rates lead to lower stock returns. It's also noteworthy that all average returns calculated for stocks are not only positive in absolute terms, but also greater than the interest rate.

Cash Isn't Enough: The Need for Diversification

The fundamental reason we invest in markets is that the risk-free rate offered by cash is often insufficient to meet our long-term investment goals. With rates around 5% and an inflation rate of roughly 3%, real yields hover around a modest 2%. A commonly accepted rule suggests a need for at least a 4% long-term rate of return above inflation, which necessitates a diversified approach encompassing multiple asset classes.

New Frontier

Things Change: The Importance of Adaptability

It's important to note that the appeal of cash fluctuates over time. Holding onto cash now means delaying investment decisions for the future, but many individual investors may lack the time and resources to continuously track the market for emerging opportunities. With today's high rates, we have a significant position in cash-like ETFs (such as Treasury Floating Rate Notes) across the conservative and moderate portfolios. But as cash becomes relatively less attractive, our portfolios will gradually transition into assets that are better suited for achieving long-term investment goals. Individuals who wait too long before investing will miss out on significant wealth gains. Rather than simply holding cash and hoping to time the market, a continuously optimized portfolio offers a prudent and effective way to navigate the complexities of today's shifting market environment. With diligent planning, the sophistication of an optimized portfolio can help you more reliably achieve your financial goals.