
# How much cash is too much?

**While cash is often viewed as a safe haven, it does have investment risks.**

Australian households are collectively sitting on close to $1.5 trillion in cash, which for the record is substantially more than the total value of Australian bank notes in circulation.

This vast sum represents the amount of cash deposits that were being held in Australian savings and term deposit accounts by authorised deposit taking institutions at the end of March, according to monthly data published by the Australian Prudential Regulation Authority.

But what is a right amount of cash to hold, if there is such a thing?

In general terms, we all need some cash to pay for everyday living costs. It also makes sense to keep an amount of cash aside for emergency expenses.

Many people are also holding large cash sums in mortgage offset accounts to reduce their loan interest charges.

Then there are cash investors. Australian Tax Office data shows self-managed super fund trustees had a massive $162.4 billion in cash and term deposit investments at 30 June 2024, representing almost 17% of total net SMSF assets.

They have their reasons, but as a standalone asset class cash has long underperformed bonds, property, and shares.

The 2024 Vanguard Index Chart shows that the average annual return in Australia from cash over the 30 years to 30 June this year was just 4.2%, which compared with 5.6% from Australian bonds, 7.8% from Australian listed property, and 9.1% from Australian shares.

Vanguard research has found that although holding cash in an investment portfolio can provide a sense of security, it can also come at the cost of underperformance and failure to achieve long-term financial goals.

Many investors view cash as a safe haven asset because of its low volatility. However, maintaining too much cash or attempting to time the market can have a detrimental and permanent impact on financial outcomes.

An investor who is close to fully funding their investment goal may be comfortable with some allocation to cash.

**Balancing risk with return**

Vanguard's approach to assessing how much cash might be appropriate to hold is built on the relationship between an investor's goals and their risk tolerance, time horizon, and funding level.

Risk tolerance relates to how much market risk an investor is able to take on. Risk and return are a trade-off. Therefore, in many cases, including cash not only moves a portfolio toward the more conservative end of the risk spectrum, it also moves it toward the lower end of the expected return spectrum.

Time horizon is the length of time an investor can keep their money invested. The shorter that period is, the less likely they are to benefit from holding riskier assets like bonds and shares.

That's because, over the long term, the returns of those riskier assets tend to be higher than those for cash on average. However, this comes with the drawback of being more volatile which can mean potentially negative returns over the short which may not be recovered from unless the investor can stay invested for a sufficiently long period.

Funding level is how close to fully funded an investment goal is. An investor who is close to fully funding their investment goal may be comfortable with some allocation to cash.

On the other hand, an investor who is far from reaching their investment goal may be willing to allocate more to riskier assets for potentially higher returns to improve their chances of success, especially if they have a longer time horizon.

**Comparing two investors**

Take a hypothetical person whose main investment goal is to finance their retirement.

They have a higher tolerance for volatility, so they are more likely to hold higher-risk, higher-return assets such as equities rather than cash.

They have a long time horizon, so by taking higher risk they can reasonably expect higher returns, giving them either a larger portfolio to retire on or the flexibility to retire earlier than planned.

In terms of funding level, they are currently far from the amount likely to be needed in retirement. Given they have a long time horizon and high risk tolerance, it's unlikely an allocation to cash would give them the best chance of meeting their goal.

By contrast, consider a person in the early stages of their career whose two primary goals are to maintain emergency savings and to save for a downpayment on a home.

As they have a low risk tolerance and a short time horizon, it therefore makes sense for this investor to have a higher allocation to cash.

Risk and return are always a trade-off. While investors with higher tolerance for risk, longer time horizons, and underfunded goals may be better off excluding cash from their investment portfolios, including cash can make sense for investors who have lower risk tolerances, shorter time horizons, and well-funded goals.

**Source:**

*https://www.vanguard.com.au/personal/learn/smart-investing/investing-strategy/how-much-cash-is-too-much*

*https://www.vanguard.com.au/personal/support/index-chart*



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