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The Joy of Cash

With risk permeating the global economy, a variety of products can help shield your investments. But don't forget a cheap and simple solution—cash

By Chris Farrell

(Editor's Note: An earlier version of this story misidentified two volatility investment products and Barclays Plc's bank unit.)

You've probably heard of a "black swan," the catchphrase coined from the 2007 book by author and investor Nassim Nicholas Taleb. A black swan for investors is essentially an outlier event that dramatically affects the economy and markets. For example, the 1998 Russian debt default that unexpectedly took down the Long Term Capital Management hedge fund and the 2008 global financial free fall when Lehman Brothers imploded.

It doesn't take much imagination to see black swans lurking throughout the global economy. Europe's crisis with the sovereign debt of the euro zone's periphery nations threatens the health of major banks in the European Union. The fear of contagion from a European sovereign debt restructuring is strong, pushing up rates on Greek, Irish, Portuguese, Italian, and Spanish government loans. China on July 6 hiked its benchmark interest rate for the third time this year as the government attempts the difficult maneuver of cooling down inflation without sending the economy into a hard landing. There's the bitter talk in Washington by high-profile politicians welcoming the risk of default if a budget deal isn't reached before an Aug. 2 debt ceiling deadline. Less immediate, but no less disturbing for investors, is the prospect of rising inflation in the U.S.

Nervous? You're far from alone. "There is risk all over the place," says Campbell Harvey, a professor of international business at Duke's Fuqua School of Business and a consultant to Man Group, one of the world's largest managers of hedge funds. "This is the time to think about downside protection."

Question is, where to seek safety in coming months? The market for insurance products against catastrophe is exploding. Wall Street rocket scientists are busy coming up with an array of strategies and products—mostly based on fixed-income, equity, and currency derivatives—that offer "tail risk" protection. Fixed-income investors can buy credit default swap indexes on investment-grade issuers and high-yield debt.

VOLATILITY PLAYS

Equity investors can turn to such products as Deutsche Bank's ELVIS index, which is constructed in such a way that stock investors can profit from the volatility that traditionally accompanies a major stock market plunge.

The difficulty with many tail risk protection strategies is they're expensive and complex—assuming they work. No small matter: The iPath S&P 500 VIX Short Term Futures ETN (VXX) is a fear-gauge play on stock market volatility. It is down 81 percent from the same time a year ago. Barclays Bank (BCS) plans to dissolve later this month its iPath S&P VIX Mid-Term Futures ETN (VXZ). "Investment banks are offering 'solutions' (investment bank speak for high-fee products) to investors and fund management companies," writes a skeptical James Montier, a member of the asset allocation team at GMO, a long-term value money manager in Boston. "The very popularity of tail risk protection should spell caution to investors."

There are better alternatives for most individual investors. A relatively cheap, easily understood, and underappreciated hedge against catastrophe exists for most investors: cash. (The title of Montier's June 2011 GMO report is *A Value Investor's Perspective on Tail Risk Protection: An Ode to the Joy of Cash.*) With cash, the investor simply reduces the amount of money at risk to a financial cataclysm. On Wall Street, "cash" isn't the money you put in your pocket or stuff under the mattress. It is T-bills and other high-quality, short-term, interest-paying investments. The price of safety from cutting your portfolio's exposure to stocks and bonds and raising the amount invested in cash is a low return. That's an acceptable price to pay considering the potentially frightening financial fallout if the European sovereign debt crisis spins out of control. Global money will flee for the safety of U.S. Treasuries.

Cash is really a tail risk twofer: It also offers protection against inflation. For instance, Mark Kritzman, head of Windham Capital Management and a financial engineering instructor at MIT, looked into constructing inflation-resistant portfolios using data from 1974 to 2009. A striking result of his research is how "Treasury bills track inflation better than any other asset, but they offer little upside." The same can't be said for long-term government debt—inflation hammers its value. A 1 percent rise for inflation will knock almost 30 percent off the value of a 30-year, zero-coupon T-bond. That's why short-term T-bills or cash are so good if Europe implodes or the rate of inflation heats up. It covers more risk than most assets. The reason is that the money is reinvested fairly quickly as interest rates rise; over the short run or the long run, T-bills are a good hedge against inflation.

RISK OF DEFAULT?

To be sure, the core cash holding to the global investor is U.S. Treasury bills. What about the risk that the government will default? That risk is so close to zero it doesn't bother Harvey. Even if there were an unexpected delay in payment, the federal government would make good on the debt, he believes. The global capital markets certainly agree with his assessment, considering that the yield on 3-month T-bills is 0.01 percent and 0.18 percent on 1-year T-bills, hardly Armageddon-anticipating rates. "I can't imagine that the U.S. Treasury won't pay interest on the debt," says Edward Yardeni, president and chief investment strategist of Yardeni Research. "It would be criminally irresponsible."

Want an additional layer of insurance? Not convinced Washington will come to its senses in time? The individual investor could turn to cash-laden blue-chip multinational corporations. Investment-grade companies have so much cash on their balance sheets that the risk they won't meet their debt obligations is minimal, while the investor picks up a slightly higher yield. For instance, the Vanguard Short-Term Corporate Bond Index (VCSH) yields 2.31 percent vs. a 0.83 percent yield on the Vanguard Short-Term Treasury Index (VFISX). An additional advantage of cash-rich multinationals is that their business is well-diversified. "They have cash flow," says Ross Levin, a certified financial planner and president of Accredited Investors in Edina, Minn. "They have business units in multiple currencies."

Gold is a traditional hedge against scary financial times. Problem is, gold is expensive. It's trading at more than $1,541 per troy ounce, up some 140 percent from five years ago. Gold gains have slowed in recent months, with the price gaining around 10 percent over the past six months. Many other commodities are well-suited to act as a hedge against inflation, such as metals, agriculture, and other natural resources. That's why a far better commodity play is owning a well-diversified index ETF that includes gold, such as PowerShares DB Commodity Index (DBC) and the Rogers International Commodity ETN (RJI).

Here's the thing: The more you delve into how to hedge a portfolio from catastrophe, the more obvious the need to figure out what risks you are insuring against. Is it cataclysmic implosion from a meltdown of European sovereign debt and banks, a sort of Lehman 2.0? Or is the concern a surge in U.S. inflation rates in coming years? How about a deflationary shock to the global economy if the Chinese boom goes bust? Each potential risk implies a different hedging strategy.

That's why the time-honored tactic of diversification remains one of the more powerful ways to protect finances from the downside. Shakespeare powerfully captured the idea when, in *The Merchant of Venice,* Antonio tells friends that his investments cause him no worry. "Believe me, no. I thank my fortune for it, my ventures are not in one bottom trusted, nor to one place; nor is my whole estate upon the fortune of this present year. Therefore my merchandise makes me not sad."

Regardless of your conclusions as to which risks present the most peril, cash still should hold a favored place. It offers protection than most investments from more downside risks, such as a European financial crisis. In times of trouble, cash is king.

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