SWFA Advisor Insights

Tips for Effectively Managing Cash

February 24, 2024

Sometimes in life, success is complicated. It takes a long, drawn-out process full of meticulous planning and course correcting. However, sometimes success comes from doing the little things right consistently over time. How you handle your cash balances is one of those little things that over years and decades can make a large difference in your life. It comes down to having an understanding around the right amount to hold (not holding too much or too little) and making sure that what you have is earning a fair interest rate.

What is the right amount of cash?

As you might imagine, the initial answer to this question is, it depends. The right amount is going to vary greatly from person-to-person, family-to-family, and situation-to-situation. However, a blanket statement for everyone is that you want to have enough available in cash where you can survive for at least a few months without any other sources of income. For more risk tolerant households or those with stable income, you might be OK holding as little as 3-6 months' worth of essential living expenses. For households with more volatile/unpredictable income, high risk jobs, or higher probability of unexpected needs you may benefit from having 6-12 months' worth of essential living expenses in cash.

There is also such a thing as holding too much cash. While excess cash increases your feelings of safety and helps buffer you from unexpected expenses, it costs you in the way of returns on your money. Cash over time has a flat or even a slightly negative real return. What is real return? It is the return of an investment after accounting for inflation. So, if inflation averages 3%, any investment that returns you less than that over time is causing you to lose purchasing power. That means that you can buy less with your dollar a year from now than you could have bought with it today. This is why you need to put in the extra thought to find the right target cash levels and only keep cash for the purpose of covering short-term expenses.

On top of your "emergency reserve", which is helping protect your life from a disruption in income or surprise expenses, you should also build up cash for large one-off purchase needs you know are coming in the next 12-15 months. These purchases could include a home downpayment, a car purchase, a large vacation, or more. It is any purchase that you would not be able to pay for from your usual monthly paychecks/income. You can raise the needed cash for these planned expenses by incrementally saving from your income over time, having investment dividends routed to cash, or by selling down some of your other investment assets gradually. A time horizon of 12-15 months is too short to take the risk of investing money into a more volatile product. As an example, if you had $10,000 for a car purchase and you put it into the stock market, if the market goes up 15% you would be at $11,500 (nice!). However, if the market happens to move like it did in early 2020 or 2008 your $10,000 would become $5,500 and you might not be able to buy the car you wanted in the same timeframe you expected. So you want to properly align your risk to the time horizon for your needs.

<u>Where should I put my cash?</u>
I usually advise clients to keep a free checking account at a local branch that is easy to access if you need banking services. This account is your bill pay account and you probably want to keep 1-3 months' worth of expected expenses in this account. Every other penny of your cash savings should be earning interest. As of the time of this article, high yield savings and investment money market accounts were paying 4.5-5.25% annually, which is significantly more than most bank savings accounts and infinitely more than a checking account (typically paying you nothing).

You can search "high yield savings accounts" on Google or use a comparison site like bankrate.com to see what's out there. Look for low minimum balance requirements, no annual fees, FDIC/SIPC insurance, and easy, flexible access. If you already work with an investment company, you can also ask them about their investment money market accounts which are only slightly different from savings accounts and often have a slightly higher interest rate. For every $1,000 you put in a high yield savings earning 5% you would get $50 per year in free money. So, if we are talking $20,000 in savings, earning that rate for 5 years, you would get paid more than $5,000 in "free" money if you left it untouched.

<u>Summary</u>
Financial success often comes from doing the little things right consistently over time. I often coach clients on the fable of the tortoise and the hare. No one would choose a tortoise in a race, but if you do the right things repetitively over time, you may not be the fastest to success, but you will end up surpassing many of your peers. Like a house, work on setting up a healthy foundation for your finances. Without it, nothing else you do will matter and you will find it challenging to get out of a state of constant chaos. So, apply these thoughts to find the right amount of cash for you and your unique situation. Make sure not to hold too much in cash, and then find an account where it will earn you some money while it's sitting there.

If you want someone to walk you through this thought process or feel like you would receive value in having a financial professional help you set up and execute on your financial plans, I'd love to speak with you! You can use my information below to reach out.

Tyler Johnson, CFP® CTFA
Learn more: Schedule A Call
Website: www.stillwaterfa.com
E-mail: Tyler@stillwaterfa.com
Socials: Facebook LinkedIn