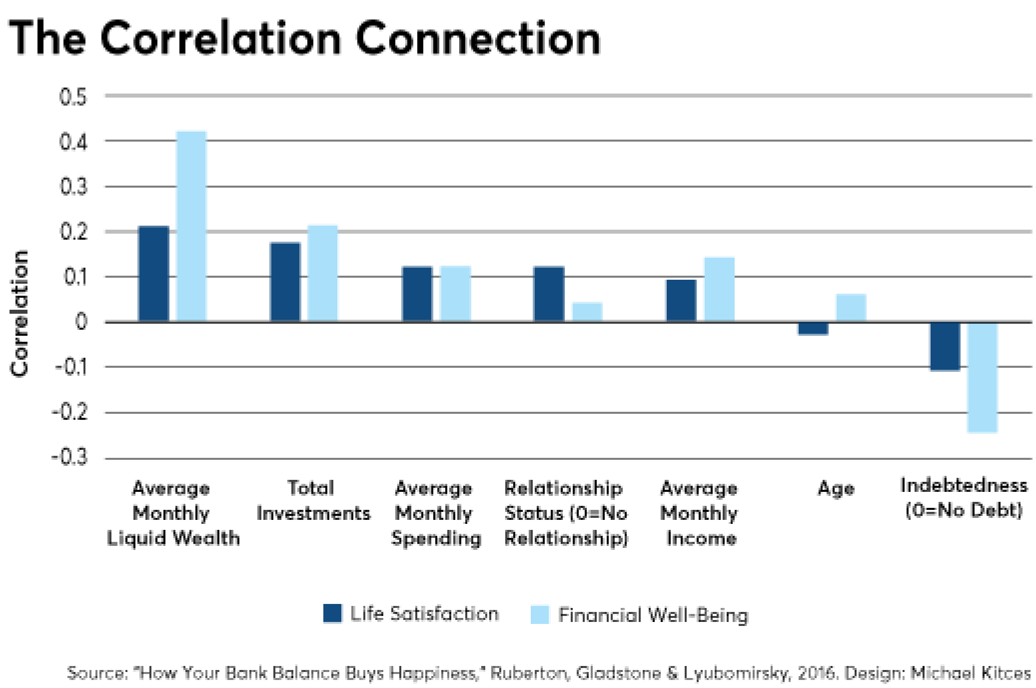
Managing clients' cash cravings

By

- **Michael Kitces**
- **June 19 2017**

In investing, cash is generally viewed as something best avoided or minimized. Holding some may be necessary for basic liquidity needs, but the classic investment strategy is to keep as little on hand as possible, and to put the rest to work on long-term goals.

Recent research, however, suggests that holding cash appears to improve our feelings of financial well-being and life satisfaction. And this research has ramifications for the entire advisory industry. If clients actually feel happier when they hold more cash, perhaps their portfolios should be adjusted accordingly.



That's not to suggest cash is king. But paradoxically, this strategy might actually help clients to feel better about staying invested for the long run.

HAPPINESS IN THE BALANCE

The old saying goes, "Money can't buy happiness," but new research suggests happiness is materially impacted by how we spend money. Furthermore, our life satisfaction and emotional well-being seem to be correlated with having greater wealth and a higher income — at least up to an annual level of roughly $75,000.

Looking at absolute levels of income and wealth, however, may obscure nuances in the relative impact of how those dollars are earned and/or held. For instance, Shefrin and Thaler have found that people mentally earmark their dollars into three types of buckets — current assets, current income and future income — and that not all of those bucket allocations contribute equally to our happiness and emotional well-being.

To test this, a recent study by Ruberton, Gladstone and Lyubomirsky analyzed bank accounts, income and spending of 585 bank customers in the U.K.—average age 37—and then surveyed those customers to measure their satisfaction with life and feelings about their financial well-being. Additionally, the authors gathered information about their subjects' other external investment accounts and debts, as well as their age, employment and relationship status.

The results revealed that the amount of someone's liquid wealth — that is, the value of checking and savings accounts — was correlated with his or her self-reported financial well-being and life satisfaction. In fact, liquid wealth had a stronger relationship to those factors than income, spending, investments or indebtedness!

Even more important though, the correlation between liquid wealth and measures of satisfaction and well-being remained — even after controlling for all the other financial variables, age, employment status and relationship status.

Quote

Wealthy people with very little in cash may still feel more financially distressed than poor people with relatively more cash.

Notably, having cash on hand was not directly contributing to life satisfaction per se; instead, liquid wealth directly (and positively) impacted perceived financial well-being, and it was that improvement which subsequently led to an improvement in life satisfaction as well.

Nonetheless, the researchers' bottom line is striking: A buffer of liquid cash available in checking/savings accounts, regardless of wealth or income, appears to confer a sense of security, which in turn is associated with positive feelings of financial well-being and more life satisfaction. Or stated more simply, wealthy people with very little in cash may still feel more financially distressed than poor people with relatively more cash.

CASH CAVEATS

While one might interpret the conclusions of Ruberton, et. al. as validation for investors who feel better holding substantial cash, the study did find a substantial diminishing effect. That's because the positive correlation was actually between life satisfaction/financial well-being and the log-transformed balance of liquid wealth.

On a lognormal scale, each increasing step in liquid wealth represents a 10X increase in the actual account balance. In practice, going from $1 to $100 would feel as beneficial as going from $100 to $10,000, which in turn would feel as beneficial as going from $10,000 to $1 million. Which in turn means going from $1 to $10,000 would feel drastically more beneficial than going from $10,000 to $20,000.

On the other hand, not everyone's improvements in financial well-being — and the transition to diminishing marginal benefits — would necessarily have the same thresholds. $10,000 cash should be treated as an inflection point — beyond which lurks dramatically diminishing returns on financial well-being and life satisfaction. It may be that more affluent households have a higher demand threshold for cash. Alternatively, because they have other investment assets, perhaps the affluent maintain lower demand for cash. There may also be variances in individuals, where some people may simply have a higher proclivity toward holding cash, and others lower.

It's also important to note that a correlation is just that: a co-relation between two factors. People who are optimistic about life's opportunities may simply be more likely to hold cash in order to have it available to spend on those opportunities.

Alternatively, perhaps more financially competent and confident individuals are more likely to apply their knowledge by holding a healthier level of cash in emergency reserves. This would mean it's actually their financial competency leading to both higher cash balances and greater financial well-being.

LIQUID COMFORT

These caveats notwithstanding, the idea that holding greater cash reserves could be a causal factor that leads to better feelings about one's own financial well-being certainly has face validity. And for many advisers, it should resonate with the real-world demand of many clients to sometimes hold substantial cash balances in their checking and savings accounts.

To some extent, this may simply be reflective of their financial realities. Those who have little or no cash don't just express greater distress about their financial well-being; they're arguably more likely to be in actual distress, as extremely low cash balances suggest the household lacks even a healthy emergency reserve and may already be struggling with contingencies it can't afford.

And we already know that consumers react more negatively to decreases in wealth or spending than they do positively to increases. Thus, it makes sense that those struggling to maintain their standard of living, and are intermittently experiencing decreases in spending capabilities, would have materially lower financial well-being compared to those who are wealthier with ample reserves to ensure household stability.

The key point of this research, however, is that greater levels of liquid wealth were associated with improvements in financial well-being — regardless of income or wealth levels. In other words, it doesn't appear to matter if the household actually needs more emergency reserves or not. There is still an improvement in financial well-being when the household increases its liquid wealth.

Quote

Choosing to keep a substantial cash balance isn't so much an inefficient investment decision as it is a decision to buy more happiness.

This shouldn't be entirely surprising, as our entire banking system is predicated on consumers demanding more liquidity than they actually need. It's why banks can conduct long-term lending using short-term deposits, after all.

And the research on mental accounting had already suggested that this would be a likely part of the hierarchy of retirement income needs for a retiree. But the Ruberton study affirms that its scope is broader, as the same effect occurred despite the average participant being just 37 years old, and thus presumably still far from retirement.

Nonetheless, from the classic investment perspective, the desire to hold substantial amounts of cash is both unnecessary — as long as other investment holdings are reasonably liquid — and outright counter-productive given the traditionally low, and currently near-zero yield on cash and cash equivalents.

An inclination toward holding cash is typically viewed as an investment mistake, and something the adviser can rectify by putting the cash to work. Yet this new research suggests that fully deploying an investor's cash reserves may actually exact an emotional toll, and one that isn't necessarily offset – mentally and emotionally — by the greater returns that may ensue. Viewed another way, keeping a substantial cash balance isn't so much an inefficient investment decision as it is a decision to buy more happiness.

CURBING THE CRAVING

Still, this raises the question of just how cash-like an individual's liquid wealth must be in order to satisfy the mental demand for current assets. The researchers found a relationship between financial well-being and the balances of savings and checking accounts, so physical cash in hand isn't a requirement. But would other, slightly less liquid investments like bonds satisfy the urge? Could easily liquidated stocks and ETFs slake the need? Might the adviser frame certain investment assets as current assets to make the client more comfortable with holding them in lieu of cash?

Similarly, what about other liquidity alternatives, such as debt — e.g., a revolving credit line, a home equity line of credit or a standby reverse mortgage for a retiree? Might one of these meet the investor's need for current assets?

Anecdotally, the answer appears to be "no," given it's not uncommon for consumers to accumulate emergency savings that earn nothing, while also still holding unfavorable debt, such as balances on high-interest credit cards. This suggests that the desire for cash is so strong that it's not enough to use cash to pay down debt and then just re-borrow later. We want to actually have the liquid wealth.

In the extreme, it's even conceivable that over-investing clients out of cash could make them more likely to panic in volatile markets, and conversely that encouraging clients to hold enough comfort cash might make them more willing to ride out times of uncertainty. Again, it's not because they need the cash, but because it satisfies their need to fill the current assets mental bucket.

On the other hand, where the cash is held is likely to matter as well. To the extent that the desire for cash is a desire to fill the current assets bucket of the mental accounting framework, holding the cash in an investment account may not scratch the itch. This in turn further opens the door to adviser technology solutions that help manage and maximize cash yields.

But the bottom line is to recognize, in a world where human beings are not always perfectly rational, that the optimal pure investment strategy may not improve a client's sense of financial well-being. Perhaps it's time to stop treating cash like a problem to solve, and more like a client's psychological need to be satisfied.

Michael Kitces

Michael Kitces, CFP, a *Financial Planning* contributing writer, is a partner and director of wealth management at Pinnacle Advisory Group in Columbia, Maryland; co-founder of the XY Planning Network; and publisher of the planning blog Nerd's Eye View. Follow him on Twitter at @MichaelKitces.