RIVERFRONT
INVESTMENT GROUP

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THE WEEKLY VIEW

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The Stealthy Destruction of Wealth: A Lost Decade for Cash

We believe that cash and bonds have unseen risks that are often overlooked. Equally we think the benefits of holding stocks offset their more overt risks over time, if purchased at reasonable valuations. The Federal Reserve has pegged short-term interest rates at zero and has driven all Treasury yields to the lowest levels in history — Financial Repression. We believe the Fed's intent is to make owning traditionally 'safe assets' as risky and potentially unprofitable as they were in the 1930s and '40s, this time to help the housing industry and encourage investment. Frankly, we struggle to explain Financial Repression to our family and friends even though it is key to RiverFront's investment thesis. To us, it means the systematic and deliberate process of destroying wealth and purchasing power. It is 'stealthy' because there is no decline in the perceived dollar value of these 'safe assets' and inflation is low enough that investors barely notice the declining buying power of their assets in the short term. In the long run, this slow erosion of portfolio value can be devastating (see Weekly Chart).

Cash's greatest attraction for investors is its near-term certainty (i.e., the extremely low risk that cash assets' value on their monthly investment statement will fall). Thus, cash has a tactical appeal when the value of other investments is declining. Cash comes in many forms: currency, checking accounts, bank savings accounts, certificates of deposit (CDs), money market accounts, and Treasury bills. From the early 1980s through 2002, cash offered an interest rate higher than inflation. However – and this is key – since 2009 the interest rate on cash has been close to zero. Inflation is only about 2%, but that imposes a 2% loss in purchasing power of cash assets held for a year. These losses compound over time. We understand the many reasons for holding cash, but we want to emphasize that it currently comes at a high cost: the 'drip, drip, drip' of lost purchasing power.

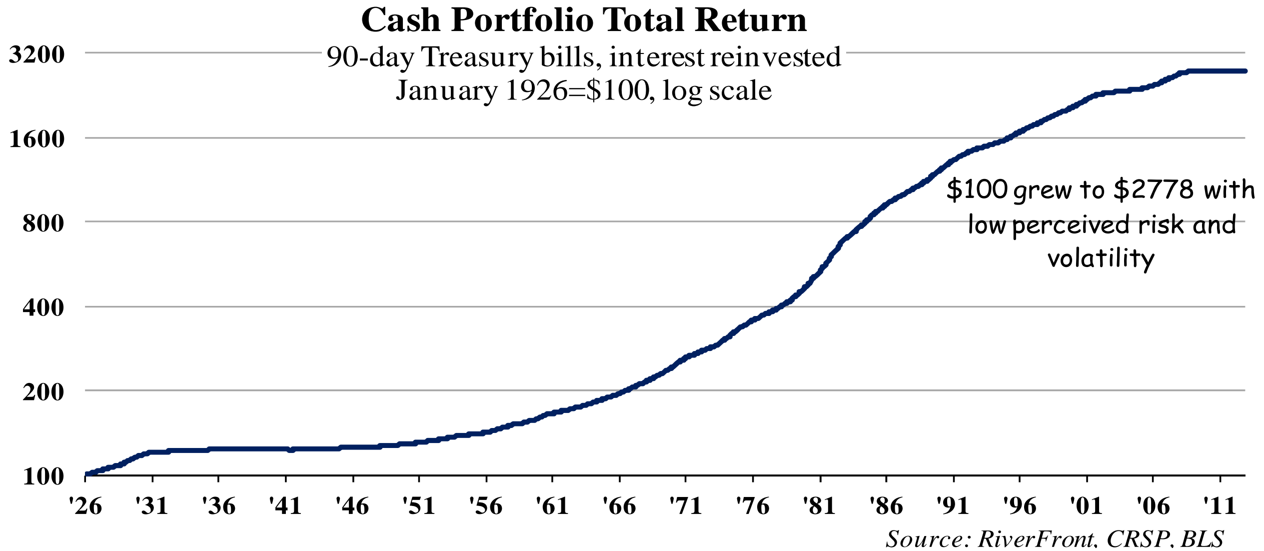
Treasury Bonds: While there are many uses for cash, we see only one reason for holding longer maturity (5 years and over) Treasury bonds — an expensive insurance policy against deflation and economic depression. We say expensive because, in any other scenario we can imagine, longer-term Treasuries and other high-quality bonds have poor risk reward. If the Fed continues its efforts to prevent both deflation and accelerating inflation, then these bond returns will roughly match inflation. If, as we believe, longer term interest rates rise by one percentage point or so in the next year, then returns will be negative. Finally, if interest rates eventually return to historically normal levels, the capital losses will be substantial.

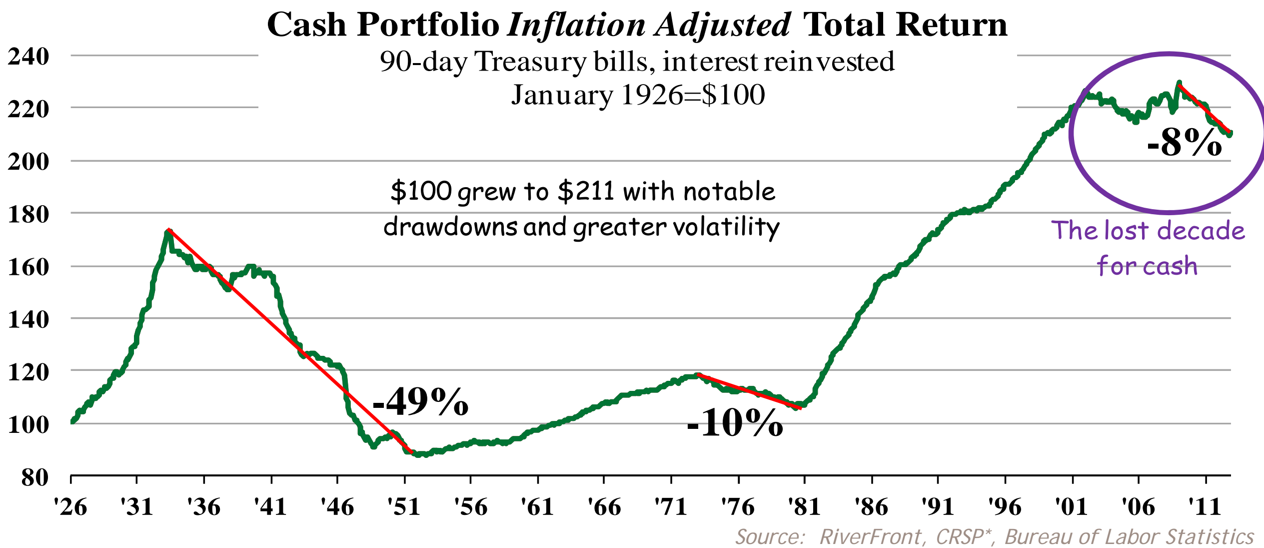
Stocks, like cash, have many attractive characteristics at current prices, in our view. More than half of the S&P 500's companies have dividend yields above the 10-year Treasury note. Furthermore, we think dividends can grow at a compound rate of 6% to 7% a year, meaning that dividends alone are likely to outpace inflation. Furthermore, we are confident that stock prices will rise 30% to 50% over the next five to seven years. However, in contrast with cash, the stock investor cannot avoid price volatility – investment statement risk – and the anxiety that accompanies it. *Dividends are not guaranteed and are subject to change or elimination.*

Stocks are RiverFront's preferred vehicle for investors with longer-term time frames because we believe they will deliver the best returns. That said, we recommend short-term bonds (especially corporates) for investors with shorter time horizons and/or lower tolerance for fluctuations in their portfolio's value. For many, the fear and experience of short-term loss

makes a balanced approach more palatable. We think the cost of deflation/depression insurance is too high; we currently have no longer-term Treasuries in any of our portfolios. We have enjoyed stock-like returns from high yield corporate bonds since 2009 but with their yields recently falling below 6%, we will likely reduce exposure. *High-yield securities are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.*

THE WEEKLY CHART: WHEN SAFE ASSETS BECOME RISKY





Much has been made of the lost decade for stocks, but we would like to highlight the ongoing lost decade for cash. Our chart shows the returns from a portfolio of 3-month Treasury bills expressed before and after taking account of inflation. The bottom panel shows the risks to a cash portfolio when inflation exceeds interest payments as has been the case for much of the last decade. The 1930s and '40s were devastating for cash investors, who lost 49% of their purchasing power as the Fed used artificially low rates to finance President Roosevelt's response to the great depression and the costs of WWII.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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