

The Death of Cash as a Vehicle for Saving

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The nation's supply of financial capital consists largely of the flow of savings from American households. However, in today's monetary environment, savers are pressed — they might as well put their dollar bills under a mattress.



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At near-zero interest rates, and with numerous government inducements to boost consumer spending, it is not realistic to expect traditional savings to fuel the national growth engine as it has in the past. The Federal Reserve Board's policies of quantitative easing and zero interest rates have pushed savers into an intolerable situation, one that looks set to last for some time.

Washington's deficit spending, low economic growth and artificially low interest rates have turned into a vicious spiral. The growth of public debt crowds out the financing of private enterprise, depriving it of capital. And a shortage of capital hurts labor as well by cutting back employment opportunities.

Unemployment and Economic Growth. The unemployment rate has been slowly coming down, but much of the so-called improvement has resulted from people dropping out of the labor force. Figure I shows the resulting fall in the ratio of employment to the working-age population.

Following the convention of equating two part-time jobs to one full-time job:

- On a full-time-equivalent basis, the employed-population measure of the jobs market stood at 57.5 percent at the beginning of 2008, but the recession pushed it down to a low of 52.5 percent by late 2009.
- It is still under 53 percent today and shows no signs of improving.

This represents a massive (and apparently permanent) exodus of people from the market economy.

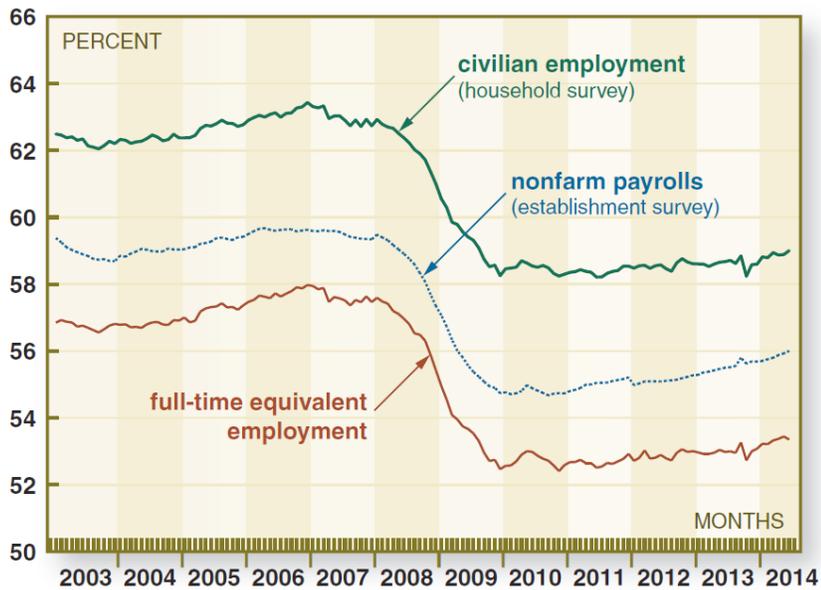
Slow growth and persistent unemployment show that monetizing the debt has not been the economic panacea originally advertised.

Minimizing Risk without Cash. Indeed, prolonged suppression of interest rates is harming the long-term prospects of the U.S. economy. It destroys the integrity of cash as a vehicle for saving. Washington has taken off the table the classic risk-free vehicle to which private investors can prudently allocate part of their wealth: U.S. Treasury bills. Many savers and investors are being pushed into taking on unwanted risk and volatility. Those who resist must put up with indecently low returns. Our economy has a grave need for other ways of preserving capital while earning a decent return at the same time.

Investors may have come to think that safety itself has ceased to be an achievable financial goal, but that is too pessimistic. While it is true that

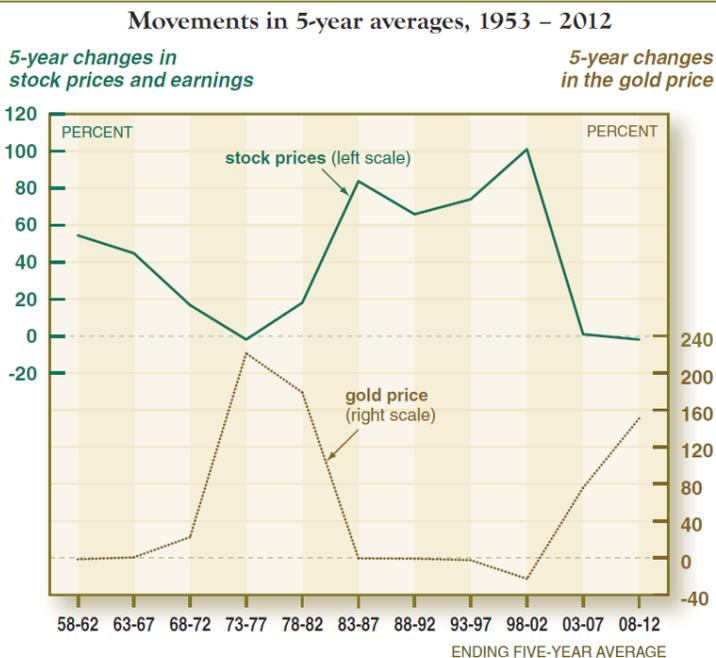
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Figure I
A Sick U.S. Labor Market:
Ratio of Employment to Working-age Population
 from the beginning of 2003



Data: Monthly civilian employment and population aged 16 and above (Bureau of Labor Statistics Current Population Survey) and total nonfarm employment (Bureau of Labor Statistics Current Establishment Survey).

Figure II
Long-term Relationship between the Stock Market
and the Price of Gold



Data: Five-year averages of month-end prices for the S&P 500 companies (University of Chicago/Dimensional Fund Advisors) and spot gold (Metals Week).

all other assets are risky and volatile, there is good historical evidence that it is possible to produce safety out of risk. At first this may sound like alchemy, but in fact a mix of volatile assets can deliver a desirable combination of stability and returns like that which cash used to offer — as long as movements in the prices of these assets are sufficiently strongly inversely correlated with one another. It is a matter of innovation. We all try to sidestep efforts by outsiders to constrain our lives. In the financial arena, markets perform this vital function on our collective behalf.

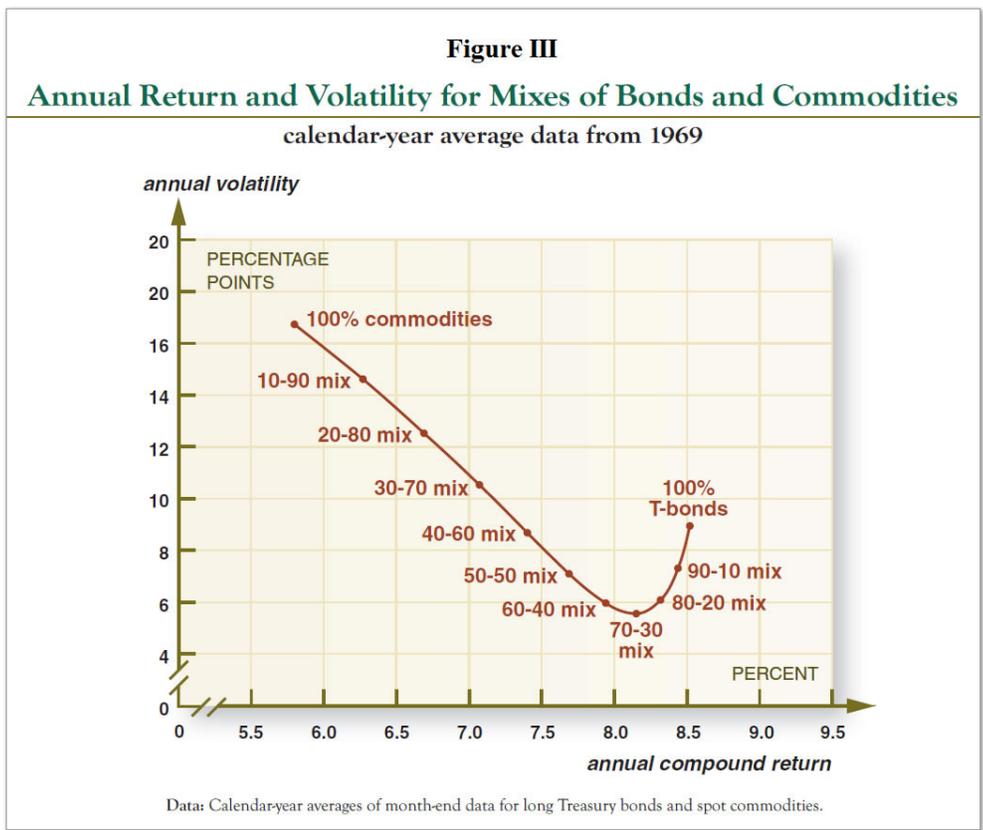
Financial innovation can design an investment vehicle that is so dependable, remunerative and stable — especially stable — that it can substitute for the role cash used to play in the capital markets. The challenge is to craft an asset mix that takes maximum advantage of the inverse correlations that are out there. The secret of that is, in turn, to select asset classes with polar-opposite responses to the economic winds.

The Inverse Correlation of Stocks and Gold. One example is the relationship between returns from stocks and gold. It is not just inverse, but highly inverse, lasting and — best of all — consistent over time. Why? Because the inflow of private capital that fuels business enterprise, and expands the economy, is deterred by currency depreciation and the threat that the real value of capital will not be preserved. Symmetrically, a stronger dollar restores that incoming capital flow. When the dollar rises or falls, therefore, the price of gold moves in the opposite direction. As capital flows in and out, equity prices advance and decline.

From year to year, and even from decade to decade, equities and gold move against one another in see-saw fashion. Figure II illustrates the sharp inverse correlation between them when returns are expressed five years at a time. In the 10 years from the end of 2000 through 2010, for example, Standard & Poor's 500 stocks produced a paltry annualized return of 1.4 percent while the price of gold advanced at an average rate of 17.5 percent. In the decade prior to that, the gold price declined at an average rate of 3.5

percent while the S&P 500 returned nearly 18 percent per annum.

Other examples include assets such as commodities and foreign equities, which tend to be inversely related to high-quality bonds. Figure III illustrates what happens to annual return and volatility when Treasury bonds and commodities are mixed in a portfolio. In this graph, volatility is plotted vertically, and average return is plotted horizontally. The extent to which volatility can be reduced by mixing assets is clear. In particular, a mix of 70 percent T-bonds and 30 percent commodities is one-third less volatile than T-bonds alone and two-thirds less volatile than commodities alone. The average return of this mix lies somewhere in between that of bonds and commodities. Thus, combining pairs of inversely related assets makes possible a degree of diversification that goes far beyond benchmarks such as the traditional mix of stocks and bonds.



Mixing Asset Classes Reduces Volatility. Figure IV compares the cumulative value of \$1 invested back in 1970 in constant mixes of four primary asset classes: stocks, bonds, gold and commodities, giving the four assets equal weight.

The vertical scale is logarithmic so that constant performance would show up as a perfectly straight line. The portfolio is assumed to be rebalanced to the original equal-weight formula on a periodic basis. Results are shown for both monthly and annual rebalancing. Although the two histories in the chart are very similar, the return from annual rebalancing is a little higher, suggesting that frequent rebalancing may be unnecessary.

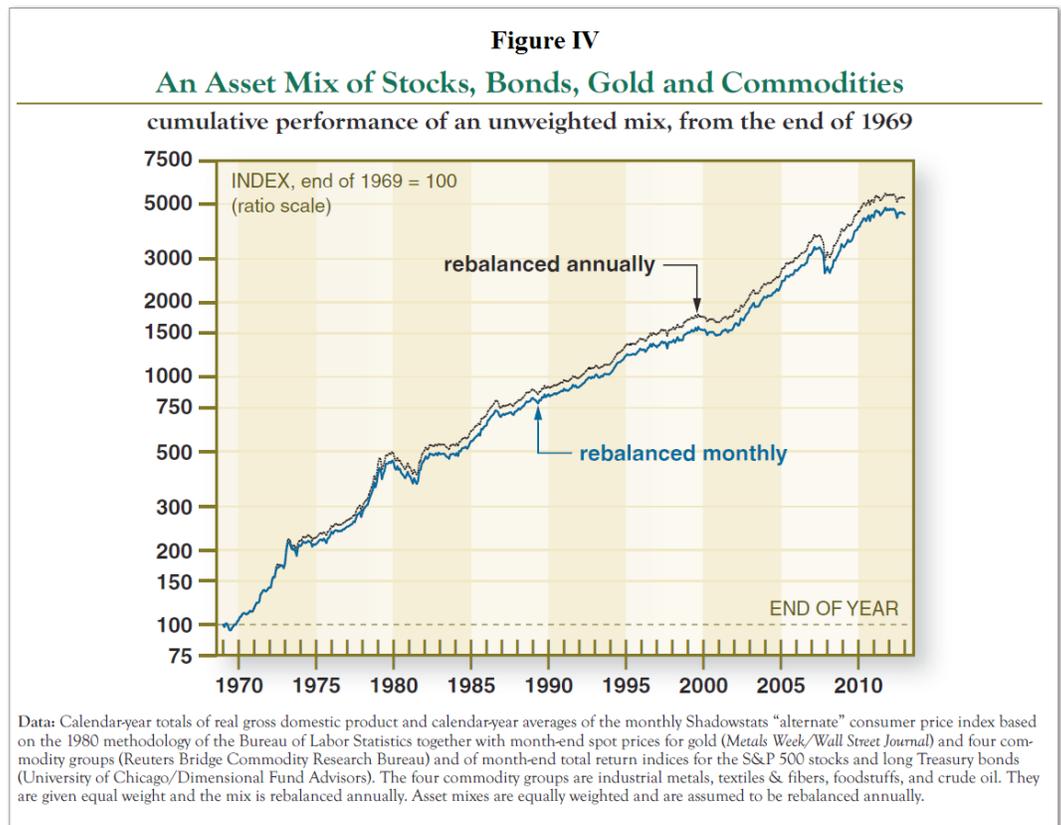
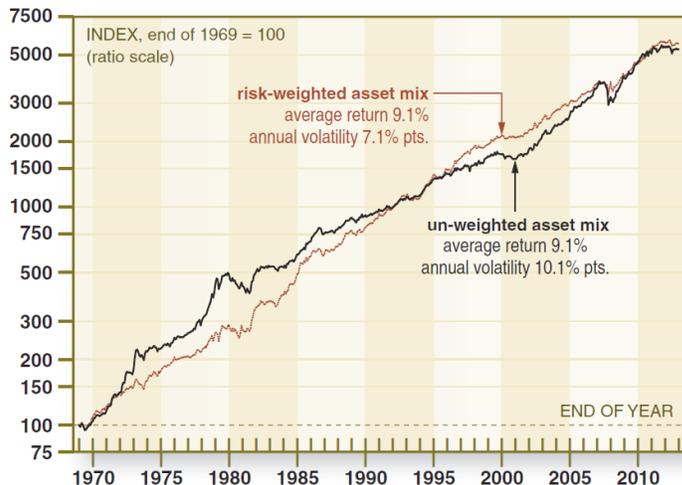


Figure V
Portfolio of Stocks, Bonds, Gold and Commodities:
Cumulative Performance of Un-weighted and Weighted Mixes
 from the end of 1969



Data: Calendar-year totals of real gross domestic product and calendar-year averages of the monthly Shadowstats "alternate" consumer price index based on the 1980 methodology of the Bureau of Labor Statistics together with month-end spot prices for gold (*Metals Week/Wall Street Journal*) and four commodity groups (Reuters Bridge Commodity Research Bureau) and of month-end total return indices for the S&P 500 stocks and long Treasury bonds (University of Chicago/Dimensional Fund Advisors). The four commodity groups are industrial metals, textiles & fibers, foodstuffs, and crude oil. They are given equal weight and the mix is rebalanced annually. Asset mixes are equally weighted and are assumed to be rebalanced annually.

The volatility of collective return also depends on the formula by which the four are weighted. There are countless possible schemes. One of the oldest, termed a “permanent portfolio,” was introduced by financial author and presidential aspirant Harry S. Browne in the 1990s, and he prescribed the simplest of formulas — equal weights, as used in Figure IV.

Another scheme, shown in Figure V, follows instead the doctrine of “risk parity,” using a formula advocated by investment guru Ray Dalio. In the weighted portfolio, each asset is given a weight that equalizes the four contributions to the variance, the so-called “risk,” of the overall mix. The unweighted and weighted portfolios, rebalanced regularly, are compared in Figure V.

Although its average return is not materially different, the risk-weighted mix is clearly less volatile and more consistent in its growth over time. Both weighting

formulas produce an asset that trounces the return from cash in the form of 30-day Treasury bills. It is clear that a constant mix of selected assets can mimic the stability of cash with a higher return both historically and prospectively.

While such asset mixes cannot rival the stability of cash on a weekly or monthly basis, they can be more stable than cash over multiyear horizons. Because the Fed manipulates the price of short-term government paper at will, capital appreciation readily falls prey to a zero interest-rate policy. Constant asset mixes like those in the figure are a way to guard against this. They are much less vulnerable.

Another conceptual advantage is the opportunity to customize a constant asset mix for a specific purpose. For example, a portfolio could be crafted to minimize the volatility of returns on an inflation-adjusted basis. That would address a universally desired investment goal which is beyond the reach of cash itself.

Conclusion. Goaded by the Federal Reserve’s zero interest rate policy, one could foresee a future proliferation of competing investment funds that would bring highly stable asset mixes at low cost to the financial marketplace. Beyond that, one could even imagine some similar vehicle — once investors have established a market for it — supplanting traditional cash as a medium of exchange as well. Though quite different from Bitcoin, it could serve the same purpose: an irrepressible form of private money.

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