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Stashing Your Cash: Mattress Or Market?

by Lisa Smith (Contact Author | Biography)

When stock markets become volatile, it makes investors nervous. In many cases, this prompts them to take money out of the market and keep it in cash. Cash can be seen, felt and spent at will and for most people, having money in hand feels safe. But how safe is it really? Read on to find out whether your money is safer in the market or under your mattress.

All Hail Cash?

There are definitely some benefits to holding cash. When the stock market is in free fall, holding cash helps you avoid further losses. Even if the stock market doesn't fall on a particular day, there is always the potential that it could have fallen. This possibility is known as systematic risk, and it can be completely avoided by holding cash. Cash is also psychologically soothing. During troubled times, you can see and touch cash. Unlike the rapidly dwindling balance in your brokerage account, cash will still be in your pocket or in your bank account in the morning.

However, while moving to cash might feel good mentally and help you avoid short-term stock market volatility, it is unlikely to be a wise move over the long term.

A Loss In Not a Loss ...

When your money is in the stock market and the market is down, you may feel like you've lost money, but you really haven't. At this point, it's a paper loss. A turnaround in the market can put you right back to breakeven and maybe even put a profit in your pocket. If you sell your holdings and move to cash, you lock in your losses. They go from being paper losses to being real losses with no hope of recovery. While paper losses don't feel good, long-term investors accept that the stock market rises and falls. Maintaining your positions when the market is down is the only way that your portfolio will have a chance to benefit when the market rebounds. (For more insight, see *How are realized profits different from unrealized, or so-called "paper", profits?*)

Inflation: The Cash Killer

While having cash in your hand seems like a great way to stem your losses, cash is no defense against inflation. You think your money is safe when it's in cash, but over time, its value erodes. (*Coping With Inflation Risk* explains how inflation is less dramatic than a crash, but can be more devastating to your portfolio.)

Opportunity Costs Add Up

Opportunity cost is the cost of an alternative that must be forgone in order to pursue a certain action. Put another way, opportunity cost refers to the benefits you could have received by taking an alternative action. In the case of cash, taking your money out of the stock market requires that you compare the growth of your cash portfolio, which will be negative over the long term as inflation erodes your purchasing power, against the potential gains in the stock market. Historically, the stock market has generally been the better bet.

Time Is Money
When you sell your stocks and put your money in cash, odds are that you will eventually reinvest in the stock market. The question then becomes, when you should make this move. Trying to choose the right times to get in and out of the stock market is referred to as market timing. If you were unable to successfully predict the market's peak and sell, it is highly unlikely that you'll be any better at predicting its bottom and buying in just before it rises. (This strategy is popular, but can few do it successfully, read *Market Timing Fails As A Money Maker* for tips.)

Common Sense Is King
Common sense may be the best argument against moving to cash, and selling your stocks after the market tanks means that you bought high and are selling low. That would be the exact opposite of a good investing strategy. While your instincts may be telling you to save what you have left, your instincts are in direct opposition with the most basic tenet of investing. The time to sell was back when your investments were in the black - not when you are deep in the red. (To learn more, read *To Sell Or Not To Sell*.)

Buy and Hold on Tight
You were happy to buy when the price was high because you expected it to go higher. Now that it is low, you expect it fall forever. Look at the markets over time. They have historically gone up. Companies are in business to make money. They have a vested interest in profitability. Investing in equities should be a long-term endeavor, and the long term favors those who stay invested. (For additional reading, check out *Long-Term Investing: Hot Or Not?*)

Nerve Wracking, but Necessary
Serious investors understand that the markets are no place for the faint of heart. Of course, with private pension plans disappearing and the future of Social Security in question, many of us have no other choice. (Be sure to read, *The Demise Of The Defined-Benefit Plan*, which provides a closer look at this situation.)

Once you've faced the facts, you need to have a plan. Figure out how much money you need to amass to meet your future needs, and develop a plan to help your portfolio get there. Find an asset allocation strategy that meets your needs. Monitor your investments. Rebalance your portfolio to correspond with market conditions, making sure to maintain your desired mix of investments. When you reach your goal, move assets out of equities and into less volatile investments. While the process can be nerve-wracking, approaching it strategically can help you keep your savings plan on track, despite market volatility.

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