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"Going Broke Safely"

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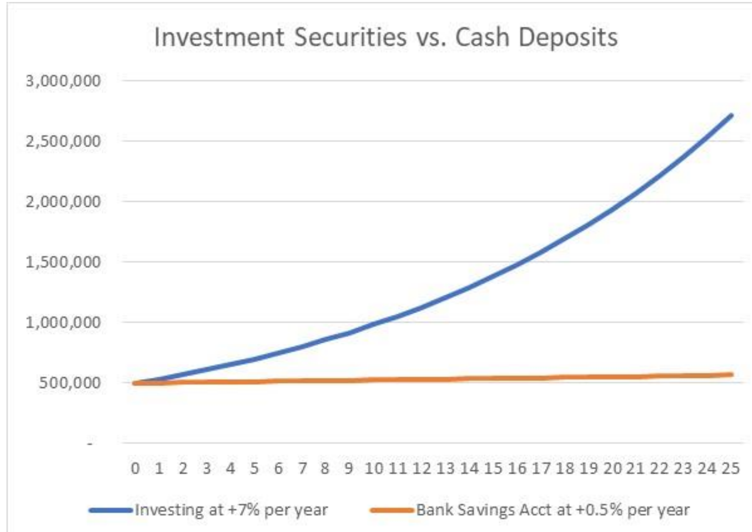
The safest thing you can do with your money is to put a large portion of it in an FDIC insured savings account at a bank. No worries about market movements, stock blow-ups, or bond defaults. All that volatility is so risky and so scary. Plus, what if you have an emergency come up – you'll need some cash parked on the sidelines for sure. With these actions, you'll be able to sleep soundly. This is the conventional wisdom. It is wrong. For those of you who were unaware, I was a guest on a podcast called Smart Money Circle in November of 2019. It was a unique experience for me, and I am so glad I did it. Afterward, I decided to listen to several of the other episodes, and I stumbled upon an adviser discussing this very issue. In it, she mentioned a phrase that succinctly summed up my own views on the subject. She noted that many people choose to keep huge sums of cash to the side as opposed to investing it, a habit she called "going broke safely."

Before addressing what "going broke safely" really means, an important concept that we must review is risk. What exactly is risk? According to many academic textbooks and professional investors, investment risk is determined by assessing the volatility or standard deviation of the movements in an investment. Said another way, risk is measuring how much an investment's value (typically a stock) bounces around on a daily, weekly, or monthly basis. In some ways, this makes sense. If ABC Corp's stock is likely to move up or down 5% every day, it is probably riskier than XYZ Corp's stock that barely budges. Or at least it feels that way. What if I told you that ABC's stock bounced around every day, but their business was growing rapidly, had higher margins, and had nice barriers to entry from their competition. Conversely, XYZ Corp's business was in secular decline, had eroding margins, and had mounting competition. Which stock is riskier? This exaggerated example is not that unrealistic. We see real-world situations like this all the time. ABC Corp might be Etsy or Floor & Decor, while XYZ Corp is IBM or a Tobacco company. The point here is the real risk is permanent impairment or declines in the business. This is called the risk of permanent capital loss. It does not matter that IBM's slow, stable business decline enables smaller day-to-day market moves in its stock.

Now let's start to apply this concept of risk to an investor's portfolio. What risk should an individual be focused on? The answer is clear. There is only one risk that any investor should worry about: the risk of not having enough money. Whether it's enough money to retire comfortably, buy a house, go on vacations, or simply to buy groceries, this is the real risk we all should be focused on. To be fair, timeframes do matter. If you are going to buy a house in the next 6 months, you probably can't handle as much short-term movement in your portfolio. Yet, if you are 55-60 years old and plan to retire in over 10 years, you can handle a lot of short-term volatility. One critical idea that all should remember is that compounding your assets is almost always the absolute key to wealth creation. Having a big salary is important, but in the end, most people's wealth is created after many years of investing and reinvesting profits. As a quick example, \$500,000 invested in the stock market for 25 years earning 7% per year would result in over \$2.7 million. In that 26th year, if you earned another 10% on top of this, you would earn \$270,000. Not too shabby. Conversely, let's say you took that \$500,000 and instead left it in a bank savings account earning a whopping 0.5% per year for 25 years. You would end up with only \$566,000. But wait, you'll say, what if the market went down during that 25-year period. Well, I would counter with the fact that the U.S. stock market has never declined over any rolling 20-year period. Never! Actually, it is rarely even down over a 10-year period (4% of all rolling 10-year periods). From a longer-term view, therefore, one must question how risky is the stock market after all?



Another concept worth mentioning is Purchasing Power. Everyone is well aware that the dollar does not go as far as it used to. Decades ago, you were to be able to attend a movie for \$0.10 and grab a meal for a few bucks. The purchasing power of \$1 is now much less than before. This decline in the value of the dollar is a function of inflation. Think of inflation as the amount of lost purchasing power per year. Current inflation levels are roughly 2%, meaning that every year the value of the dollar (in terms of goods it can purchase) declines by about 2%. When looking back at my previous example, it shows the poor financial result of the \$500,000 bank savings account. While your bank statement may say \$566,000 in 25 years from now, the true purchasing power of it is more like \$341,000 (assuming 2% inflation). You didn't create wealth in that savings account, you actually lost wealth – a ton of it. Higher inflation rates would likely only make the disparity worse.

One last caveat to consider is the commonplace idea of an "emergency fund." The reality is that the only people who truly need an emergency fund are those that do not have any assets at all. What emergencies typically come up that require a lot of cash immediately? You need dental surgery? Your car dies? These items might cost up to \$50,000. If you have minimal savings, these emergencies can be devastating and may lead to bankruptcy. Thus, if those without investable assets can build up an emergency fund of over \$25,000, they can avoid disaster if an emergency arises. For them, emergency funds do make sense. On the other hand, why would someone with a $2 million investment portfolio also need $200,000 in an emergency fund? If you have $2 million in an investment portfolio and you suddenly need $40,000, sell a few investments and move the cash to your checking account. By carrying that $200,000 in a bank savings account that basically pays nothing, all you are doing is reducing your investing power and reducing your long-term financial well-being. The cost of holding a large emergency fund is indeed very high.

I define "going broke safely" as having too much money in super safe places – ensuring that you will eventually run out of money in a slow, steady manner. By trying to "play it safe" through avoidance of volatile stock markets or sidelining a large emergency fund, you can actually cause your own financial insolvency. It's both ironic and tragic. I have met very few people who feel they have too much money. Investing these assets optimally will significantly reduce the true financial risk of not having enough. However, this does not mean that you should never have cash as part of your overall portfolio. If you have a near-term financial need or you are trying to tactically avoid a market downturn, it makes sense. The key is to not have a sizeable, structural allocation to cash. Despite the saying that "cash is king," cash is more likely to make you a pauper than a king.