

Office for Financial Success – Financial Tip of the Week  
A service of the Personal Financial Planning Department  
College of Human Environmental Sciences  
University of Missouri-Columbia  
(10/09/2009)

Cash is Queen

Over the past six months, we've heard a lot about how important cash is to one's portfolio. Cash provides liquidity, in order to cover emergency expenses, as well as money to take advantage of market opportunities as they become available. Realistically, how much cash should you have and how do you manage your cash?

The answer to the first question is easy. You should have a minimum of three to six months living expenses readily available to cover any emergency situation; such as being laid-off from your job, to pay for medical or property loss deductibles, to provide a disability income while you recover from an injury, or whatever financial disaster comes your way. You know by now that the greater your ability to self-insure (having a larger deductible); the lower will be your insurance premiums. These savings provide money for you to save and invest toward your future. Moreover, I did hear, earlier this morning on television, that a characteristic of the current health reform debate is to have people with a greater risk of health claims to be expected to carry a larger deductible on their health insurance. Now, whether or not this truly comes to pass, it is always true that the ability to self-insure some of your losses is a key to savings and wealth accumulation. Thus, establish your emergency fund as soon as possible. It is a goal that dwarfs most others.

The second question is less clear. How do you hold your cash, once you've accumulated a balance? We will discuss a few options.

A likely source for cash is in your checking account or share-draft account. These accounts are very liquid, yet their annual percentage yield, if any, is very low. Regardless, a month, or two, of living expenses is not uncommon to be found in these accounts. Let's assume we've a month and one-half in these accounts to allow us to pay a budget busting bill, should one come due.

A second source is a money market mutual fund ( MMMF), as compared to a money market deposit account ( MMDA). A money market mutual fund is where your cash balance is mixed with the cash of others to purchase a diversified portfolio of short-term debt obligations of federal and state governments and larger companies. As these securities are short-term, they do not experience interest-rate risk (the risk of increasing interest rates lowering the value of outstanding fixed-rate securities, or vice versa). MMMFs are purchased from brokerage firms, as opposed to MMDAs which are purchased from banks. MMDAs, however, are FDIC insured, thus they pay a little lower rate of interest. Finally, if you're in a relatively high tax bracket, MMMFs can be found that contain tax-free, short-term municipal securities. We'll plan on putting one and one-half to four and one-half months of living expenses here.

This takes care of your emergency fund but what about other cash you may want to hold? Consider bank certificates of deposit, or CDs. CDs require you to lock up your money for a period of time, typically 3, 6, 9, 12, 18, or 24 months, with a penalty if you withdraw the money before maturity. Typically, the longer the term of the promise you make to the bank to let them use your

money, the greater will be the rate of interest you receive. Given this, an often employed practice is to ladder ones' CDs.

Assume you have \$20,000 to put in CDs. Laddering would imply that you pick a time interval, say six-months, and put ¼ of \$20,000 (or, \$5,000) in a six-month CD, ¼ in a one-year CD, ¼ in an eighteen month CD, and ¼ in a two-year CD. Then, when the six-month CD matures, you put the principal in a two-year CD. In this way, you are always investing your money at the higher, two-year rate, while always having ¼ of your money coming due in six months, which you can reinvest at higher rates, should CD rates increase. While, recently, the difference between short- and long-term rates has been very small, this method is widely used for fixed income investments. As of today, for Columbia, MO the published rates on CDs are:

Term	Annual Percentage Yield
6 months	0.80%
12 months	0.92%
18 months	1.26%
24 months	2.15%

I won't go into the details, but these rates imply that rates are heading higher. (Recently, this was also indicated as a choice of the Chair of the Kansas City Federal Reserve Bank.) If they do, you are fine. In six-months, you'll be able to reinvest ¼ of your money at the higher two-year rate, while having ¼ of your money coming due, again, in six-months. If we're wrong and rates stay low, you will reinvest at the 2.15% rate for two years. Soon, you are always investing your money long-term, for higher rates, while always having CDs maturing in the short-term, to allow you to take advantage of changing markets or to provide liquidity for your living expenses.

While this doesn't guarantee financial success, it does take the guess work out of one aspect of your financial plan, while providing a source of liquidity. Liquidity may not be as important over the long-run but, when compared to other characteristics of investments such as return, in the short-run, it can make the difference between eating well - while making the mortgage payments - and eating less-well - while losing your home. If you don't believe me, ask a friend who is among the 9.8% of our workforce who is unemployed.

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