When should you hold on to cash in your portfolio?

Generally, keeping money in cash or low-yielding investments can hurt your portfolio. There are some situations, though, where cash comes in handy.

Having "too much" cash may sound like an ideal situation to be in, but in the world of investing and personal finance, excessive cash holdings can sometimes be a disadvantage. That's because cash—which from an investment standpoint includes any short-term asset that can be easily withdrawn, including guaranteed investment certificates (GICs), 90-day treasury bills, and cash held in a savings account—offers such low returns that it often fails to keep up with inflation, which over time, can erode your purchasing power.

As well, if you are holding cash in a bank account or stuffed in a drawer, then it's not in the market—where hopefully, it can grow. And yet, cash does serve a purpose. The key is keeping just enough: in other words, not so much that you can't reach your long-term savings goals.

So, when should or shouldn't you use cash?

Yes to cash: For emergency funds

When life goes awry, it's money—the liquid and easily accessible kind—that can help you get through the tough times. That's why most people should have some sort of emergency fund so they can quickly access cash. If you lose your job, need to fix your car, repair your house, or take an unexpected medical leave from work, then having money that you can use to pay for that expensive item or bridge the gap until you can find work is important. Generally, people recommend having enough put away in a savings account to cover

at least three to six months of your ongoing expenses, which usually includes mortgage or rent, food, and transportation (among others).

If you know you may be out of work for longer—maybe your job is in a highly specialized field where positions are hard to come by—you could consider setting aside enough to pay for as much as two years' worth of expenses. In that case, because the total size of your emergency fund is quite substantial and will likely be sitting around for a fair bit of time, you might be better off putting those savings into short-term GICs that can either be cashed in or will at least mature in a short period of time, like one month, six months, or a year. (If you don't need the money when that GIC is due (matures), put it back into another short-term GIC.) Additionally, if you have room,

consider keeping those GICs in a Tax-Free Savings Account so your returns compound tax free.

You can choose GICs that mature at different times so that you're not limited by having all of your funds locked up at once, for longer. This is an approach called "laddering." By laddering, you can also get exposure to different interest rates. For example, a 5-year GIC might have the highest interest rate available today, but if interest rates increase a year later and all of your cash is locked into that 5-year GIC, you will have to wait to reinvest your money and may miss the opportunity to reinvest at a higher rate.

Yes to cash: For short-term savings

It's helpful to have cash on hand if you're going to need a certain amount of money for a specific, sizeable purchase in the near future. Perhaps you are planning a move, or want to take your whole family away for a trip in a couple of years, or to pay for a momentous family occasion like a wedding. In such cases, you may want to consider holding whatever you'll need to spend in a high-interest savings account, where, unlike in the market, the money is safe from volatility. While you won't earn a lot, some institutions are paying interest rates in excess of 2%.

You can also make use of GICs and short-term bond funds, which hold fixed income products with maturities of around one or two years that could provide a little more of a financial boost. However, if you need the money sooner and the bond market falls, then you could end up losing some of your principal.

No to cash: When investing in the market for the long-term

Many investors like to keep cash on hand to invest in the market when they see buying opportunities, which is typically when the market falls. But there are a couple of problems with this strategy.

First, you may end up leaving your holdings in cash much longer than you anticipated. Are you waiting for a 3% correction in the market, or a 30% drop? Yields on cash instruments are so low right now (roughly around 1% to 2%) that keeping those funds out of the market for any length of time could drag down your portfolio's overall investment returns.

Secondly, and crucially, it's impossible to time the market. You may think you're buying at the bottom, only to see the market slide further after you invest the cash. The best way to ensure you'll enjoy the gains of a market rally is to stay invested. It is generally better to invest in a suitable asset mix and be patient. Indeed, a recent study showed that an investor who put $10,000 into the S&P 500 at the end of 2003 and stayed fully invested over the next 15 years would have earned $15,230 more than someone who missed just 10 of the market's "best days" over the same time period. Time is often on your side, so put your money to work.

Cash can serve a purpose, but, in general, you should hold on to what you need and then invest the rest. If you are sitting on a big chunk of cash, you can invest a lump sum, or, if you're worried about putting it all in at once, split it up and put some into the market regularly. In other words, establish a strategy and stick to it, rather than waiting for a 'good' time to invest. In any case, it's usually best practice not to keep cash sitting around for too long.

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