Cash is for spending

In investment parlance, "cash" refers not to the notes and coins in your wallet, but to any certificate of deposit, treasury bill, or other interest-bearing vehicle with a maturity of one year or less. Prior to autumn 2022, such instruments paid so little that they attracted almost no attention from anyone with funds to deploy. That changed abruptly, however, when central bankers around the world launched aggressive rate hiking programs to blunt surging inflation and, just like that, cash was in vogue. *With geopolitical fires igniting on top of each other and economies apparently on the brink of recession, why risk capital on the uncertainty of stocks when sitting on one's proverbial hands would yield as much as 5%?* By mid-December, more than $1 trillion had rushed to US money market funds alone, with similar flows inundating GIC's, treasury bills, and other deposit instruments.

Undoubtedly, some of the dollars being kept liquid *(maybe a lot of them)* would have found their way to longer term assets in more sanguine times. Though rarely acknowledged in the moment, delaying investment until things "feel right" is really an attempt at market timing and once that train has been boarded, it can be difficult to disembark. If markets fall, our fears get confirmed and we become even more ensconced under our blanket of cash; if they rise, then they've grown more expensive and our original case for sitting on the sidelines is only made stronger. In an investment portfolio, however, the objective shouldn't be to maximize a series of short-term returns, with the hope of stringing them together to arrive at an optimal end result – it doesn't take a great deal of consideration to realize that the odds of pulling this off over any length of time are next to zero. Rather, allocations are best made according to a plan, and that plan should differentiate between what is needed within the coming year (cash), what will be required in the next one to five years (fixed income), and what is intended for long-term growth and inflation protection (equity). Overriding a well-structured plan to shift capital from one bucket to another (especially from equity to cash and vice versa) puts the original strategy in jeopardy and significantly raises the probability that intended goals won't be met *(see below)*.

Cash is risk-free … *right?*

Setting aside the punitive tax treatment of interest income and the poor job that short-term deposit vehicles do to offset inflation, parking otherwise investable funds in cash raises at least two distinct risks, both of which are now being emphatically realized:

Reinvestment Risk

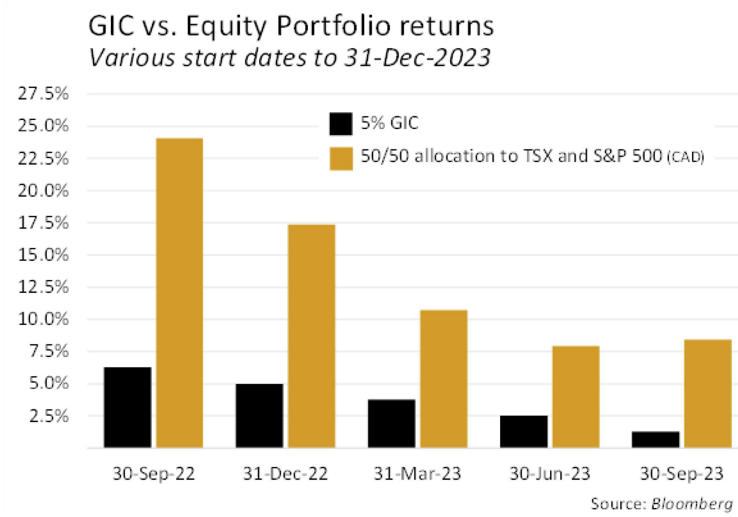
Booking a seemingly attractive short-term rate instead of investing one's long-term capital means that these funds must be redeployed when they come due, which introduces the corresponding risk that future yields might not be as attractive as they were when the original decision was made. As it happens, the interest rate backdrop was quickly turned on its head in the fourth quarter, with the US Federal Reserve softening its tone in its December communication and the futures market suddenly pricing in as many as six policy rate cuts for 2024. On top of that, the challenge of what to do with maturing capital in a falling rate environment has been doubly amplified by what has been missed in the meantime.

Opportunity Risk

In October of this year, individual investors in the US sold $15.6 billion worth of stocks, marking the largest monthly outflow from equities since 2021 and undoubtedly contributing to the sudden bulge in money market fund balances. Unfortunately, they did so right before the S&P 500 posted its 18th best month since 1950 and the second best November in more than 40 years; December was pretty good too, helping to lift the benchmark by more than 24% for the year, not including dividends.

To gauge the recent effectiveness of delaying investment, we calculated how an individual would have fared had they elected to employ this strategy instead of buying a generic 50/50 allocation to the TSX and S&P 500 market indices, assuming different entry points beginning when short-term rates first jumped in the fall of 2022.

Assuming that a deposit earning 5% was available throughout the period, the investor was worse off in cash – *often significantly so* – no matter when the decision to postpone investment was made. Unfortunately, this person must now not only navigate a less attractive rate environment for maturing funds, but must also contend with the emotional hurdle of getting long term capital back into long term assets when the prices of those assets are significantly higher than they were six or twelve months ago.



Over the past year and a half, stocks have absorbed and shaken off a ton of macro uncertainty, and so it's reasonable to wonder what they'll do if things get better, or just less bad. On top of that, the trillions of dollars that have been ploughed into short-term vehicles could soon be looking for a new home, especially if it turns out that rates have passed their peak. Against this backdrop, hiding in cash could quickly flip from being the prudent trade to being the pain trade, if it hasn't already.

Looking ahead

Not only did the S&P 500 finish 2023 with a gain of 24%, it's now more than double its covid low and within a hair's breadth of its all-time high, results which next to no one had predicted 12 months ago (in fact, the net forecast of Wall

Street strategists for the past calendar year was negative for the first time this century). Just as markets often surprise to the upside, however, they can also drop by 20% or more at any moment and, unfortunately, none of the issues that worried investors over the past several months have gone away. The thing is, markets are in jeopardy of falling by that much *even in the best of times* and do so about every five or six years on average, no matter what's happening in the world. That uncertainty, though, is a feature, not a bug and it's what causes stocks to be priced to generate superior long-term returns vs. other asset classes. As is often said, volatility is the price of admission to the growth offered by equity ownership – it's also what gives the patient investor a decided edge over the impetuous horde.

So, with all of that said, do we have a prediction for 2024? Of course not! Far too much could happen over such a short interval – *for better or worse* – for us to try a guess at what the next year might bring. This is not a stance taken by most of our industry, however, and each year the big investment houses dutifully distill the efforts of their many analysts and strategists down to a precise market forecast. For 2024, the S&P 500 targets of these venerable firms imply expected 12-month returns which range from -12% to +15%. Though the work supporting these predictions is inarguably rigorous and always accompanied by compelling data, charts, and commentary, it's hard to think of another profession where expert opinion could be separated by such a vast chasm *(Doctor #1: "you're very ill and it's unlikely that you'll make it past Easter"; Doctor #2 "not only are you not sick, I think you may actually be younger than you were last year!").* Hopefully you'll forgive us for not joining this spectacle.

As always, we paid only passing attention to macroeconomic metrics over the past year and instead maintained the approach that we believe offers the best chance to grow assets and add value beyond what a passive investment in the broad market would provide. In other words, we spent our time evaluating the merits of individual companies, meeting with management teams, and assembling allocations to provide what we thought would be the most effective balance between risk and potential return. Though we got a few things wrong, the vast majority of our decisions in 2023 worked out well, allowing the DM Canadian Equity, DM US Equity, and DM Small Cap Funds to beat their benchmarks by 7.6%, 8.5%, and 16.5%, respectively. While bonds continued to struggle in the first half of the year, they staged a powerful recovery in the final quarter, as inflation worries subsided and interest rates retreated in sympathy. A continuation of this trend could make 2024 a much more favourable period for fixed income assets vs. recent years, which would also provide a boost to balanced allocations.

As you brace for the harrowing news which is sure to arrive in the days and months ahead, and digest the many convincing predictions and recommendations that flash across screens throughout the year, hopefully 2023 will serve as a useful reminder that near term market behaviour is unknowable and that yielding to the natural desire for safety is more likely to undermine a well-structured investment plan than help it. In the year to come, we'll keep doing what we've done for more than two decades, but feel free to reach out anytime with questions about our approach or the choices we make in any of our mandates.

Happy New Year to DM clients and friends of the firm!