



Economics & Strategy

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"if history is a guide, investors who are sitting on the sidelines to wait out the volatility, will hang onto the cash too long and miss out billions of dollars in lost investment opportunities."

Holding Onto Cash

by Benjamin Tal

With the level of stock market volatility at a five-year high, Canadian investors are seeking asylum in the safety of cash. In fact, Canadian investors are already sitting on a record \$45 billion in excess cash they would normally invest in the markets. If history is a guide, investors who are sitting on the sidelines to wait out the volatility, will hang onto the cash too long and miss out on billions of dollars in lost investment opportunities.

Rising Cash Positions

The implied volatility index of the TSX, a measure of Canadian equity investors' nervousness, has risen by a dazzling 80% over the past year (Chart 1), and is now at a level not seen in more than five years. Judging from recent sales and redemptions from equity mutual funds, investors are in a bad mood. On a three month moving average basis, net sales of equity mutual funds are now in negative territory—the

worst showing on record (Chart 2, left). In fact, a total of \$35 billion worth of equity funds have been redeemed in just the last six months.

Where is the money going? Clearly, safety is "in" these days. A significant portion of the money leaving the equity market is going into cash and cash equivalent instruments. The most popular destination is by far money market mutual funds which have seen cumulative net sales over the past six months rise eight times faster than during the same period last year (Chart 2, right). Sales of money market funds hit a record of \$10.7 billion during the first three months of 2008. In fact, in March, all of the \$2.6 billion in net mutual fund sales flowed into money market investment. And with balances surging at more than 30% on a year-over-year basis, the share of money market funds in total mutual funds has shot up from 7% in September 2007 to the current 10% (Chart 3).

Chart 1 Rising Market Volatility

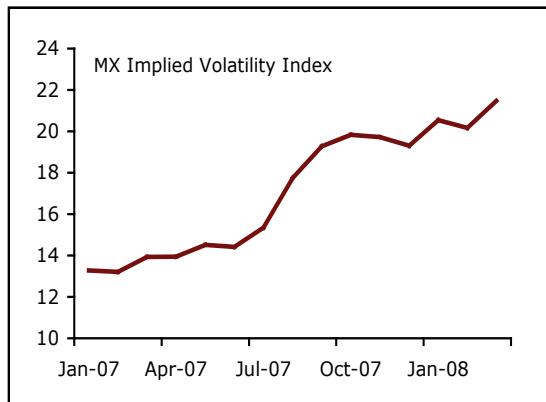
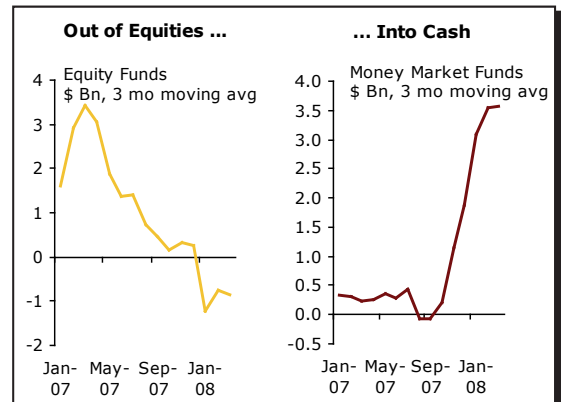


Chart 2 Net Mutual Funds Sales

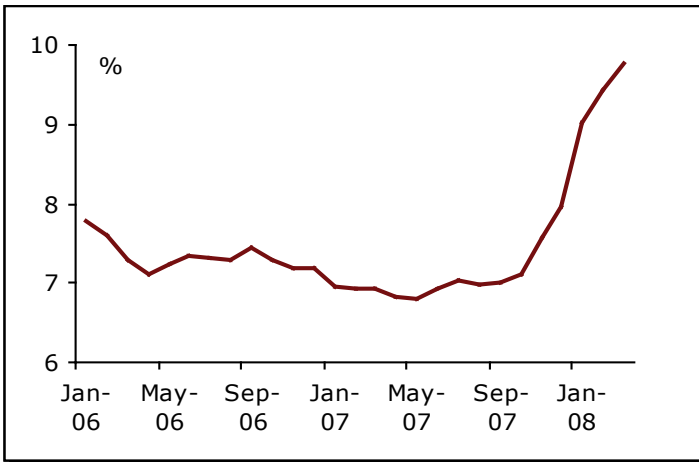


Source: IFIC, CIBCWM

http://research.cibcwm.com/res/Eco/EcoResearch.html

Chart 3

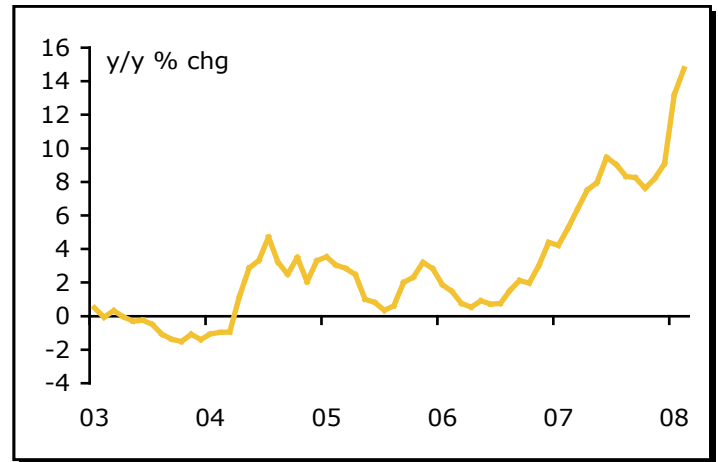
Share of Money Market Mutual Funds in Total Mutual Funds



Source: IFIC, CIBCWM

Chart 5

Canadian Household Liquidity Position



Source: IFIC, CIBCWM

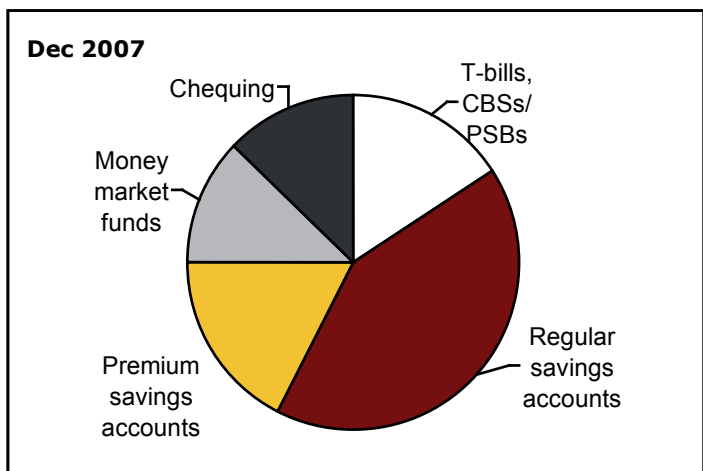
But money market mutual funds represent only one of many cash instruments in the Canadian household liquidity spectrum (Chart 4), with a value of close to half a trillion dollars. In this context, the anxiety about the stock markets also worked to reacquaint Canadians with their chequing and savings accounts, with balances currently rising at over 7% on a year-over-year basis. Cash positions in brokerage accounts are also rising by an estimated annual rate of 15%.

To put things in perspective, we are currently witnessing the creation of excess liquidity reserves. This process started in early 2007 and has accelerated significantly

over the past few months. The overall liquidity position held by Canadian households is now rising at a year-over-year rate of 15%—the fastest rate in more than six years (Chart 5). When measured in both nominal and real terms, the current value of personal liquid assets is at a record high. We estimate that as of March 2008, the size of excess liquidity reserves held by Canadians stood at \$45 billion or almost 10% of the total value of overall personal liquid assets in Canada (Chart 6). In other words, the recent rush into cash has created a situation in which Canadians are sitting on \$45 billion of **extra** cash (that is above the amount that would have been consistent with a risk aversion level seen at the eve of the current financial crisis).

Chart 4

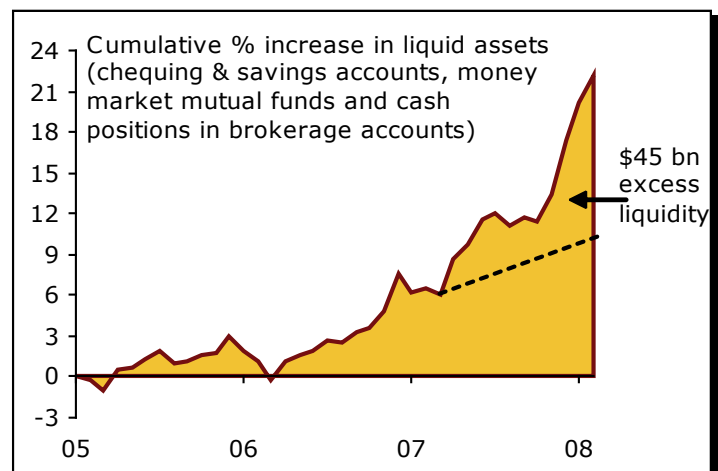
The Household Liquidity Spectrum



Source: Investor Economics, CIBCWM

Chart 6

Excess Liquidity



Source: Bank of Canada, IFIC, Statistics Canada and CIBCWM

As risk aversion rises with age, it is hardly a surprise that older Canadians are the first to make a beeline to the safety of cash. The median balance of cash held in chequing and savings accounts among Canadians age 55 and over is \$7,650—more than double the \$3,150 observed among younger Canadians¹. As illustrated in Chart 7, one-third of the excess cash holdings generated over the past year was due to rising cash balances among Canadians age 65+.

However, what is surprising is the near 40% contribution of Canadians age 25-49 to the current liquidity position. This amount is twice as large as what we saw in 2001. Back then, some of the money that left the stock market was deployed in the real estate market. Today this option is less attractive.

Sitting on Cash for Too Long

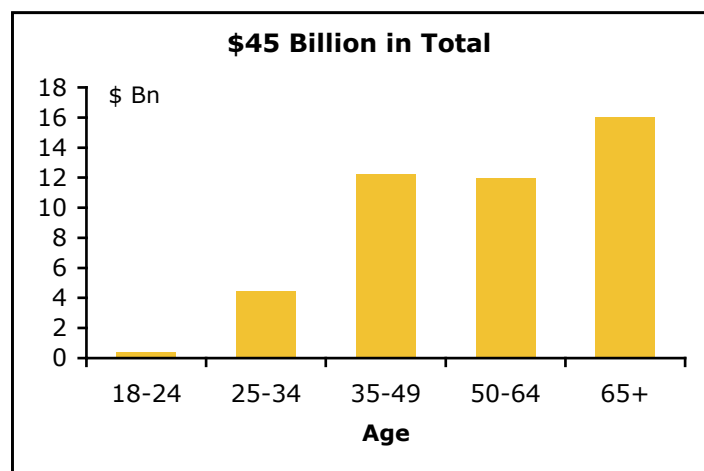
To be sure, this is not the first time that increased market volatility led to a creation of excess liquidity reserves. The 1987 stock market crash led to a 20% increase in overall cash positions held by Canadian households. And more recently, following the 2001 correction, overall liquidity positions surged by more than 30% or \$38 billion in today's dollars—with the main acceleration accruing following September 11th. In this context, the current rise in excess cash positions to a record \$45 billion follows the trend seen on previous occasions of increased risk aversion.

The rush into cash during periods of increased volatility is understandable. But in all recent instances, Canadians sat on their cash for far too long after the markets rebounded. The October 1987 stock market correction lasted two months, but investors sat on their newly created mountain of cash for a lengthy 16 months, during which time the stock market gained more than 20%. Ditto for the 2001 flight to safety. As illustrated in Chart 8, investors reacted almost immediately to the stock market correction by aggressively raising their cash positions. But they failed to adjust these positions when the stock market started to recover, maintaining them at record high levels during the bull market that started in early 2003. We estimate that by not adjusting their liquidity positions to pre-2001 levels, Canadians assumed more than \$30 billion in lost investment opportunities.

Fast forward to today's situation and it appears that history is repeating itself. Despite the recent recovery in the stock market, Canadians are still sitting on cash positions which in real terms are 15% higher than the already elevated level seen in 2001. And as was in the past, by doing so, investors are sacrificing billions of dollars in potential investment gains.

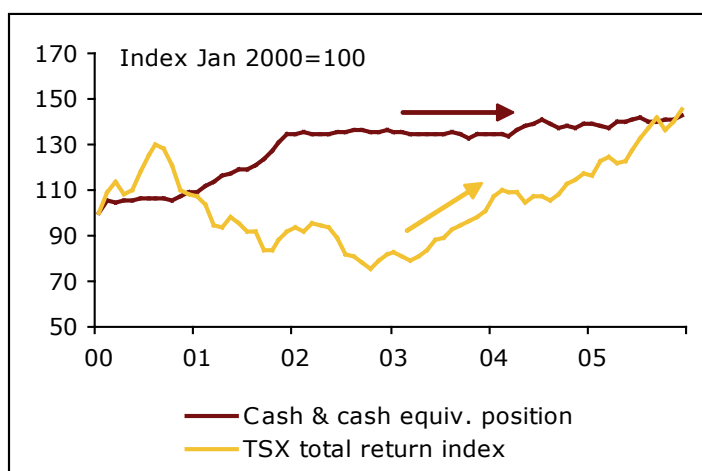
Note
 (1) Source: Ipsos Reid-Canadian Financial Monitor

Chart 7
**Age Distribution of Excess Liquidity—
 Generated Over the Past Year**



Source: CIBCWM estimates based on Ipsos Reid-Canadian Financial Monitor

Chart 8
**Sitting on Cash For Too Long—
 The 2001 Example**



Source: Bank of Canada, IFIC and CIBCWM

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