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YOUR MONEY

Switching to Cash May Feel Safe, but Risks Remain

By RON LIEBER

It's a question we've all asked in our darker moments of late: Why not just put all of our investments in cash, 100 percent, just for a little while, until things calm down?

Some people already seem to be acting on that instinct. In the first six days of October (through Monday), investors pulled $19 billion out of mutual funds that invest in United States stocks, matching the outflows for the entire month of September, according to TrimTabs Investment Research.

"What clients are looking for is safety," said John Bunch, president of retail distribution at TD Ameritrade. "They are seeking solutions that are backed by the federal government. Specifically, F.D.I.C-insured money funds and certificates of deposit. All of it is under the umbrella of, 'Am I safe and insured?' "

By fleeing for the comfort of safe and insured, however, investors with a time horizon beyond a few years may be doing real damage to their long-term finances. If you're tempted to make a big move to cash right now, you're doing something called market timing. It's an implied statement that you've figured out the right moment to get out of stocks — and will also know the right time to get back in.

So let's dispense with the first part straightaway. The right time to move out of stocks was a year or so ago, before various stock indexes the world over fell by one-third or more.

If you missed that opportunity, you're hardly alone.

But if you sell now, you'll be locking in your losses. And once you're in cash, there isn't much upside. In fact, with interest rates low, you're likely to lose money in cash, because inflation will probably eat up the after-tax returns you earn from a savings or money-market account.

A guarantee of a small loss may sound good right now. But if you're not bailing out of stocks once and for all, how will you know when it's time to get back in? The fact is, any peace of mind you gain by being on the sidelines now will turn into a migraine once you see how much you can harm your portfolio over time by missing just a bit of any rebound.

H. Nejat Seyhun, a professor of finance at the Ross School of Business at the University of Michigan, put together a study in 2005 for Towneley Capital Management, where he tested the long-term damage that investors could do to their portfolios if they missed out on the small percentage of days when the stock market experienced big gains.

From 1963 to 2004, the index of American stocks he tested gained 10.84 percent annually in a geometric average, which avoided overstating the true performance. For people who missed the 90 biggest-gaining days in that period, however, the annual return fell to just 3.2 percent. Less than 1 percent of the trading days accounted for 96 percent of the market gains.

This fall, Javier Estrada, a professor of finance at IESE Business School in Barcelona, published a similar study in The Journal of Investing that looked at equity markets in 15 nations, including the United States. A portfolio belonging to an investor who missed the 10 best days over several decades across all of those markets would end up, on average, with about half the balance of someone who sat tight throughout.

So moving to cash right now is just fine as long as you know precisely when to get back into stocks (even though you didn't know when to get out of them).

At some point, stocks will indeed fall enough that investors will remove the money from their mattresses and put it to work, causing prices to rise significantly. But, as Bonnie A. Hughes, a certified financial planner with the Enrichment Group in Miami, put it to me, there won't be an e-mail message or news release that goes out when this is about to happen. It will be evident only afterward, on the few days when the market surges.

And it gets worse for those who think they won't have any trouble investing in stocks again later. Medium- or long-term investors who are considering a big move into cash right now are probably making an emotional decision, at least in part. For those who follow through, the same instincts will probably hurt when trying to figure out when to reinvest in stocks.

"The emotional forces that drove them out of the market aren't likely to let them back in 'until things are better,' " Dan Danford of the Family Investment Center in St. Joseph, Mo., said in an e-mail message. "And for most people, things won't feel better again until the market has already moved back up." In fact, he added, plenty of people may not allow themselves to get back in until the market has already risen significantly.

That situation is worth considering if you think your mood, or returns, can't get any worse. "People feel worse missing out on the bounce-back that will inevitably come than they do hanging in there through the down period," said Elaine D. Scoggins, a certified financial planner with Merriman Berkman Next in Seattle.

The truly downbeat do not see the bounce as inevitable. This outlook is essentially a bet that our current predicament is so different that the equity markets won't bounce back at all, even though they survived 1929, the Great Depression, 1987 and a major terrorist attack. I do not believe that the markets are in some kind of permanent decline, and I haven't found an expert who does.

That said, some retirees, or those close to leaving the work force, may be well-off enough to leave stocks behind for now. If the tumult in the economy and the decline in the markets have altered your risk tolerance, then it may make sense to move to a portfolio of Treasury bills, certificates of deposit and money market funds.

Michael G. Coli, 56, of Crystal Lake, Ill., decided to take his 401(k) money out of the market in February. As an investor in his sons' pizza restaurants, he noticed that an increasing number of customers were relying on credit cards. And as the owner of a winter home in Naples, Fla., he witnessed the housing market dive. Taken together, he decided to pull his retirement money, which he would need in five years, from the Vanguard Balanced Index Fund and move it all into certificates of deposit.

"I had the feeling the economy was not on real firm ground," Mr. Coli said. "I decided to get out and put it all in C.D.'s, and that is where I've been ever since."

If you can't afford to live off the proceeds of cash investments (or dividends from your investment in your kids' pizza joints), you may have no choice but to hold on to whatever stocks you have left. Then, you can hope for a rebound that will allow you to live out your later years more comfortably. Selling now and moving to cash could mean guaranteeing a lower standard of living for the rest of your life, because you'd be locking in your losses.

But if you're a bit younger, try to think of your investment portfolio in the same way you consider the value of your home, if you own one. After all, if you're not moving anytime soon, your home is a long-term investment, too.

"Today's price is not your price. Your price is 10 or 20 years from now," said Thomas A. Orecchio, of Greenbaum & Orecchio, a wealth management firm in Old Tappan, N.J. "Unfortunately, stock market investors don't always see things that way."

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