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Types of Cash Alternatives

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What are they?

Cash alternatives, sometimes called cash equivalents, are vehicles that are considered safe and are highly liquid (i.e., you can convert them to cash quickly if needed). Thus, cash alternatives are often used to fund a cash reserve. There are a variety of cash alternative investments, each with distinctive strengths and tradeoffs, and varying degrees of risk.

Cash alternatives include the following:

- Savings accounts
- Money market deposit accounts
- Money market funds
- Certificates of deposit
- Guaranteed investment contracts (GICs)
- Government savings bonds
- U.S. Treasury bills
- Eurodollar certificates of deposit
- Commercial paper
- Face amount certificates

Strengths

You can use cash alternatives for a variety of purposes:

- To provide relative stability. While cash alternatives can't assure you of a gain or protect you from losses, they are generally considered safer than other types of investments such as stocks or bonds.
- To earn income on cash that would otherwise be idle. Most cash alternatives pay interest, which may help to reduce the effects of inflation.
- To maintain a ready source of cash to pay for goods or services, such as a down payment on a home or car, a new washing machine, or a family vacation.
- To meet unexpected demands on cash, such as repairing storm damage to your home or other financial emergencies.
- To serve as a temporary parking place for assets when you're not sure where to put your money.

Tradeoffs

Opportunity cost

The primary tradeoff you accept in return for the relatively safety of cash alternatives is that their potential return is not as high as higher-risk investments (this is known as opportunity cost). By playing it safe, you may be limiting your investment income, especially over longer time periods.

Risks

Because of their conservative nature, cash alternatives are considered the least risky investment vehicles overall. However, none are completely without risk, and different types of cash alternatives carry different levels of risk. Here are some risks to keep in mind:

- Because returns on all types of cash alternatives are modest, earnings may not keep pace with inflation, especially over longer periods.
- While checking accounts, savings accounts, and CDs are FDIC insured (up to a limit), other types of cash alternatives are not.
- While government savings bonds, U.S. Treasury bills, and U.S. government securities are backed by the full faith and credit of the United States, other cash alternatives carry higher default risk.
- Even if a mutual fund invests in cash alternatives backed by the full faith and credit of the United States, the fund's shares are not guaranteed or insured by the FDIC or any government agency. Though a money market fund attempts to preserve the value of your investment at \$1 per share, it is possible to lose money investing in one.
- Eurodollar CDs carry risks associated with foreign investments.

Tax considerations

Tax planning for cash and cash alternatives is relatively simple compare to that for many other investments. Unless they are held in a tax-deferred account, interest payments from most types of cash alternatives are taxable as ordinary income in the year they are earned. If cash alternatives are held in a tax-deferred account, such as a 401(k) plan or traditional IRA, earnings are not taxable until you make withdrawals. Interest payments from municipal money market funds are free from federal income tax.

What is laddering?

Strategies for cash alternatives often involve laddering. When you ladder investments, you set them up so that payments of interest and principal are staggered over time, creating a more even cash flow.

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