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How to invest a large lump sum of new cash

Receiving a large sum of money, as pleasant as it is, can quickly become a source of stress and concern as you ponder what to do with the new and substantial amount of cash; whether to invest it or not, how quickly and following what type of investment plan. This will guide you through a few simple steps that should ultimately make this exercise less daunting. For the purpose of this note I will define a large sum of money as one that accounts for 20% or more of your pre-lump-sum wealth across retirement accounts, taxable accounts and other financial assets.

First, you do not have to do anything immediately. Nobody should be pushing you to invest. Proceed only when you have thought the process through, either on your own or with the assistance of someone qualified to guide you and whose interests are totally aligned with yours. That said, you need to manage to find a balance between rushing to action and not acting at all, in order to avoid two potentially unpleasant outcomes: 1) investing under real or imaginary pressure and making painful mistakes that can promptly lead to substantial losses and, ii) doing nothing and not earning a penny.

Second, you need to have a plan of action. I believe that there should be three major components to it:

i) Finding out what your tax bill might be. Do you need to pay taxes on this sum or not? If it is an inheritance, chances are it is completely tax-free. If it is cash coming from a substantial real estate sale, it might or not be taxable depending on the nature of the property, the size of the capital gains or some other consideration. If it is a transfer from a benefit plan, it is generally tax-free as long as the funds are directly moved to your IRA or 401K. In all cases, be sure to consult a tax professional to assess the potential fiscal impact associated with the lump sum payment. Once you know what the tax bill might be, you are left with the amount to invest. What matters now is:

ii) Knowing where you stand (ie: properly measuring your post-lump-sum asset allocation). How does this new sum of money affect your asset allocation? In order to answer this question correctly it is important to avoid the behavioral bias called "mental accounting". "Mental accounting" is the tendency that many of us have to put money in different mental pots based on the intended use for the funds, or their point of origin. This leads us to erroneously treat each amount of money separately from the others. In reality, the new cash is not different from the old cash. Unless you intend to use the totality of the new funds rapidly and for a specific purpose, such as funding a new business venture or buying a new house with the proceeds of the old one, the new money should be a part of your newly investable wealth. As such, it will impact your asset allocation and should be properly included in your new asset mix.

The degree to which your asset allocation will be affected by this influx of cash depends on the relative size of the new money compared to the rest of your wealth. If you have a $1 million total financial wealth and your asset allocation is currently 60% equities, 40% fixed income and cash,

a $500,000 influx of new money is going to change your allocation to 40% equities ($600,000/$1.5 million) and 60% fixed income and cash. This is a significant change, but not a fundamental one. If your new money is $2 million, and you started with a $1 million total wealth, using the same initial 60%-40% allocation, your new asset mix is now: 20% equities ($600,000/$3 million) and 80% fixed income and cash. That is a significant change of allocation and one that needs to be addressed more urgently. Knowing where you stand once the cash has arrived matters. Computing your new asset allocation properly by avoiding mental accounting or other similar mistakes is important. It is your starting point to decide whether to change or not your risk, return and liquidity objectives and how your new asset allocation should look like.

iii) Knowing where you want to go (ie: deciding on what your new target asset allocation should be). Now is the time to re-assess your risk and return objectives and answer the following questions: Does this new money change my life significantly? Am I still going to go to work every day? Am I set for retirement? Do I want to use part of this new wealth to travel, buy a new house? Alternatively, do I need part of this cash to fund my on-going living expenses? The answers you give to these questions may affect your risk posture and cause you to reduce or not your allocation to equities and bonds or to seek more or less liquid investments. Spending the time necessary to adequately answer them and seeking advice from competent sources, when and if needed, is an essential part of a well thought out process. When you have reached that point and have decided what your new target asset allocation should be, you need to work towards achieving it.

Third, you must execute the new plan: A lot of people who have written about this topic concentrate on answering the following question: Should I invest all at once or over a period of time? As far as I am concerned, you should never invest all at once. Since nobody really knows where the market is going from one day to the next, moving a large amount of money all at once is not a sensible option. Doing so equates to trying to time the market, a poor choice in most instances. Investing a large sum of money a few weeks or days before a long-term market top hurts a lot more, and for far longer, than investing sub-optimally over an extended period of time. The right question should be: What is a reasonable time frame to invest this new cash? There is no simple answer. Here is how I do it.

Absent major rumblings in the market that may cause me to slow down or even temporarily cancel an investment plan, I deploy the new cash over a period of about six months. I invest it sequentially, in equal monthly amounts. I have found that doing so over a longer time frame reduces risk only minimally and ends up costing more in terms of potential loss of return. On the other hand, deploying the cash faster increases the chance of investing a significant portion of it close to a market top. If markets conditions change substantially while I am midway through the plan, I may decide to accelerate or to stretch my purchases. Absent that, I stick to the six-months time frame. Overall, it seems neither too long to render each purchase irrelevant nor too short to make any one of them too decisive. I have used this approach to positive effect with both institutional and individual accounts.

Each situation is different and the general advice that I have provided here would need to be refined to adjust to the specifics of each case. The size of the cash amount to be invested, its origin, its intended use if any, the potential tax liability, the needs and wants of the beneficiaries, are all important components of the decision process, each requiring careful consideration. Nevertheless, I hope that the broad outline offered here will show you the general direction to take and ultimately help you reach the most appropriate decisions.

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