

Short Duration Deserves a Second Look

RETHINKING THE ROLE OF CASH IN TODAY'S
FIXED INCOME PORTFOLIOS



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REASSESSING CASH VERSUS SHORT DURATION IN A POST TIGHTENING ENVIRONMENT

From the end of 2022 through much of 2024, elevated cash balances became a more common feature of institutional fixed income allocations. Federal Reserve (“Fed”) tightening pushed short-term interest rates to levels above those of longer-duration bonds, an inversion that persisted at various points during the period. Treasury bills and money market funds offered attractive yields, daily liquidity, and almost no volatility. In an inverted yield curve, concentrating at the front end was not just convenient, it was a sensible response to the policy environment.

As monetary policy and market pricing have now adjusted closer to historical norms, the relative positioning of cash versus short duration fixed income is worth revisiting. With policy rates at levels that market-implied pricing suggests are past their peak and the yield curve inversion largely dissipated, the structural advantage that benefited cash holdings during the tightening phase has diminished.

For investors whose liquidity needs are already met, the rationale for maintaining a significant excess allocation to cash becomes less compelling. Alternatively, short duration fixed income has the potential to contribute income, reduce reinvestment risk, and provide measured price stability for capital not required in the near term.

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CASH AND SHORT BONDS: THE ROLE IN FIXED INCOME ALLOCATIONS

Cash and short bonds play different roles in a fixed income allocation and respond differently to changes in interest rates. Cash offers principal stability and immediate liquidity, with returns that reset quickly as policy rates move. This feature supports performance during tightening cycles but increases reliance on future reinvestment conditions once rates stabilize or decline. In those periods, reinvestment risk increases as maturing balances roll into lower yields, often just as longer maturity bonds begin to recover.

Short duration bonds, typically in the 1–5-year maturity range, generate returns from income, yield curve rolldown, and modest price movement. While this introduces interim mark-to-market variability, short duration total returns reflect more than current overnight rates. Historically, this segment has delivered higher returns than cash across full market cycles with drawdowns that have been materially smaller than those experienced in longer-duration fixed income.

HISTORICAL PERFORMANCE PATTERNS: RISKS AND TRADEOFFS

A look at rolling 12-month total returns provides context for the tradeoff between holding cash and allocating to short duration fixed income. The below analysis of rolling returns captures the outcome across different entry points and market environments rather than focusing on isolated calendar years. Cash and short duration fixed income are represented by the Bloomberg U.S. 1–3 Month Treasury Index and the Bloomberg U.S. 1–5 Year Government/Credit Index, respectively.

ROLLING 12-MONTH RETURNS - CASH VS. SHORT DURATION FIXED INCOME (January 2000–March 2026)

	Cash (Bloomberg U.S. 1–3 Mo. Treasury Bond Index)	Short Duration (Bloomberg U.S. 1–5 Yr Gov't/ Credit Bond Index)	Short duration outperformed cash in ~75% of rolling 12-month periods.
Mean Return	1.85%	3.28%	
Median Return	1.16%	2.91%	
Best Period	6.20%	12.77%	
Worst Period	+0.01%	-7.29%	
Percent of Negative Returns	0%	~10%	
Percent Outperforming Cash	-	~75%	

Source: Bloomberg

Several patterns in the rolling return data are relevant for allocation decisions. Throughout market cycles, short duration outperformed cash in roughly three out of four rolling annual periods. The median short duration return exceeded cash by approximately +175 basis points, reflecting the ongoing contribution of income and rolldown. Downside outcomes for short duration were measured and concentrated in brief, well-defined periods of interest rate tightening. Approximately 10% of rolling periods produced negative results, with the most severe outcomes occurring during sharp upward interest-rate repricing episodes. Cash avoided drawdowns due to its return drivers, but the limitation to the downside was at the cost of consistently lower total return outcomes relative to the short strategy over time.

Extending modestly beyond cash into short duration is not a risk-free proposition noting the market value volatility of short duration is a relevant consideration. The representative indices provide historical context around this risk. Periods of underperformance for the 1–5 year segment of the yield curve have not been random nor persistent. Instead, underperformance has clustered around sharp interest rate tightening episodes (not credit stress), including 2013, 2018, and 2022. Aside from these environments, short duration returns relative to cash have generally been positive and, in many cases, sustained.

Importantly, post these rate tightening episodes, higher starting yields and rolldown typically reemerged as the primary drivers of return. For principal preservation oriented investors, the decision between cash and short duration is not “risk-free” versus “risky”, but rather a decision between potential reinvestment risk in cash and measured price volatility in short duration.

VALUATION TODAY: STARTING YIELDS AND MARGIN OF SAFETY

While history illustrates how cash and short bonds have compared in the past, valuation provides insight into the current opportunity set. As of March 2026, yields across the front portion of the Treasury curve are elevated relative to long term history.

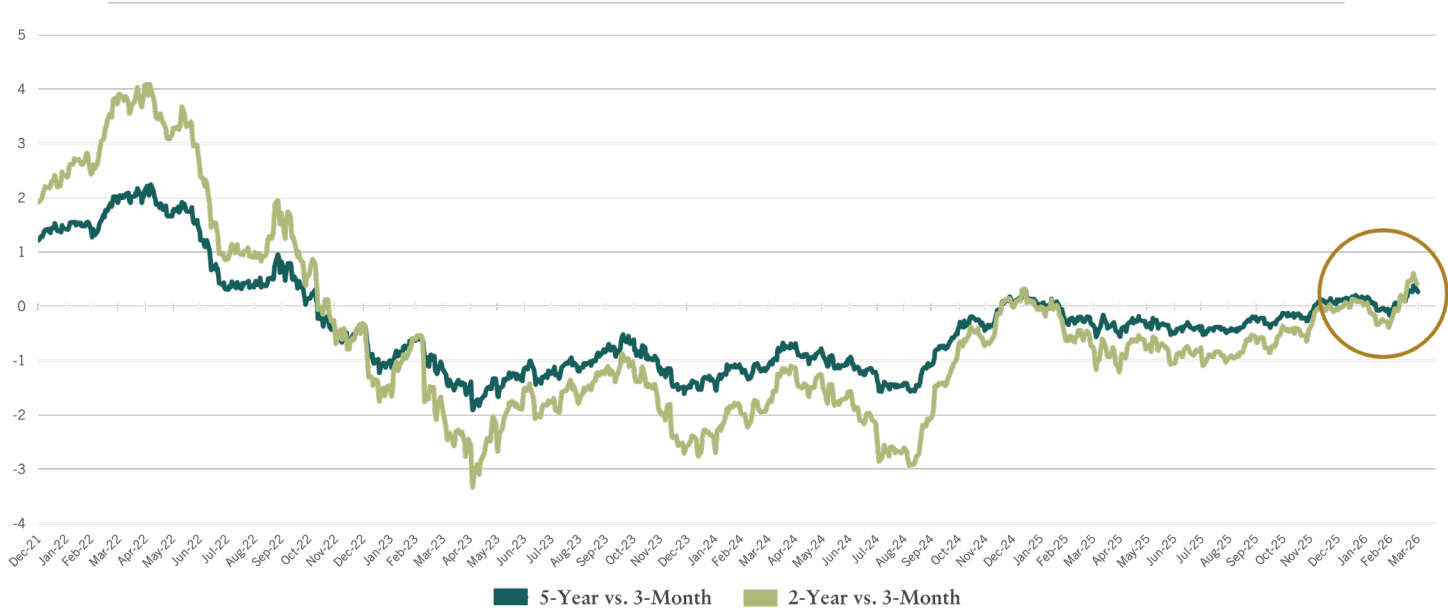
U.S. TREASURY YIELDS
(as of 3/31/2026)

Maturity	Yield	Approximate Historical Percentile (Since 2000)
3-Month U.S. Treasury Bill	3.68%	75th Percentile
2-Year U.S. Treasury Note	3.80%	75th Percentile
5-Year U.S. Treasury Note	3.94%	74th Percentile

Source: Bloomberg

From a longer term perspective, current Treasury yields sit near the upper quartile of observations, exceeding three-quarters of all yield observations, over the past ~25 years. This contrasts sharply with the 2011–2021 period, when low starting yields left total returns heavily dependent on falling rates rather than on income. Higher yields today shift a larger share of expected return toward income and rolldown, reducing reliance on price appreciation alone and improving the return profile across a wider range of interest rate scenarios.

TREASURY SPREAD VS. THE 3-MONTH TREASURY



Source: Bloomberg

Yield curve shape also informs the relative appeal of extending beyond cash. While the yield curve remains relatively flat, as measured by the spread between 2-year and 5-year Treasuries versus the 3-month Treasury, it is no longer meaningfully inverted. Inverted curves often penalize duration extension. However, once inversion fades, modest carry and rolldown reappear, and the structural advantage of cash due to the inversion declines.



A MEASURED DECISION, NOT A FORECAST

Extending modestly into short duration bonds does not require a specific view on Fed policy or the near-term direction of interest rates. In range-bound rate environments, higher starting yields, rolldown, and diversified high-quality exposure have historically differentiated short duration strategies from cash. While cash remains essential for liquidity and very near term funding needs, treating cash as a long term strategic allocation introduces its own risks. Over full market cycles, modest duration extension to a short duration strategy has historically been rewarded.

For investors with excess liquidity in the current environment, a modest move into short duration can be a practical, measured way to improve potential outcomes, grounded not in a bold forecast but in a combination of history and today's compelling starting yields.

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Matt oversees investment research, valuation, and monitoring of structured financial products. In this role, he covers traditional asset securitizations such as commercial mortgage-backed securities (CMBS), and consumer and industrial receivables/asset-backed securities (ABS). In addition, he covers structured government securities, such as SBA loans, Ginnie Mae Reverse Mortgages, EXIM Bank guaranteed bonds, and IDFC guaranteed bonds. Matt is also involved with the research and monitoring of Galliard's covered bond investments.

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