Countering client calls for cash comforts

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For Financial Advisers

With some savings rates topping 6% and a mortgage costs crisis, clients can be forgiven for at least asking about cash. But there is a cost to not staying invested, as Morningstar's Ed Fane explains…

You'd need to go back to April 2008 for the last time the base rate stood at 5%. Then, as now, cash was not an unattractive proposition.

Are we about to see interest rates go higher, and what if we do? With mortgage costs spiralling – and against a backdrop of a less-than-optimistic outlook for the UK – is cash the place to be?

Structural or transitory?

A crucial question in the conversation around cash is: What are the investment implications if the next 10 years feature consistently higher inflation and interest rates?

A debate is raging in the economics community about whether the current inflationary environment represents a structural shift – i.e., longer-term change – or something more transitory. The former view, spearheaded by former US Secretary of the Treasury Larry Summers, has been the dominant narrative, evidenced, its proponents say, by ageing populations, labour force shifts, de-globalisation, and other factors.

But there is a 'team transitory' too, featuring no less than former Federal Reserve Chair Ben Bernanke and renowned French economist Olivier Blanchard. They argue that what we are seeing is consistent with what we might expect to see in the face of a series of coincidental price shocks. Regime change, they argue, is not yet evidently what we are seeing.

The UK is standing out

Much of the enthusiasm around equities since the second half of 2022 has been predicated on disinflation. Looking at headline inflation across the UK, US and Europe, we are beginning to see a turn. Energy and food prices, both heavily affected by the Covid pandemic and the war in Ukraine, are beginning to normalise.

Meanwhile, core inflation, which removes those fast-moving elements from the equation, is also showing promising signs; what is happening in the US could be described as a sustained fall. But the UK is looking a little different. Core inflation is still pushing higher, with UK-specific issues including post-Brexit frictions and supply/demand issues playing their part.

More broadly, though, there are signs that 'team transitory' might be winning out.

So, how appealing is cash?
Yes, cash is attractive. Rates now are where they were before the 2007/8 financial crisis, though that was at the end of a 30-year bull run. Our view is that cash absolutely has a place in portfolios, but that the world is a dynamic place and so caution should be applied to any notion that inflation-busting returns – or complete financial safety – can be found in any single asset class.

Plus, adjusted for inflation, real yields on cash aren't all they're cracked up to be. Only the US has managed its rates up high enough to offer positive real returns (helped as that has been by US inflation adjusting downwards). Elsewhere, including here in the UK, investors in cash are just holding water, with real returns close to zero.

When it comes to mortgages, which for many will be painfully expensive as they come off fixed rates (and many are yet to do so), it is not as simple as moving to cash and paying down outstanding mortgages.

We are at a juncture now where our central bank, in its ongoing battle with inflation, could bring about recession. In that scenario, interest rates may come down as they shift to stabilise the economy. And it is here where cash's flexibility – otherwise a strength – could come back to bite it. As rates fall, so will cash returns.

In fact, any scenario involving weakened UK economic stability might expect weakness in Sterling. So even holding a simple basket of cash and UK property still has investment related implications – diversifying away from GBP would help to alleviate some of that.

We do not have to look very far to find alternatives to cash that hold up to better scrutiny. Short-term government bonds, which are currently offering similar yields to cash, would benefit from a fall in rates and, unlike cash, they have 'duration'.

Roughly, duration approximates to a rise in a bond's price – by its duration – for every 1% fall in interest rates. Conversely, for every 1% rise, the price of the bond will fall by its duration. So, taking a three-year bond, if rates fell 1%, the bond's price should rise by about 3% (getting technical: it would be a little less as the duration of a bond that pays regular interest would likely be between 2% and 3%). That's one of the benefits of investing "through the curve". Broadly it means investors could get their expected returns more quickly and, depending on appetite, invest in other assets that may have suffered in a recessionary environment.

Where else then, if not cash?
Our view is that it always pays to be in globally diversified, multi-asset portfolios. The more potential scenarios a portfolio covers, the more robust it will be. So, how can you best counter clients' claims around cash, and where else besides cash?

Bonds are potentially a good place to be, and yet there's a lot more to life than bonds. We see many areas that are appealing, both from the riskier side of things – some of the emerging markets for example – but also, more defensively, in areas such as US consumer staples.

Our position is this: it is impossible to know what is going to happen, and forecasting is not the answer. We consider an event – such as a recession – then think about its effects if it occurred, rather than trying to decide whether it will or not. Next, we imagine the range of possible outcomes before, finally, constructing a portfolio. Put another way, we acknowledge the narrative, try to understand its impact, then consider its investment implications.

One final thing: it's important to remember than not everything in a portfolio can or should go up at once. If everything is going up, something may be wrong. A portfolio should have offsets against different environments and there should be things that aren't working as well as things that are.

Embedding this diversity and remaining invested is often the best way to access the value that can be found in investing.

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