Investment Insight

Cash is not the answer | Cash is back as a home for short-term capital

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For Financial Advisers to use with their clients

Interest bearing bank accounts and very short term fixed income securities now offer their highest returns for decades. This is welcome and means that savers are no longer being penalised for being thrifty or risk averse.

For over a decade, cash offered miserly returns, driven down by the drop in the Bank of England Base rate (source: Bank of England) to below 2.0% between January 2009 and August 2022.

Inflation exceeded interest rates, so holding money in cash left savers worse off, in terms of purchasing power. This period of ultra-low interest rates lasted so long that it incentivised greater risk taking, just to offset the impact of inflation and preserve the real value of their capital.

Thankfully, this is no longer the case. Over the past 12 months the Bank of England increased base rates by 3% p.a. (source: Bank of England), in contrast to the 3% fall in the inflation rate (CPI Index). While interest rates are still lower than inflation (over the past 12 months), the gap is small and is expected to shrink further as inflationary pressures ease. In short, if you can earn about 5% from your cash then it stands a much better chance of matching future inflation and hence maintaining its value in terms of purchasing power.

Cash has two advantages that make it the asset of choice for funding short term needs.

First, cash is a very secure investment. The risk of not getting your interest and your capital repaid is very low. The security for money held with UK authorised bank, building society or credit union comes from government deposit guarantees which are capped. The security for money invested in a money market fund or directly in short term fixed income securities comes from the creditworthiness of the issuer and the legal commitment embedded in the security arrangement. As money market funds typically invest in government and A, AA or AAA credit rated issues, you are lending to large, established entities with long standing track record of repayment. You are due to be repaid shortly so the view today is a very good guide to what is likely to happen when your money is due to be repaid.

The second advantage is liquidity. You can get your money back very quickly at no extra cost or penalty, by selling your fixed income security or simply withdrawing funds on deposit. But other assets are much better suited than cash for building wealth and meeting needs in retirement.

Cash returns are not linked to economic growth so there is no sustainable basis for income or capital growth. Returns are consequently lower in the majority of scenarios than other asset classes over the medium to longer term.

Unlike high quality fixed income, cash offers no effective diversification benefit in the scenario most associated with large falls in share prices: a deep recession. In fact, all prolonged economic crises have resulted in a reduction in interest rates, ultimately bringing down returns earned from cash.

Finally, the return from cash is only fixed in the very short term, changing when the Bank of England respond to new data that paints a different picture of current conditions and future inflation prospects. Fixed income securities offer much greater certainty of return on a buy and hold basis for cashflow planning, from a single year to more than 10 years to maturity.

All of this means that higher interest rates have restored cash to its natural role as a home for short term capital rather than made it a substitute for assets that can provide the growth and diversification needed to build wealth and sustain retirement.

Unless stated otherwise, all data sources are from Morningstar Direct as at 31/08/2023.

Important Information