The Red House

Taking care with cash

"There's a special providence in the fall of a sparrow. If it be now 'tis not to come; if it be not to come it will be now, if it be not now, yet it will come: the readiness is all". (Shakespeare)

Last week's note focused on default risk and how to protect one's cash from a bank failure. This week we look at how we help our clients to manage inflation risk.

Bank base rate is currently at 0.5% and many current accounts pay less than this (some as low as 0.05 %). For a client suffering income tax at 40%, and with inflation currently at 5.2% (1), an interest rate of 0.5% produces a negative return of -4.9%. An interest rate of 8.7% would be required to maintain capital in current real terms. This rate is not available without taking risks. Such risks are unacceptable to funds which may be required to meet both known expenditure and a contingency reserve within a short time horizon (up to five years).

In these conditions, it is easy to be tempted into taking on additional risk in an attempt to secure higher returns. A fundamental investment principle is that risk and return are related. The lower the risk, the lower the expected return. An accepted measure of the 'risk-free' return is the yield on UK one month Treasury Bills - currently 0.488% (2). Any return above this rate must carry additional risk. Putting it simply, a return currently above 0.5% carries a risk to capital.

I would now like to share some of the ways in which TRH are helping clients to identify and manage inflation risk and some pitfalls to be avoided when considering your cash:-

1. Identify how much cash to hold

Holding too much in cash in current conditions further amplifies the adverse effect of negative real returns. TRH use detailed cash flow forecasts in order to identify the short, medium and long term liabilities that a client needs to provide for. The short (1-2 years) and medium term (2-5 years) liabilities need to be met from cash and cash type arrangements. Investment risk in these funds gives uncertainty as to whether these liabilities can be met. The size of the short and medium term 'pots' depends on the size of the liabilities which need to be met over short time horizons. Once identified, they are placed in a variety of accounts to achieve the lowest acceptable risk.

Higher risk can only be taken with assets required for longer term liabilities. Over the long term, equities provide the most effective protection from inflation risk.

2. Capture the best 'clean' interest rates available

Cash is placed in a variety of accounts for different terms depending on the profile of the liabilities it needs to meet. We look to access the most competitive rates (examples below (3)):-

- Instant access - 3%
- 1 year fixed - 3.5%
- 3 year fixed - 4.2%

Once a selection of appropriate accounts is identified, risk is further mitigated by considering the following:-

- Only use UK regulated banks and building societies participating in the Financial Services Compensation Scheme and not exceeding £85,000 in any one account (as explained in the last note).
- Avoiding 'teaser' rates that come with withdrawal penalties, requirements to open other accounts and many other devices that reduce the 'clean' interest rate available.
- Watching for the end of introductory bonus rates that can reduce the overall interest rate.

3. Invest in National Savings Index Linked Certificates

As many of our clients are aware, TRH are firm advocates of these products which provide a tax free return in excess of the Retail Price Index. They are the most effective solution for funds in the 3-5 year cash space. Many of our clients have taken up each new issue, and rolled up those certificates for a further term when they mature, building up a sizeable fund which provides real protection to capital. This capital protection is obtained at the lowest possible risk as NS&I products are backed by the Treasury. With RPI at 5.6 % the equivalent gross return for a 40% tax payer is at least 9.75 % (4). We will be in touch again with all clients when new issues are announced.

4. Avoid alternatives with higher or hidden risks

Clients have asked us about the following:-

Structured products

These products are often advertised by banks with attractive headline rates and added 'downside' protection. We do not believe that they are appropriate as an alternative to cash for the following reasons:-

- The return is often dependent upon the performance of one or more indices or a handful of stocks.
- They can require a hold period of 5-6 years.
- The capital protection could be provided by counterparty separate from the issuing provider.
- They are complex and difficult to understand
- Complexity often disguises hidden costs.

Gold

Gold has traditionally been considered a safe haven in troubled times by some investors. Unfortunately gold exhibits volatility characteristics which make it unsuitable as an alternative to cash. In September, the price of gold dropped by more than US $300 an ounce - the largest short-term fall in more than 20 years. This risk to capital could cause significant damage to the ability of your low risk funds of meeting your anticipated short term liabilities.

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5. A risk to consider?

We have a few clients with significant cash balances where the logistics of juggling multiple bank accounts under the £85,000 FSCS limit has become time consuming and administratively unwieldy. After securing all expected short term liabilities with cash deposits, we have used an alternative neater solution for funds not required in the short term, typically in the two to five year space.

We have accessed the returns from a fund holding high-quality fixed interest short-term bonds. The bonds carry an increased risk to capital, but this risk is compensated with a higher expected return. More detail on the fund we used, the high quality of the holdings and performance data can be accessed here *http://www.theredhousefp.com/news/files/20110620-bond-article.pdf*. In addition to the potential for superior returns over cash, the fund provides a diversification benefit against default risk with over 90 holdings.

In conclusion

Whilst it is difficult to accept negative real returns from cash we caution against taking any risks that could mean a loss on the capital required to meet anticipated short term liabilities. By adopting the tactics outlined in this note, the threat to your cash and savings posed by inflation risk can be mitigated. In summary:-

- Use detailed cash flow planning to work out the amounts required.
- Hold only cash required for short and medium term expenditure and contingency funds.
- There should be little or no risk to these holdings.
- Long term 'pots' can consider other asset classes, such as equities, that exhibit higher risk with the potential for higher returns.
- Do not be seduced by headline interest rates and yields.
- Only take risks that are proven to be rewarded.

Whilst no one is happy with current returns, some comfort can be taken in knowing that with careful planning the cash one requires is available when needed.

If this note leaves you with any concerns regarding your short-term holdings please get in touch and we will explain in more detail the work we do with our clients in this area.

Gareth Marr
The Red House
19th October 2011.

Notes

1. **August 2011 CPI.**
2. **UK Debt Management Office website 14/10/11.**
3. **http://www.moneysavingexpert.com/savings/savings-accounts-best-interest**
4. **Based on the 22nd and 49th issues which return RPI + 0.25%.**

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