DELMORE
ASSET MANAGEMENT

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Returns on cash continue to disappoint

Since the onset of the Great Recession returns on all cash deposits, in the markets of the developed world, have been at very low levels. As investors are aware, this is an inevitable consequence of the heavy intervention by central banks such as the Federal Reserve, Bank of England, Bank of Japan and the European Central Bank. All these institutions recognised that the financial crash of 2008 needed an urgent response. Consequently they provided plentiful liquidity at extremely cheap interest rates. In fact short rates in the UK are at their lowest level since the Bank of England was founded in 1694. In Japan, Switzerland, and Sweden we now have negative interest rates actively punishing savers who hold cash.

Interest rates have collapsed

Savers who put money aside at the present time, which they intend to spend in the future, will earn little by the way of interest. To accumulate a target lump sum, they will need to save much more capital in current conditions than they needed to before the onset of the Great Recession. In addition current deposit rates provide minimal protection against future inflation.

Negligible interest rates have had a pervasive impact on global capital markets. There have been many reports of substantial holdings of liquidity by high net worth individuals across different wealth bands. The loss of income suffered by these wealthy families will have significantly lowered their returns. In fact these low returns served to reduce the opportunity cost and perceived risk of indulging in investments of passion. This almost certainly helps to explain the buoyancy of fringe markets ranging from classic cars, stamps and vintage wine to fine art.

How safe is cash?

The anchor investment for short term investors has always been cash. Cautious investors who want more security and the certainty of low volatility in capital values have always invested a large proportion of their wealth in cash. Books on investment theory often proceed as if cash was always invested in Treasury bills. This is rarely the case. Most of the time investors use money market funds, bank deposits and certificates of deposit. Usually small and medium sized investors do not have sufficient cash to be able to invest directly in Treasury Bills.

One of the most shocking features of the credit crunch's early stages in 2007-08 was the sudden erosion of confidence in cash investments held at virtually all global banks and in money-market funds. This was coupled with uncertainty about the attitude of governments towards bailing out depositors in the event of bank failures and the extent of any government deposit insurance. It was a ripe environment for crowd behaviour by savers as they responded to rumours of impending bank failures.

The first major financial collapse was that of British retail bank, Northern Rock, in September 2007. Its online cash withdrawal service was overwhelmed and customers formed long lines in the street to remove their savings from Northern Rock's branches. It was the first run on a British retail bank since 1866. One year on, a $64bn US money market fund, Reserve Primary Fund, "broke the buck" by marking down its unit price to 97 cents following losses caused by the failure of Lehman Brothers, a global financial services firm. As a result, within days investors withdrew over half the assets managed by the fund and US authorities moved to shore up confidence in money-market funds by providing a temporary guarantee to underpin their value.

There were other signs of sudden loss of depositor confidence in banks. But concerns about the security of bank deposits were allayed by the clarification of deposit guarantee schemes, and in particular by the growing understanding shortly after September 2008 that deposits at major banks would be protected, not least by the steps taken to bolster bank capital. It remains the case that unguaranteed cash investments in banks need careful due diligence.

Time Horizon

Private wealth has a particular problem. Families continue from generation to generation, but family wealth gets spent. There is much less scope for the following generations to accumulate wealth exponentially as may have been achieved by the founding entrepreneurs. Private wealth is consumed, dissipated in fees, paid in taxes, or donated to charitable foundations. If this did not happen, the parsimonious among the wealthy could become stupendously wealthy. For example, in the 113 years to December 2012, the cumulative return from US equities after inflation, but before all costs, was 6.3% a year!

This implies that a very wealthy family with perhaps $20m in 1900, the equivalent of $500m today, could have an inherited a fortune of almost $500bn if it had been invested in the diversified US stock market. This fortune would be even greater if that family had consumed nothing apart from what they earned independently of their invested wealth and had contrived to pay absolutely no costs. Such a scale of wealth or parsimony does not seem to exist!

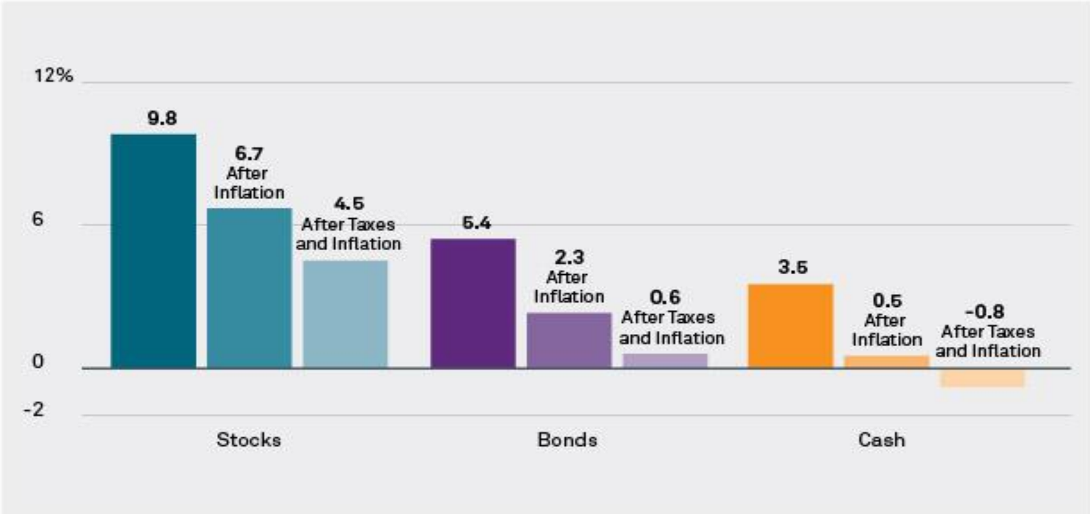
Unexpected inflation

Due to the pervasive existence of inflation over time, there is no place for cash as a major asset in long-term models. This is because cash is volatile relative to inflation-linked bonds and it normally offers no performance advantage. At the same time, the future relationship between inflation-linked bonds and conventional government bonds is sensitive to views on inflation. It should be assumed that these inflation risks cannot be properly reflected in any set of modelling assumptions, and that it will be necessary to rely heavily on judgemental opinions. Furthermore, the judgements of "experts" should probably not count for more than the views and experiences of informed investors on issues such as inflation expectations. However, the apparent views of the financial markets on the break even rate of inflation should always be used as a point of comparison.

Conclusion

Cash investments are billed as the typically safe investment. It has always been a primary goal of investment to preserve capital. Before the Great Recession, one could rely on receiving predictable returns from solid financial institutions to help achieve some of this protection. Today there is a strong probability that these predictable returns will be too small to satisfy one's long term investment goals. This does not detract from the use of cash in a diversified portfolio to manage risk and take advantage of investment opportunities, but at the present time too much cash will not provide sufficient income or preserve wealth.

CASH HAS AVERAGED A NEGATIVE REAL, AFTER-TAX RETURN
Compound Annual Returns (1926–2012)



Sources: BlackRock; Morningstar; Tax Foundation. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs. This is for illustrative purposes only and not indicative of any investment. Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $110,000 in 2012 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. Capital gains for stocks are assessed every five years when there is a cumulative gain from the last high and assume a five year holding period to determine the long-term capital gains rate. Bonds are assumed to be held to maturity. No state income taxes are included. Stocks are represented by the S&P 500 Index. Bonds are represented by the Morningstar/Ibbotson Intermediate- Term Government Bond Index. Cash is represented by the Morningstar/Ibbotson 30-Day US Treasury Bill Index. Inflation is represented by the Consumer Price Index. It is not possible to invest directly in an index.

As mentioned above, the major downside to holding cash is the historical persistence of inflation. Even during periods of low inflation in the developed world, returns on cash have not kept up with consumer price increases. Thus, the value of cash in real terms will diminish over time. Inflation and taxes erode the long-term returns on all assets, but cash is the only asset class that has consistently lost money over time.

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Regulatory Statement

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