

Cash Holdings

According to Which? magazine, savers are losing £12 billion a year in interest by leaving their cash in low paid accounts.

With interest rates at record low levels, our view on cash as an asset class has been strongly negative for some time.

We score each asset class based on its outlook with a score between -5 and +5. Our long term average assumption for cash is 3% net of basic rate tax. Our outlook score for cash is currently -5, meaning we expect returns of less than 1.5% pa net.

For many people, 1.5% is wildly optimistic. The Which? figures compare returns to the best cash rates around, however even the top accounts are not that great. The best instant access Cash ISA rate according to Moneyfacts is currently 2.8% pa, but that includes a temporary bonus of 2%. Most accounts pay less than 1.5% pa unless you are willing to tie up your money for some time.

We don't see interest rates climbing much for a while and therefore we recommend clients generally hold the minimum amount of cash appropriate for their needs. We believe most clients should have an emergency fund equivalent to around 1 year's expenditure, plus any capital expenditure you need in the next three years.

We suggest you take a moment to calculate whether you have more cash than required. If you do, we recommend you consider investing the excess.

It is now possible to transfer Cash ISAs to stocks and shares whilst retaining the tax benefits and we believe all clients should consider doing so where appropriate.

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Case Study

We recently reviewed the following portfolio of Cash ISAs for a client:

Provider	Current Balance	Interest Rate
Natwest	£17,171	0.95%
Natwest	£ 8,023	2.75%
Natwest	£ 10,467	3.00%
Nationwide	£ 12,973	0.35%
Natwest	£ 22,308	1.09%
Natwest	£ 5,284	2.75%
Derbyshire	£ 3,770	0.5%
Total	£79,996	1.4%

(weighted average)

Some of these rates look quite attractive. However, most were “special offers” to existing customers and the 3% pa rate is a fixed rate bought two years ago. Some also have short term bonuses as with the Moneyfacts best buy.

The most important thing to note is that these clients have a number of separate accounts. This is because all those “special offers” are only available to new ISA contributions (your maximum £5,100 a year). You cannot transfer existing ISAs to them. This is typical and applies to most of the accounts on the Moneyfacts best buy lists.

This means that, despite some of the individual accounts having decent rates, the overall return of this cash portfolio is only 1.4% pa.

Long Term Returns

ISAs are naturally designed as long term investments. However, our research shows that cash is never a good long term investment.

Since 1990, cash has outperformed fixed interest only once over all the rolling five year periods we’ve looked at. Cash has been the worst performing out of all the asset classes in over 50% of the five year periods we analysed. It has NEVER been the best performing asset class over any of these periods.

The argument for investing with your ISA allowance is therefore compelling. Unlike the best cash rates, there are no minimum tie-in periods or exit penalties when investing your ISA in funds.

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ISAs

In our opinion, many of our clients are wasting the tax advantages of their ISAs.

If you are getting 1.5% interest, then the tax advantage of holding cash via an ISA is 0.3% for a basic rate taxpayer, or 0.6% for a higher rate tax payer.

Compare this to fixed interest, for example. The average estimated yield of the Strategic Fixed Interest funds we hold is currently around 4.5% pa. By holding these funds in an ISA the tax advantage is equivalent to 0.9% pa for basic rate and 1.8% pa for a higher rate tax payer.

We therefore believe that clients should use their ISA allowance for investments rather than cash.

Of course all the asset classes are more risky than cash and you should hold the amount in each asset class that is right for your circumstances.

However, where you hold investments anyway we believe it is better for these to be held within ISAs, with cash held outside of an ISA wrapper.

Action You Can Take

We suggest clients look to transfer their cash ISAs to stocks and shares ISAs in order to boost potential returns and tax efficiency,

This is a simple process, only requiring completion of a short form. We will do all the paperwork for you and calculate how much you should leave in cash for emergencies.

If you would like to consider transferring, please get in touch and we will provide personal recommendations.

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Market Views | November 2010

General Economic Overview

GDP growth is expected to be muted but positive. More quantitative easing is happening in the US which has already boosted markets. It could also happen in the UK.

We believe inflation may remain well above the Bank of England target for some time, and potentially be a concern in the long term. We believe interest rates will remain low throughout most of 2011 despite the inflation outlook, in order to stimulate economic growth.

The combination of high inflation and low deposit rates hits pensioners the hardest.

Although we may appear negative towards most asset classes, if our scores are correct it would give an expected return for a balanced portfolio of around 7% pa over the next 18 months, still way above inflation.

Asset class key

+ positive

- negative

= neutral (normal behaviour)

+5 strongly positive

-5 strongly negative

	Outlook
Equity Markets Despite recent upward moves, equities still look fair value on current earnings. Earnings continue to be revised upwards and if next year's projections are correct there is still scope for growth. However, we have reduced our previous "overweight" position to reduce risk. We believe that high quality, international focused companies should outperform as they have not seen the same growth as poorer quality stocks.	=
Fixed Interest Gilt yields remain very low, making corporate bonds look reasonably attractive in relative terms. However we do not believe gilt yields will remain at such low levels in the long term, although QE would give gilts a temporary boost. A fall in gilt prices would have a knock on effect on corporate bonds. If inflation remains high, fixed interest returns look less attractive and so we now expect below average returns over 18 months.	-2
Commercial Property The rental yield on the commercial property index remains very attractive relative to other asset classes. However, capital growth has leveled off and we don't expect to see much more capital growth over the next 6 months. Growth may improve after that. Property funds are sitting on high cash levels which is a drag on returns. Returns should improve again once the strong inflows into funds reduce to more normal levels.	-1
Residential Property We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.	-5
Cash With interest rates remaining at record lows, returns on cash are as low as they have ever been, and we don't see that changing for some time.	-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.