Monday 6 November 2023

focus

Cash Isn't Always King

Interest rates from the likes of bank accounts and term deposits are the highest they've been in well over a decade. In contrast, investment markets have been bumpy with recent returns modest at best. It's understandable why some are starting to ask "Why bother with markets? Why don't I just keep all my money in the bank?" We do think it's reasonable to hold a bit more cash than normal at the moment. But investors should remember that, over the long-term, stock markets have performed well in high and low interest rate environments and, over the long-term, sitting in the "safety" of cash has been detrimental to your wealth.

FORSYTH BARR

...Global shares...are about -10% below their peak...

How times have changed

It was only a few short years ago that interest rates were at the lowest levels in human history. Central bank interest rates were, there or thereabouts, at zero. Many investors gave up on keeping their money in the bank and looked for alternatives – some went into property, others into shares, while a few went into very high risk assets like crypto currencies.

Unfortunately for these people, their timing was poor. Most asset prices are down from their peaks. New Zealand house prices have fallen -15% from their late 2021 highs, with Auckland and Wellington leading the way down -20% and -22% respectively. Global shares, after the recent pullback, are about -8% below their peak, with the New Zealand market fairing even worse, down -18%. For those playing in the crypto space, most coins have halved or more. (These are just further reminders of how jumping between different investments and trying to time markets is more likely to hurt than benefit you.)

Even those invested in the traditional safe haven of bonds haven't been immune. Bonds are normally a steady, income-generating part of an investment portfolio. But from late 2021 to early 2023 bonds delivered negative returns due to the starting point of super low interest rates followed by very sharp rate rises. (Bond prices move in the opposite direction to interest rates – when rates rise, bond prices fall.)

It's always surprising how quickly markets can change – the landscape today compared to a few years ago is quite different. Interest rates on bank deposits are the highest since 2008. Many investors' sentiment has also shifted. Some are now nervous about markets and (at least considering) seeking safe haven in cash.

6-MONTH TERM DEPOSIT RATE

Source: RBNZ, Forsyth Barr analysis

Cash has value

We understand why some investors are holding a bit more cash than normal at the moment.

Higher interest rates mean you're now getting a better return. Cash allows investors to seize opportunities in volatile markets – if asset prices fall, cash enables you to pick up some bargains. And importantly for some, holding cash may reduce your stress, enabling you to sleep better at night.

Investors do need to remember, however, that cash isn't king over the long-term.

Over the long-term cash isn't a great investment

> *"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."* ***Sam Ewing, baseball player***

Over time, the purchasing power of cash decreases due to inflation – a dollar you earned in 1980 is not worth nearly as much today, and a dollar you earn now will not be worth as much in the future.

To highlight, in 1980 $1 had the equivalent spending power of about $6.50 today. Said differently, if you'd put that 1980's $1 in your bottom draw or under the mattress, today it'd be worth the equivalent of 15 cents – the real value of your dollar would have fallen by 85%.

Even if you put that money in the bank and earned interest, the real value of your cash (at best) only creeps higher over time. $1 in the bank, that's sat in term deposits over the past four decades or so, with all the interest reinvested, would be worth the equivalent of $1.24 today, a real return of 0.5% per annum … less than 1c per year.

Companies tend to grow over time

The contrasts between holding cash compared to investing in stocks are two-fold. On the positive side, the outcomes of putting your money in the bank are a lot more predictable – the value of your cash doesn't move much day to day or year to year. On the flipside, the price you pay for that surety is much lower returns over the long-term.

There are a few reasons that, over the long run, companies (it's always important to remember stocks are an underlying share in a company) provide better returns.

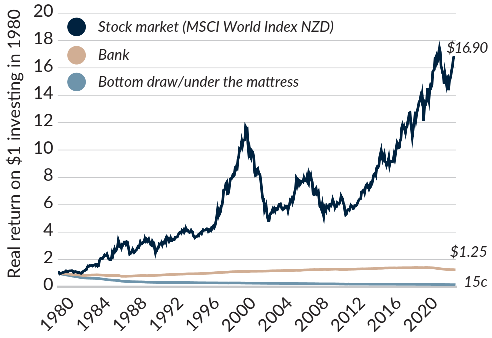
Firstly, good companies have pricing power. During inflationary periods they tend to be pretty good at recovering higher costs by raising prices. After all, that is what inflation is – companies putting up their prices. Cash has no pricing power.

Secondly, companies have the ability to reinvest, maybe in new technologies that improve customer products or services, or deliver operating efficiencies. If done well, this reinvestment grows a company's profits and value over time.

Thirdly, the tax you pay on interest is typically higher than what you pay on shares. In New Zealand there is no tax on capital gains on higher share prices over time, while imputation credits attached to dividends paid by New Zealand companies mean there is no double taxation on dividends, unlike in many other countries.

The difference in outcomes is quite stark. That $1 invested in 1980 which became $1.24 if held in the bank, would be about $17 if it had been invested in the share market.

INVESTING IN THE SHARE MARKET VS. CASH



Source: Refinitiv, RBNZ, Forsyth Barr analysis

Markets haven't worked in recent times. Interest rates are high. Why don't I wait?

We fully appreciate that, in general over recent years, stocks haven't fulfilled the role of growing wealth. We also recognise that interest rates are more attractive than they've been for a long time. It's understandable that some investors are tempted to sit on the side lines and wait for calmer waters. While we can't provide one size fits all advice – it really does depend on your individual circumstances – there are a few things to consider before completely hunkering down.

1. Unfortunately, share markets don't go up in a straight line. Volatility is never comfortable, but it's normal – it's the price we pay to earn higher returns over the long term.
2. Choppy markets provide buying opportunities. The silver lining of lower asset prices is that they'll generally provide better returns over the long run.
3. Timing markets is (at best) extremely hard. While there will always be someone who successfully calls the bottom of the market each time, the evidence is clear – there are extremely few (if any) who can do it consistently.
4. The last few years have highlighted how quickly the market mood can change. If you wait for conditions to improve, by the time you're comfortable getting back in the share market, prices will have very likely already moved higher.
5. While interest rates seem high relative to the past decade or so, on a longer time horizon, they're only back to around normal levels. Share markets have done well through periods of both high and low interest rates.

...interest rates move up and down...

6. As we've been reminded in recent years, interest rates move up and down. Those wanting to lock in current interest rates for the medium-term can take advantage of the higher rates on offer from defensive assets like bonds.
7. Interest rates on deposits can vary widely. For those holding cash it's important to look around and make sure you're getting a decent return. (Forsyth Barr has a number of cash management solutions that typically provide more attractive returns than what's on offer from most retail bank deposits.)

For most investors it is prudent to hold some cash for short-term needs, emergencies, and as dry powder for potential future investment opportunities. And yes, cash can be a safe haven during challenging market periods. However, it's also important to balance this with your longer-term investment objectives. Over time, holding too much cash has been a poor investment strategy.

We appreciate recent years haven't been plain sailing in markets. If at any time you wish to discuss the nature and composition of your portfolio please don't hesitate to contact your Forsyth Barr Investment Adviser.

Matt Henry
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If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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