Beware of the hidden cost of cash

Russell Investments

Many Australians have a love affair with cash. For some people, cash provides a sense of security and familiarity. But is there a cost to carrying cash?

Following the COVID-19 related market volatility, we observed that individuals held high levels of cash. In fact, between March 2020 to March 2021, we saw cash in banks increase by 12%, accounting for an additional $124 billion in additional cash[1].

There are often two reasons why an individual may feel comfortable with holding higher levels of cash:

1. Cash is liquid. People like knowing they can access it at the drop of a hat.
2. Cash carries little perceived risk to many investors, while investing in the markets can see portfolios have positive and negative returns. People like the idea that cash is inherently safe: no market risk comes with having cash sitting in the bank.

But sometimes we need to look a little closer to understand if these reasons stack-up.

Cash bias 1: Cash is liquid

This one is simple, yet it is often misunderstood by individuals.

While cash held in a bank account can be withdrawn at any time, the interest rates offered by banks are often low. Some investors opt for term deposits which offer slightly higher interest rates, however there are often terms and conditions for withdrawals prior to the term date.

There can be negative implications of holding too much cash in a portfolio. Investment professionals refer to this as 'cash drag', which is when holding too much cash erodes the potential returns of a portfolio.

An adviser can help investors find the best source and process for accessing cash via other financial products when required, and keep their portfolio invested to achieve their investment goals.

Cash bias 2: Cash can help avoid negative returns

We know that equity markets can go up and down. Whilst cash in banks collect steady interest with seemingly no risk of losing any capital, providing investors a sense of confidence and consistency.

So, what's the problem? To see the underlying problem, let's take a step back and look at the impact of inflation on the return on cash. Once we do, the appeal of cash begins to fade. For many, cash equals certainty. But the comfort of having this certainty in return may come at a cost. There are hidden drags that can have a significant impact on the amount of wealth investors ultimately accumulate.

Hidden costs: Inflation versus purchasing power

One cost is inflation, which represents the increase in an items purchasing price. When investing, investors hope to increase their savings which gives them more money to spend. This is known as an increase in purchasing power. But there are two sides of a coin—how much extra purchasing power we end up with (i.e. how much more we can buy) depends on the role that inflation plays along the way.

Here's a simple example to illustrate the impact inflation can have. Say we're looking to purchase a new flat screen TV. After shopping around, we decide on a beautiful, 76'' LED TV that costs $1,000. Being a prudent investor, we consider 2 potential options:

A. Buy the TV today for $1,000

B. Wait one year to buy the TV and invest the $1,000 in a Term Deposit to earn 1% over 12 months.

Since we don't need the TV today, we decide to go with option B and wait until next year to purchase the TV while making some extra money. After investing $1,000 in a one-year Term Deposit earning 1%, we earn $10 at the end of the term and our investment grows to $1,010. Are we better off? That depends on the impact inflation has had over the year.

[1] Source: Australian Prudential Regulation Authority (APRA)

Here's what could happen.

Scenario 1: Inflation is less than 1%

- The price of the TV in one year will be less than $1,010.
- Since investing resulted in a larger amount than the new cost of the TV, we have additional money left over after buying the TV.
- *Our purchasing power has increased.*

Scenario 2: Inflation is exactly 1%

- The price of the TV in one year will be equal to $1,010.
- The price of the TV equals the amount we have after one year of investing.
- Although we earned $10 on our investment, since the price of the TV also increased $10 we will still have only enough money to only buy the TV.
- *Our purchasing power has stayed the same.*

Scenario 3: Inflation is more than 1%

- The price of the TV in one year will be greater than $1,010.
- We no longer have enough money to buy the TV with our investment. We will either take money from other sources to buy the same TV or find a cheaper option.
- *Our purchasing power has decreased since we can buy less with our money than before.*

The real return on an investment

The idea of evaluating investment results after the effects of inflation is known as the real return on investment. This is the return that is most meaningful to investors, since this tells them how much their purchasing power has gone up or down.

If the real return on an investment is zero, we are keeping up with inflation, but our purchasing power remains the same. If the real return is positive, we are earning more than inflation and we can buy more goods down the road, which is the desired outcome.

Purchasing power risk

Scenario three can happen, where the real return is negative, and inflation is larger than the return on the investment and purchasing power decreases.

This is known as purchasing power risk and represents the risk that prices go up by more than the amount an investor earned while investing.

Whilst an investor in this scenario may have technically made money by investing, they lost the ability to purchase the item they originally wanted to buy. This can have significant consequences for investors near or in retirement impacting their cost-of-living needs such as food, other consumables, and healthcare.

So, what if the safety of cash today means that we have less money to spend on potential key elements in retirement?

Beware of the corrosive nature of inflation

It is important that investors are aware of inflation and the impact it can have on their savings – especially now.

An investor seeking a cash investment, would likely get a one-year Term Deposit rate of about 0.25% p.a. (June 2021). If we consider what the Reserve Bank of Australia (RBA) refer to as the 'break-even' inflation rate, or what is referred to as the expected inflation rate, which is 2.1%.

Therefore, while the return on cash is 0.25% over 12 months, and the return after inflation is taken into consideration, the real return on cash is expected to be -1.8%[2].

The investor is effectively paying the bank to store their cash.

What's the solution?

We recommend investors work with a financial adviser to help keep their portfolio invested where appropriate to grow assets for future spending needs, and finding the best source and process for accessing capital when required.

Financial advisers can also help coach and guide individuals to avoid switching to cash at the wrong time, and to stick to the plan designed to achieve financial confidence.

[2] One-year Term Deposit rate: Retail deposit and investment rates; Banks' term deposits ($10,000) (Source RBA). Current inflation as measured by current Consumer Price Index (CPI) rate of 1.1% as of March 2021 (Source ABS). Expected inflation as measured by the Australian Break-even 10-year inflation rate as of March 2021 (Source RBA).

IMPORTANT INFORMATION

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