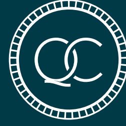
Approver: Quilter Cheviot Limited 31 October 2023



WHY CASH IS STILL NOT KING

Cash has understandably become far more attractive as an investment position in the last 12 months as interest rates have jumped sharply. Why take market risk when you can get a cash return in the region of 5% has become a common refrain.

The case for cash is not just based on the higher returns on offer; there is also a growing feeling of increased macroeconomic uncertainty and last year's sizable declines in stock and bond markets are still fresh in investors' memories. The thinking goes along the lines of move money into cash, wait for a more predictable investing environment, avoid any short-term drawdowns and earn a respectable return. However, investors should resist the urge to go to cash because of issues surrounding forecasting, timing and time horizons.

Forecasting

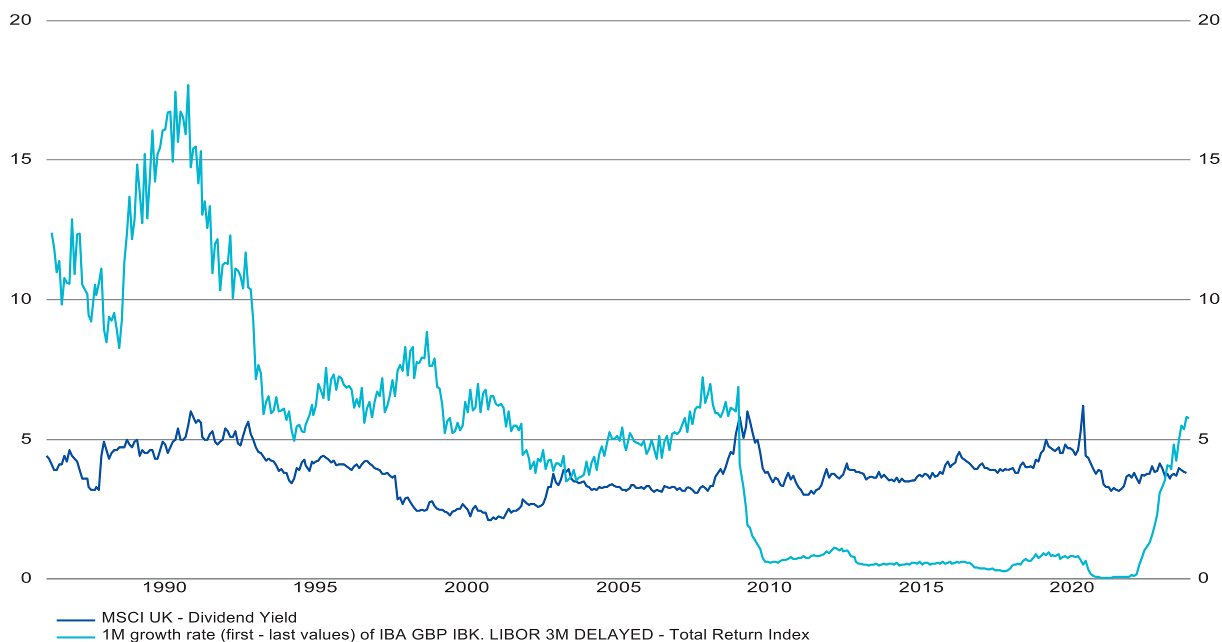
Forecasting errors are the first reason to avoid this approach. There are three broad outcomes for the global economy over the near term, and in each scenario, cash is not optimal:

- **Recession** – the impact of rapid interest rate hikes sends western economies into contraction. Seen by several leading economists as the most likely outcome, this would mean a drop in cash rates as central banks switch course*. The last time the SONIA** rate was this high (April 2008) it was soon cut sharply, falling to 2.5% within seven months and under 1% 10 months later. While this is an extreme example as it occurred due to the onset of the global financial crisis, other assets would expect to comfortably outperform cash even if cuts were far smaller. A 1% drop in yield over the next 12 months on a UK 10-year gilt (government bond) from 4.5% to 3.5% would give an investor approximately 13% annual total return – far higher than the current cash rates, never mind lower ones.
- **Resilience** – economies hold up better than feared and continue to grow. While cash would likely outperform bonds in this scenario, stocks would be expected to do better than both. For instance, financials and small cap stocks are trading on relatively low valuations and benefit strongly from better-than-expected growth and the avoidance of a recession. So, for cash rates to stay at elevated levels, economic health will have to hold up well, in which case the return prospects for stocks would be more attractive.
- **Stagflation** – a combination of low/negative growth and high inflation would be a repeat of the 1970s. Weaker corporate earnings would weigh on broad stock indices while bonds would suffer from even higher rates – similar to what we saw in 2022, although to a lesser extent given current valuations. However, cash would still likely underperform commodities. Exposure to infrastructure and commodities through funds or stocks would be expected to perform well.

**To avoid this possible setback, you could invest in a one-year bond, effectively locking in a return until a fixed future date. However, a drawback to this approach is the lack of flexibility. Should an investor attempting to time the market decide that the outlook has improved significantly and wish to move back into a greater allocation to equities, it is not possible until the bond has matured.*

***SONIA (Sterling Overnight Index Average) is an interest rate benchmark based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors. It is widely used as a proxy for short-term interest rates.*

Several of the largest UK-listed stocks are in the commodities sector, including the oil majors and miners. Furthermore, UK benchmarks currently trade at valuations below their long-term average and offer fairly attractive dividends. Although the return on cash has recently overtaken the MSCI UK dividend yield the spread is still quite a bit smaller than it was for much of the 1990s and 2000s. An increase in commodity prices could see the dividend yield move back above 5%, as it was as recently as 2020, and as well as receiving these pay outs, investors also stand to benefit should the market move higher.



Moving to cash is seen by some as a way to avoid having to forecast what happens next. But making no forecast is a forecast in itself.

Under each scenario above cash is not the optimal allocation. While it may outperform certain asset classes in the near term, a diversified multi-asset approach has been proven to deliver superior returns over the longer term. Looking at the past decade, the best and worst performing assets have varied considerably year on year and very few, if any, investors have the ability to invest solely in the asset class that will do best in the coming year.

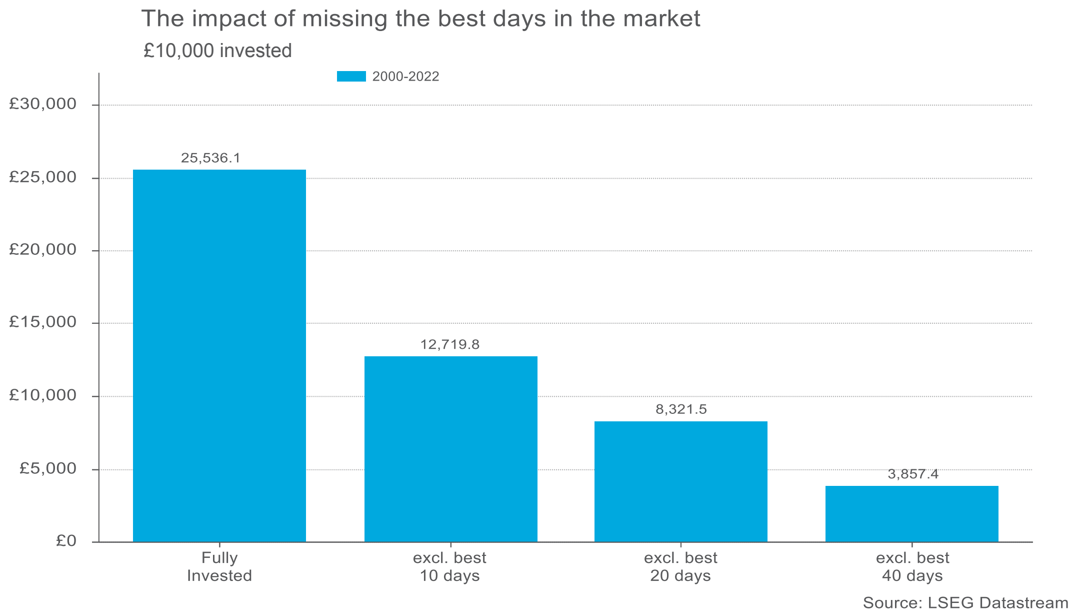
Order of returns by asset class

Return (%)	2013 - 2014	2014 - 2015	2015 - 2016	2016 - 2017	2017 - 2018	2018 - 2019	2019 - 2020	2020 - 2021	2021 - 2022	2022 - 2023
Best	Europe ex UK equities	China equities	US equities	China equities	China equities	US equities	China equities	US equities	UK property	Europe ex UK equities
	UK equities	Japan equities	Global equities	Europe ex UK equities	US equities	Global equities	US equities	Emerging markets equities	UK equities	US equities
	UK property	US equities	Global bonds	Asia Pacific ex Japan equities	Global equities	Europe ex UK equities	Japan equities	Global equities	Cash	Japan equities
	US equities	UK property	Japan equities	Emerging markets equities	Japan equities	Global bonds	Global equities	Asia Pacific ex Japan equities	US equities	Global equities
	Global equities	Global equities	Asia Pacific ex Japan equities	Japan equities	UK equities	Emerging markets equities	Global bonds	Europe ex UK equities	Global equities	UK equities
	Global bonds	Asia Pacific ex Japan equities	Europe ex UK equities	Global equities	Asia Pacific ex Japan equities	Asia Pacific ex Japan equities	Asia Pacific ex Japan equities	UK equities	Japan equities	Cash
	Asia Pacific ex Japan equities	Emerging markets equities	Emerging markets equities	US equities	Emerging markets equities	UK equities	Europe ex UK equities	China equities	Global bonds	Global bonds
	China equities	Global bonds	UK equities	UK equities	UK property	UK property	Cash	Japan equities	Europe ex UK equities	Emerging markets equities
	Emerging markets equities	Europe ex UK equities	Cash	UK property	Europe ex UK equities	Cash	Emerging markets equities	UK property	Asia Pacific ex Japan equities	Asia Pacific ex Japan equities
	Cash	Cash	UK property	Cash	Cash	Japan equities	UK property	Cash	Emerging markets equities	UK property
Worst	Japan equities	UK equities	China equities	Global bonds	Global bonds	China equities	UK equities	Global bonds	China equities	China equities

Source*: The following disclaimer is with regard to our distribution of data from MCSI indices to you, the recipient/user. The MSCI information may only be used for your internal use, may not be reproduced or redisseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com)*

Timing the market

Even if cash does outperform bonds, stocks and a diversified multi-asset portfolio over the near-term, the opportunity cost can be massive. Without a crystal ball it is extremely difficult to know when a period of cash outperformance will end and exposure to risk assets should be dialled back up. And more importantly, missing the timing by just a small margin can have a severe negative impact on overall returns:

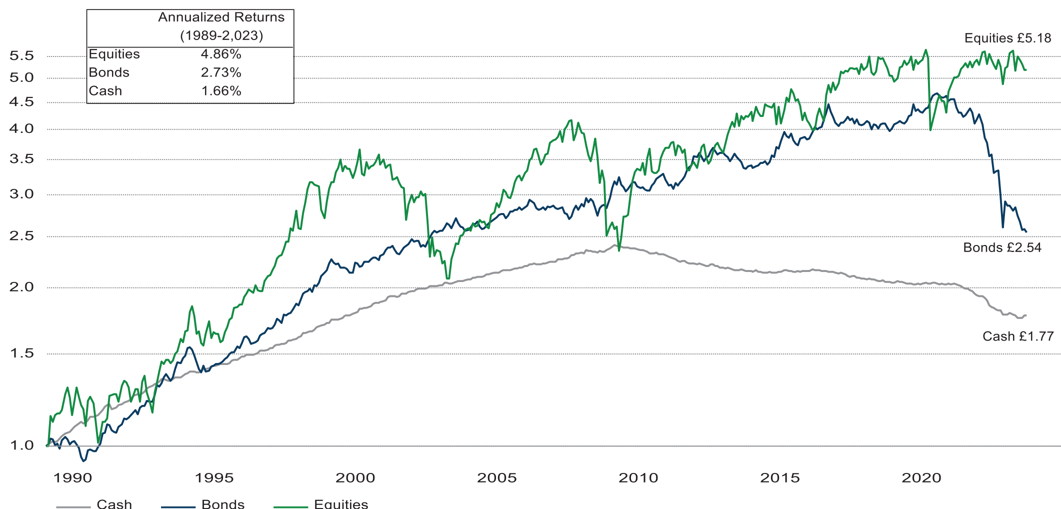


An investor missing the best 10 days since 2000 would see a return on £10,000 of £12,719.80 – just under half of the £25,536.10 they would have received if they were fully invested the whole time. Quite incredibly, missing the best 20 (and 40) days would see a negative return over the period. It is clear that missing even a relatively small number of large up days has a major impact on total return.

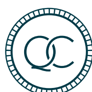
The levels of returns on offer from cash are currently in the same region as historical annual average returns from bonds and not far lower than that from stocks. However, looking at long-term average annual returns belies the fact that individual years are often far more volatile. Missing the best years, months, weeks or even days can have a substantial negative impact on overall returns.

Time horizon

The most compelling reason to avoid going to cash is that history has shown that over the long-term, stocks and bonds have strongly outperformed – it's not even remotely close.



Past performance is not a reliable indicator of future performance.



Starting with a £1 investment in 1990, returns on holding cash would amount to £1.77, far less than the £2.54 that would have been earned in bonds and well under half of the £5.18 that equities would have returned. History shows that over long-time horizons, equities are one of the best hedges against inflation, due to companies' ability to adapt to inflationary environments through a combination of altering operating processes and increasing prices to offset higher input/production costs, whereby the end consumer ends up bearing, at least some of, the brunt of inflation.

Trying to predict what asset class will do best in the next year is extremely difficult, but the good news for investors is, from a long-term perspective, it does not matter that much how accurately you forecast the next 12-18 months. Very few successful long-term investors have built their wealth on accurate near-term economic forecasts. It's far easier to stick to a time-tested approach, rooted on long-dated historical evidence and sound economic rationale.

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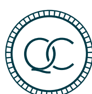

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(10/2023)