

## Introduction

We all use cash to fund our general living expenses, whether we actually handle paper money itself, or simply transfer our cash electronically. However, the purpose of this Guide is to **consider cash as an investment**.

We can define a cash investment as a deposit account, or similar arrangement, which **promises to pay us a rate of interest and return our initial investment intact**.

As individual investors we use the retail arms of **banks and building societies** to hold our cash investments. Such organisations also have a 'wholesale' arm where they lend to, and borrow from, each other. This is referred to as the 'money market'.

The money market is beyond the scope of our present discussion except that we will touch on unit trusts, life assurance and pension funds **which invest in the money market**.

"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."

Robert G Allen author of bestsellers  
*The One Minute Millionaire and The Enlightened Way to Wealth*

## Interest

The **only investment return** from a cash investment is the interest that is paid. The initial capital invested is returned but, as this is without growth, it is not an investment return as such.

Interest is **usually paid at variable rates** but fixed rates can also be offered.

Although a cash investment should be simplicity itself, investors need to be aware that the **'headline' interest rate** may not tell the whole story. In the examples below The Blue Bank and The Yellow Bank are meant to be fictitious banks:

- The interest rate quoted **may include a temporary bonus**.  
For example, a deposit account with The Blue Bank may appear to offer an interest rate which is 0.5% pa more favourable than The Yellow Bank. However, The Blue bank account includes a **1.0% bonus for the first 6 months**. Therefore unless the account holder takes action after the first 6 months they could find that their rate is lower than that of The Yellow Bank account.
- The actual return may be **reduced by penalty charges**.  
For example, a deposit account with The Blue Bank may appear to offer an interest rate which is 1.0% pa more favourable than The Yellow Bank. However, The Blue Bank account **only allows 4 free withdrawals pa**, and then there is a 30 day loss of interest on each withdrawal. This may be fine for some depositors but expensive in terms of lost interest to others who will use the account more actively.

- Interest may be paid **annually or monthly**.

For example, a deposit account with The Blue Bank and The Yellow Bank offers the same rate of interest. However, The Blue Bank accounts **adds interest annually** and The Yellow Bank account adds interest monthly. The same headline rate **would produce a greater return** in The Yellow Bank because interest is added to the account monthly and compounded rather than added annually.

- Headline **rates are usually quoted gross**, that is, no tax is taken into account. However, most investors will only receive interest net of 20% tax (and may then have to pay a further 20% if they are higher rate tax payers).
- The deposit may **be in another currency**, in which case there may be a loss, or gain, on the actual interest received once it is converted into sterling.

## Security of Capital

We have already indicated that one of the characteristics of a cash investment is that our initial investment is **to be returned intact**. However, the reality is not as simple as it sounds.

A very important issue for cash investors is **the security** (ie the credit worthiness) **of the bank or building society** or other deposit taker.

This should be of particular concern if the deposit taker is not regulated in the UK. Even where the bank or building society is in the local high street, **there is still an element of risk** of loss if a large amount of capital is held in one account.

This is because **there are limits to the amount that can be claimed** from the **Financial Services Compensation Scheme (FSCS)** in the event of the failure of a UK regulated deposit taker.

The information that follows uses maximum claim amounts **which apply from 7 October 2008**.

- The maximum amount that can be claimed is **currently £50,000** (this increased from £35,000 on 7 October 2008). So £100,000 on deposit in one account holds out **the risk of a 50% loss**.
- This amount is **per person**, so that if you use a joint account the maximum amount that can be claimed is **currently £100,000**. So £100,000 on deposit in a joint account holds out **no risk of loss**. However, gaining compensation can be a slow process.
- The **highest security** would therefore come from restricting any deposit to £50,000 (or £100,000 if jointly held).

There is a **trade-off between security and the inconvenience of having a lot of different accounts** and those with very large amounts of money on deposit might decide to keep somewhat higher amounts in any one bank but still being aware of the amount of their money which is secure.

- You can only claim against the FSCS if the bank is authorised by the Financial Services Authority (FSA).

If your bank account is held in another country then you may have no claim against anyone in the event of the failure of that bank, or at least there will be a different level of compensation that can be claimed via the regulators in that country. You should make sure of the limit of compensation that would apply before depositing your money in an overseas bank.

- FSA authorisation is also important when considering a deposit in a subsidiary of another bank.

For example, if The Yellow Bank is a subsidiary of The Blue Bank and you hold deposits of £50,000 in each (or £100,000 in each in joint accounts) is your money secure? The answer depends on how the FSA authorises them.

If the FSA directly authorises both banks then you can claim up to £50,000 (or £100,000 if joint accounts) from your account with each bank.

If the FSA authorises The Blue Bank as the holding company and The Yellow Bank simply gets its authorisation as a subsidiary company rather than being directly authorised by the FSA then you can only claim up to £50,000 (or £100,000 if joint accounts) in respect of one of your accounts.

To find out if the FSA directly authorises any bank that you wish to use go to [www.fsa.gov.uk/pages/register/](http://www.fsa.gov.uk/pages/register/)

- A limited company is treated in law as a separate entity from the owners. The maximum amount that can be claimed is currently £50,000 per company. To qualify the company has to meet any two of the following three criteria:

The company has a turnover of less than £6.5 million

The company has assets (ie a balance sheet total) of less than £3.25 million

The company has less than 50 employees

- A partnership is treated as a single depositor. The maximum amount that can be claimed is currently £50,000 per partnership.
- The maximum amount that can be claimed by a sole trader is currently £50,000, however this includes all of the sole trader's personal and business accounts.
- If you have an account with a UK branch of a bank incorporated in the European Economic Area (EEA) there is a minimum level of protection under the EU Deposit Guarantee Schemes Directive of 20,000 Euros per eligible depositor in the event of a bank failure.

Where the bank's home state scheme provides a lower limit of compensation than FSCS (ie £50,000), the bank may choose to join FSCS to 'top up' the level of protection offered by the home state scheme. A list of banks that have topped up into the FSCS scheme are available from [www.fscs.org.uk](http://www.fscs.org.uk).

In the event of a failure of one of these banks, there would be a two step process as the home state scheme would have lead responsibility for claims, and would be responsible for paying the first part of any compensation. FSCS is only responsible for paying compensation for the topped up element to £50,000 on deposits with the UK branch.

- If you have an account with a UK branch of a bank incorporated outside of the European Economic Area (EEA) then you can claim the full £50,000 from the FSCS.

"I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful."

Warren Buffet, stock market investor, philanthropist, and one of the richest people in the world

## Security of the Bank

At the time of writing, there is nothing to beat the 100% guarantee on deposits on offer from Northern Rock and the UK Government. However, the Government is mindful of not upsetting the competitive situation for other banks in the UK and is currently limiting the attractiveness of the accounts on offer.

In terms of the security of the other banks, we believe that most depositors will be best advised by (a) checking that the bank with which they are depositing their money is directly authorised by the FSA and (b) keeping their deposits below £50,000 (or £100,000 if a joint account) in any one bank.

It is possible to gauge the security of any particular bank, in relation to other banks in general, by looking at the credit default swap (CDS) market. CDS spreads measure the premium to the risk-free interest rate that a bank can expect to pay in the market for 5-year loans. The higher the CDS for any given bank, the riskier the market thinks that particular bank's debt is.

This information is available on [www.bloomberg.com](http://www.bloomberg.com) but is difficult to find as information on UK banks is swamped by a mass of US data. Lists of CDS ratings are sometimes published in the financial press or on financial websites. However, the perception of risk by the market is something which changes quickly, so out of date lists can give you a wrong impression.

Such information is not available on building societies as these are mutual organisations without shareholders. From one perspective building societies are in a relatively more vulnerable position than the banks purely because if they do get into difficulty they cannot raise capital from their shareholders or in the money markets. This inability to overstretch themselves gives other people confidence that their management will be acting prudently.

## Online Bank Accounts

The best interest rates are usually to be found from online (ie internet) bank accounts and telephone/post accounts. Such accounts benefit from a saving to the bank in staff and premises costs.

There is no difference from the point of view of the security of the bank in using an internet account provided that you make sure that the bank is directly authorised by the FSA and you are aware of the FSCS limits.

There is, however, an additional 'online' risk in that there are many 'boiler room' scams by which criminals very cleverly seek to impersonate genuine bank websites and obtain your password and account details so that they can then steal your money from the genuine website.

There are a number of basic safeguards that you should use when dealing with any internet bank. You should know that your bank will never email you requesting your password details, or ask you to update your online information. You should always log in via the bank online address held on your computer, never through a link that is emailed to you purporting to be from your bank.

Online banking, together with online bank deposits, is now the norm for hundreds of thousands of UK citizens. **Provided that the investor is confident about what they are doing** and the way to reduce risk when dealing online, there is probably no more risk than walking to the local high street branch of the bank where you may get involved in a car accident or a bank robbery!

Unfortunately there are **many people who fail to keep their wits about them when receiving communications by letter, telephone and email** and such people should steer well clear of internet banking for as long as high street banks are available.

## Offshore Deposit Accounts

Offshore deposit accounts sometimes have higher interest rates than UK deposit accounts and sometimes the reverse is true.

If the offshore account is not in sterling then **the currency risk has to be taken into account**, that is, there may be a loss, or gain, in the value of your deposit when it is converted back into sterling.

The attraction of offshore accounts is that **UK investment tax** (currently 20%) **is not deducted at source**. However, if you eventually bring your capital and interest to the UK **you will be liable for tax at your marginal rate on all of the interest at that time**.

If, however, you intend to spend your capital and interest outside of the UK then you will effectively be making a 20% tax saving. This **depends on whether another country is going to tax you on the interest** but that is often not the case.

The **Markets in Financial Instruments Directive (MiFID)** came into effect in the UK on 1 November 2007. This is a European Union law which provides a harmonised regulatory regime for investment services across the 30 member states of the EEC (ie the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein). In terms of risk the members of the EEC will increasingly offer similar protection to the UK but as we have seen they are quite a long way behind at present. **Outside of the EEC it is very much 'buyer beware'**.

At the time of writing the security offered by the **Isle of Man Depositors' Compensation Scheme (DCS)** is very much less than that offered in the UK by the FSCS and depositors in **Jersey and Guernsey** do not have access to any form of depositor protection scheme, so that in the event of the failure of a Jersey or Guernsey bank, you would be exposed to the potential loss of your deposits.

## Annual Equivalent Rate (AER)

Since 1999, UK banks and building societies have been **required to quote an annual equivalent rate (AER)** in their advertisements for deposit accounts.

The AER is a notional rate that illustrates **what the annual rate of interest would be** if the interest was compounded each time it was paid. Where interest is paid annually, the quoted rate and the AER are the same.

If the AER on an account is **lower than the headline rate** it should warn you that the rate is being boosted by a temporary bonus.

## Extension Rates

An account can **default to an extension rate** once the initial agreed deposit period is over. This is **particularly likely when a fixed rate** is being offered.

The extension rate might be **considerably below the original rate** offered and may also be lower than the general market rate. If you overlook this change of rate and leave your money on deposit the overall rate of return could be very different from the expected rate.

As with any other investment, **cash should not be placed on deposit and then forgotten about**. The rates of interest vary noticeably between the best and worst accounts at any time.

As a further incentive to keeping a watchful eye on such accounts, the Government has announced its intention to **use money held in bank or building society accounts which remain dormant** for 15 years to fund social projects.

It is estimated that **hundreds of millions of pounds lies unclaimed** in dormant accounts, with tens of millions more added to the pile every year.

## The Role of Cash

Cash investments offer:

- A **safe** (within limits) **or low risk way to earn income**, particularly over the short term.
- A **temporary holding place** or 'bolt hole' when investment conditions are not favourable.
- A place to keep cash **secure from theft**.
- An ideal **emergency fund**.

However, cash investments **suffer badly from the effects of inflation** and are unlikely to produce much by way of a real rate of return, over a longer timescale, once tax is taken into account.

## Barclays Capital Equity & Gilt Study

The Barclays Capital Equity & Gilt Study 2008 compares the **annualised real returns** (ie after allowing for inflation) from cash investments against those of gilts, bonds and equities over more than 100 years.

We can add in returns for property from the Investment Property Databank (IPD).

Investment Type	2007	Last 5 years	Last 10 years	Last 20 years	Last 50 years	Last 108 years
Cash	1.0	1.4	2.5	3.5	2.0	1.0
Gilts	1.2	1.0	3.3	5.1	2.4	1.1
Index-Linked	1.4	2.9	3.7	4.4		
Corporate Bonds	-5.9	1.7	4.2	7.9		
Property	-7.4	8.8	8.2	7.9		
Equities	1.0	11.2	3.1	6.7	7.2	5.3

The Corporate Bond figure in the 'Last 20 years' column is actually for the last 17 years as this is the maximum period for which figures are available.

The study also allows us to illustrate **the probability of equity outperformance over cash**.

From the table which follows you will see that the longer the investment period the higher the chance that equities will outperform cash.

	Number of consecutive years					
	2	3	4	5	10	18
Periods where equities outperform cash	72	75	78	78	92	90
Periods where equities underperform cash	35	31	27	26	7	1
Total no of years	107	106	105	104	99	91
Probability of equity outperformance	67%	71%	74%	75%	93%	99%

## Cash ISAs

If you are a tax payer and you are going to hold money on deposit then you should **consider moving £3,600** (the maximum) **into a Cash ISA** each year. This will protect the money you hold in the Cash ISA from income tax on the interest.

An individual **aged 16 and over** can open a Cash ISA. As with ordinary deposit accounts these will usually have **variable interest rates**, but some will offer fixed rates. Many Cash ISAs will offer **instant access to money** with no penalty or loss of interest.

Others will have restrictions, such as a fixed term or require notice to be given before money can be withdrawn. If a withdrawal is made within a fixed period then a penalty or loss of interest may result.

When the maximum allowance has been invested for one financial year **you are not able to invest any more even if a withdrawal has been made**. For example, if £2,000 is invested near the start of a financial year, the maximum amount that can be invested over the remainder of the year is £1,600. If a withdrawal of £1,000 is made halfway through the year, the maximum amount that can be invested during the remainder of the financial year is still £1,600 not £2,600.

Please be aware that **if you do deposit money in a Cash ISA** in a tax year, the maximum you can invest in an investment linked ISA is **reduced from £7,200 by the amount of your deposit**.

For the sake of simplicity, and to avoid problems with HM Revenue, we believe it is best to assume that if you deposit money into a Cash ISA during a tax year, **the maximum you can invest in an investment linked ISA** in the same tax year **is reduced to £3,600**.

## National Savings & Investments

The advantage of holding cash in certain National Savings products is that **your capital will be returned to you in full**.

As the National Savings products are backed by the Government there is no possibility of loss through the collapse of the product provider, as there is with a bank or building society.

There is **some misunderstanding about National Savings**, however, in that **some people think that all National Savings products are tax free** when that is not the case.

- National Savings ISAs, Premium Bonds, Fixed Interest and Index-Linked Savings Certificates and Children's Bonus Bonds **are tax free**.
- However, Capital Bonds, Pensioners Bonds, Income Bonds and the general Savings Accounts are **taxable but credited in full without deduction of tax**.

If you have one of these accounts, therefore, **you are required to complete an annual Self Assessment Tax Return**, or otherwise inform HM Revenue of the income you have received even if you would otherwise not need to complete a tax return.

- To complicate matters further, National Savings Fixed Rate Savings Bonds **are taxed at 20% deducted at source** in the same way as a bank account.

## Cash Funds

Many forms of investments and pensions offer one or more cash funds. These come under the general heading of 'money market' funds and should not be considered in the same light as deposit accounts.

The main differences are:

- There is **no promise of the return of the original investment**. The return will be dependent on the unit price and the number of units held.
- The interest earned will be **an amalgamation of the rates** earned from the underlying deposits and cash instruments and will vary as these are purchased and sold.
- There will be **an annual management charge** for running the fund. This will usually be deducted from the income but may be deducted from the capital.

The advantage of having access to a cash fund within your investment or pension is that **monies can often be switched into the fund** at either no cost, or for a low switch fee. This is useful when trading conditions increase the risk of loss in equity funds.

Whereas **'market timing'** (ie investing in or moving out of particular markets at the right time) is **notoriously difficult to achieve** there can be merit in moving into cash at the right time. However, the 'right time' is usually understood by investors to be exactly the wrong time. If a move into cash is to be made **the right time is when equity markets have been racing ahead for a time** so that profit is taken from the sale of equities when their value is high.

Unfortunately **many investors switch into cash after dramatic falls in the equity markets**, thinking to secure their investments. What they are actually doing is **locking in their losses** so that when equity markets move ahead strongly after such falls they do not partake in the upturn as they are sitting in cash.

Pension funds, in particular, can make good use of cash funds as the planned retirement date approaches. **Gradual switches can be made from equity funds into cash** so that a last minute market reversal does not undermine your retirement plans.

One advantage for tax payers of holding large investments in a cash fund within, say, a life assurance bond, is that investors in UK authorised insurance companies are covered by the Policyholders Protection Act, **which gives 90% compensation without limit**.

## Risk Factors

- Levels and bases of taxation can change at any time and depends on individual circumstances.
- There are limits to the amount that can be claimed from the Financial Services Compensation Scheme in the event of the failure of a UK regulated deposit taker. Gaining compensation can also be a slow process.
- Inflation reduces the real value of your initial investment when it is returned to you. For this reason cash is not usually recommended as an investment for the long term.
- Past performance is neither a guide to, nor a guarantee of, future returns.
- The value of an investment in a cash fund is not guaranteed and can go down as well as up, and you may not get back the amount you originally invested.
- Where the cash deposit or cash fund is not in sterling, changes in currency exchange rates may mean that the value of your investment goes up or down.
- Annual management charges will reduce the income from a cash fund and in some cases may be charged to the capital.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether a cash deposit or an investment in a cash fund is suitable, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

### For personal advice

If you would like to discuss whether a deposit account or an investment into a cash fund might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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