A forgotten asset class
A case for cash

First Sentier Investors

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Shares, bonds, and alternative asset classes tend to dominate media attention and headlines, but there's a forgotten asset class that underpins most investors' portfolios: cash. Record low interest rates around the world saw cash fall out of favour with investors in recent years, but prospective returns from cash portfolios are now rising again owing to higher official interest rates in key regions.

In this paper, Tony Togher, Head of Fixed Income, Short Term Investments and Global Credit, explains some of the different investments that fall under the category of 'cash', some of the risks to be aware of and, finally, outlines the investment case for cash.

There's more than one way to invest in cash

'Cash' funds managed by professional investment managers like First Sentier Investors provide an alternative to term deposit products that are typically offered by major banks. Blending various short-term, money market instruments into low-risk portfolios can deliver steady income with the flexibility of daily liquidity. Unlike most term deposits, investments in cash funds can be withdrawn at any time without surrendering accrued interest.

Over the last two decades, a large number of variant investments have been used in the management of cash portfolios. Most Australian cash portfolios compare or benchmark themselves against the return generated from the Reserve Bank of Australia ('RBA') Cash Rate, or alternatively the Bloomberg 90 Day Bank Bill index. Using a tried and tested investment approach, our cash portfolios have delivered returns over and above these reference indices over the long term.

Cash portfolios that benchmark their exposures against the RBA Cash Rate usually maintain higher allocations to overnight deposits with banks. To enhance returns, they may also include other highly liquid investments (securities that can be sold on the open market on a same day basis).

Cash portfolios that benchmark their exposures against the Bloomberg 90 Day Bank Bill Index also hold these types of investments. Additionally, they tend to have some exposure to income-style investments with low volatility and favourable ratings from independent credit rating agencies like Moody's and S&P.

Investments that might be used in the management of either portfolio type include:

- Overnight Deposits;
- Term Deposits (TDs);
- Bank Bills;
- Negotiable Certificates of Deposit (NCDs);
- Government Treasury Notes;
- Semi-Government Promissory Notes;
- Corporate and Asset Backed Promissory Notes;
- Floating Rate Notes; and
- Floating Rate Securities.

With changes to bank funding prudential regulations in recent years, various other investment types have emerged such as:

- Advance Notice Accounts (requiring notice of intention to redeem); and
- Convertible Term Deposits (which convert to liquid NCDs upon notice, or at interim maturity of a rolling deposit).

Cash funds may make opportunistic use of these securities, if they can improve the risk/return profile of the overall portfolio without materially affecting overall liquidity or capital security.

The risks

They say there's no free lunch, and that's right. In investment markets, it isn't possible to increase potential returns without accepting a commensurate increase in risk. That said, it is possible to minimise risk in cash funds through a comprehensive analysis of all holdings and by applying rigorous risk management techniques in the portfolio. The various types of 'cash' instruments outlined above carry different levels of traditional investment risk. The primary ones are as follows:

- **Duration risk** – the risk of interest rates changing following the initial investment. The longer the term profile, the larger the potential risk.
- **Credit risk** – the risk associated with the counterparty with which the investment has been undertaken.
- **Liquidity risk** – the risk of being unable to sell / redeem or reduce the exposure of the investment, if desired.
- **Return risk** – the risk that both nominal yields and margins associated with various securities may change over time.
- **Inflation risk** – the risk that inflation may exceed the returns received on the investment.

These risks are inherent in all debt instruments, though can be mitigated with diligent and active management. With more than three decades managing cash portfolios, we have the experience and expertise to manage exposures through active duration management, portfolio diversification and ongoing monitoring.

As mentioned previously, regardless of the investment – in cash products or other asset classes – investors should expect to receive an enhanced return profile when exposing themselves to a longer investment horizon and to counterparties with credit risk. These risks should not necessarily be considered detrimental – the important thing to bear in mind is that the level of expected return adequately compensates the investor for the risks. In relation to cash portfolios, these risks need to be constantly monitored with allowance made for known – and, potentially unknown – cash flow requirements. This can help ensure that adequate funds are available to meet these requirements and that no penalties are incurred that would detract from the expected return profile.

The case for cash is a personal one

The structural decision to own cash largely depends on an investor's time horizon and liquidity requirements. For example, clients with specific near-term projects planned, or other known cash flow requirements might maintain higher cash levels than superannuation funds with a young member base, or other institutional clients whose liabilities are longer term in nature.

Cyclically, the case for cash – as always – largely depends on one's views of other asset classes. The investment profile of cash is unlikely to change significantly in the foreseeable future, so allocations will primarily reflect expected returns elsewhere. In this sense, the use of cash essentially reflects investors' short-term risk appetite. With this in mind, many investors 'park' assets in cash funds during periods of expected volatility in other asset classes.

Australian monetary policy, as represented by the RBA cash rate, had been sitting at historically low levels due to significant easing that was required by the RBA required in response to the Covid-19 pandemic. On the 3rd of November 2020, the RBA lowered the cash rate to 0.10% - the lowest level it has ever been. However, beginning in Q4 2021 inflationary pressures started to emerge and over the course of 2022 these pressures have accelerated, both in Australia and offshore. Central Banks globally have responded to the challenges posed by increasing inflation by aggressively hiking interest rates. The RBA began its tightening cycle in May 2022 and since then, across seven rate hikes, has increased the cash rate in Australia from 0.10% to the level of 2.85% announced at the RBA's November 2022 meeting.

In a speech following the November rate hike, RBA Governor Philip Lowe acknowledged "The Board's base case remains that interest rates will need to go higher still to bring inflation back to target" and current market pricing is expecting the cash rate to continue to rise into 2023. Market expectations of the terminal (peak) cash rate this cycle have, however, been wound back somewhat in recent weeks, given the RBA's last two moves have been 0.25% and that communication from the RBA acknowledges that they are aware that moves in monetary policy involve times lags before taking full effect. As at the time of writing (4th of November 2022) market pricing is expecting the RBA to continue to hike rates in a gradual manner moving forward, peaking at around 4.00% in Q3 2023.

Cash funds won't shoot any lights out from a performance perspective, but their very low risk profile may provide 'sleep at night' comfort, particularly during periods of market uncertainty when capital preservation considerations are often paramount.

Generally, investors able to accurately forecast their cash flow requirements can allocate strategically to higher yielding, income style investment options. If cash flows are unlikely to impact an investment portfolio for the foreseeable future, the question becomes one of relative value for various investment options going forward. Investors' investment horizon is also critical, as it will determine the likelihood of other investment types delivering superior levels of return.

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