

# THE HIDDEN COST OF CASH: WHY PLAYING IT SAFE COULD HURT YOUR RETURNS

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We have heard the adage “Cash is king” many times before. As we look forward to another potentially tumultuous year, our instinct may be to seek the safety of cash in uncertain times. However, there are compelling arguments for embracing uncertainty and taking on some risk, so that we can benefit from higher returns.

## CASH IS A “SURE THING”

Why is cash, as an asset class, or a money market fund, as an investment vehicle, so attractive?

The theory is (mostly) sound. At the most basic level cash provides liquidity, with a money market fund generally seen as the most liquid option, allowing investors to trade in and out with relative ease. It is also often equated to being a risk-free investment, or as close to risk free as we can get. The interest rate we expect to earn on the investment can be calculated upfront with a reasonably high degree of certainty, giving us a near-guaranteed nominal return. Finally, cash is sometimes viewed as providing an opportunity to keep our “powder dry” for when attractive investments prospects arise.

## THERE IS A COST TO MISSING OUT

These widely held beliefs may not be entirely accurate. Money market funds are not risk free. The most prominent risk is inflation uncertainty – we cannot be 100% sure of our prospective real return, even if we can lock in a nominal return (by investing in a 12-month fixed deposit, for example). Despite being well regulated, money market funds are not void of credit risk, which is often under-appreciated in the South African context. In addition, there is re-investment risk, but it is easy to argue that this holds true for any investment once our target levels or returns have been achieved.

When we take a long-term view, there are additional considerations in allocating only to money market funds. We face not only the opportunity cost of foregoing higher returns, but we also lose out on the compounding of these higher returns.

## THE EROSION OF CASH RETURNS AMID A MONETARY POLICY EASING CYCLE

As part of our investment process, we incorporate the macro-economic outlook, in particular cycle analysis, to inform our asset allocation decisions. All asset classes are impacted by the economic cycle, but money-market returns are directly linked to the macro environment via the monetary policy cycle. Granted, there may be a structural element in elevated real yields available in short-term instruments in South Africa – due to a conservative, independent, and credible central bank, as well as how banks fund themselves – but we cannot ignore the cyclical aspect.

Money market investments became increasingly attractive as the Reserve Bank embarked on a hiking cycle in 2021 and even more so when inflation turned the corner in 2022. While inflation is widely expected to remain relatively well-contained in the medium term, reducing the primary risk associated with investing in a money market fund, the current easing cycle should result in lower nominal and real yields from cash.

## SOUTH AFRICA IS IN RECOVERY MODE

The South African economy is currently characterised as being “early cycle” or in the recovery phase. Contained inflation and lower policy rates bode well for potential returns from riskier asset classes, such as bonds and equities. While political risks may temper our confidence in benign macro and market outcomes, early signs suggest that despite ongoing tensions between the ANC and the DA, strong incentives on both sides will ensure the GNU survives.

This, in turn, should ensure a continued commitment to reform, with the potential for an accelerated pace. Early successes at the Department of Home Affairs, stable electricity supply, and the recovery in rail freight volumes are positive indicators. Furthermore, the Finance Ministry’s commitment to fiscal consolidation and debt sustainability is promising.

## TAKE PART IN THE UPS, WHILE LIMITING THE DOWNS

Given the run-up in SA Inc and listed property stock prices in 2024, it seems that reflation prospects are partly priced. However, there is still potential upside to returns as the asset price re-rating may continue beyond short-term drivers, such as the impetus from the two-pot withdrawals, to better reflect structurally stronger growth and a durable EPS rebound. Notwithstanding the “ifs, buts and maybes”, valuations appear sufficiently attractive to justify taking calculated risk.

Including riskier asset classes in our portfolio provides upside participation, while maintaining adequate downside protection. This approach reduces the opportunity cost of investing solely in cash, allowing us to reap the benefits of compounding over time.

There is no time like the present, and no better present than time when investing.

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