CASH in hand

The desire to keep large amounts of money in cash for long periods can be a frustrating one, as investing in alternatives to cash deposits will mean taking on much higher risks, warns Stuart Davies, a director of Private Client Services at Deloitte.

Investors wishing to hold cash as part of their portfolio, for the long-term or in large amounts, typically look for products that offer a better rate of return than that offered by straightforward cash deposits. However, the withdrawal of floating-rate loan notes from this market, following the UK's December 2004 pre-budget report, has narrowed the cash-equivalent alternatives available to investors.

Alternatives to cash deposits can be complex products, and may have a higher risk profile. Many products marketed as low-risk alternatives to cash hold other asset classes, such as bonds, certificates of deposit and asset-backed securities. In addition, a number of alternatives rely on derivatives for their incremental return.

Care should therefore be taken when considering such investments, to ensure the structure and risk are clearly understood in advance. For the interest earned on a holding to be higher than the base rate, someone somewhere is taking additional risk. This risk can be with the capital, the income or both, and should be noted when choosing a cash-equivalent product. Furthermore, this risk could manifest itself in additional professional fees, if HM Revenue & Customs undertakes a detailed review of the product, which would impact adversely on the overall returns. Other factors that need to be considered when looking at cash investment options include:

- The investment period
- The notice period
- Other assets owned
- Overall investment risk profile
- Tax status

This list is not exhaustive, but highlights the key points to consider.

Alternatives to deposit accounts

Instant-access savings accounts are often most appropriate for small sums that may be needed at short notice. Due to the low rates of interest they pay, however, these accounts are not normally the optimum vehicle for investment growth. For long-term cash holdings, there are better options available.

Cash funds

Cash funds are collective investment vehicles and the attendant risk is determined by the type and variety of assets held within the fund. The capital value of the units is determined by changes in the price of the underlying assets and income generated is also subject to fluctuation.

The underlying assets of cash funds can vary significantly, making it difficult to appreciate the exposure to risk at the outset, as it may change over time. Some funds may therefore be higher risk than the investor would normally be prepared to accept. Proper research is vital.

Life assurance bonds

Life assurance bonds are non-qualifying whole-of-life policies which can invest in cash funds offered by life companies. Due to the unique tax treatment of life assurance company products, they can provide the opportunity to achieve better returns than deposit accounts for medium- or long-term cash holdings.

Structured products

Structured products come in many forms, often with complex tax structures. Institutions offering these products are able to offer more competitive rates of return, sometimes taxed as capital gains rather than income, but often with an increased risk exposure.

Before investing in any products promoted as an alternative to cash, it is vital to understand the structure, how advertised returns will be achieved, the tax treatment and the level of risk to which capital will be exposed. □

Author

Stuart Davies is a director in the London office of Private Client Services at Deloitte. He has 18 years of experience in financial planning, and advises wealthy clients on the design, implementation and management of investment portfolios. His clients include wealthy individuals and families, trusts, charitable organisations and companies, both in the UK and overseas.