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Elston Insights

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Cash vs Equities: a question of time

- Cash can now earn up to 5% interest
- But inflation undermines real returns
- Over most time periods, equities outperform

Cash is earning up to 5% interest – shouldn't it be allocated to?

Inflation has gathered pace since early 2022 prompting central banks to pivot on interest rates which had sat close to – or even below – zero in the years after the financial crisis. Ratcheting upwards in quarter point, half point and even three quarter point increments over the past year and more, benchmark rates in both the US and the UK now stand at or around 5%. While bad news for borrowers on variable terms, it is a welcome shot in the arm for savers and begs the question why not hold cash risk-free and simply collect the interest?

Cash returns versus inflation

While increasing numbers of investors are rethinking the role of cash in their wider portfolio, it is worth pointing back to the reason that interest rates have risen in the first place, namely inflation. The best deal in the market may offer interest on cash at or close to the benchmark rate of 5% but if you are UK-based, inflation is running at well over 8% meaning that the real return on cash is negative. And negative returns means losses. So what becomes pertinent is the consideration of time horizon. For investors with extremely short-term horizons ie, 3 months or less, there is merit to holding cash for practical purposes as much as any. But for anything longer, historical evidence suggests that equities will always outperform.

Equities can give investors a bumpy ride

While long-term data strongly suggest that equities are more likely to beat inflation than other assets, what illustrations often don't show is the volatility endured along the way. In approximately half of the past 50 years, stock markets have fallen 10% or more and in a quarter of the past 50 years, the market has fallen by 20% or more. Returns are consistent over the longer-term, but for short-term investors, there is inherent risk attached.

Stocks vs cash – it's all about timeframe

If we look back at the past 5, 10 and 20 years, savings held in cash have failed to keep up with the rate of inflation. By contrast, for every 20-year period since the earliest days of stock market investing in 1926, equities have delivered real returns ie, returns that outpace inflation. While having a cash balance on any portfolio constitutes good management from a liquidity and a hedging point of view, allocating in earnest for any period over three months is likely to leave investors out of pocket when compared with the returns that can be earned on equities. Cash has been so unattractive in the ultra-low interest rate area that followed the financial crisis that it is understandable that when rising interest rates mean that it starts showing signs of life as an asset class, investors' interest is duly piqued. However a close look under the bonnet confirms that equities still provide better real returns over pretty much all periods over three months, hence careful consideration of timeframe is required.

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