Equity Research; Cash ISA's; we give a thumbs down!

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Key Risks to Price Target

Not applicable

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Over 2021 inflation returned. But central bankers talked about inflation as only transitory, hence justifying their nonchalance. This 'buying time' approach has limitations, if inflation persists, it will badly damage policy credibility and nominal interest rates will have to rise sharply to catch up.

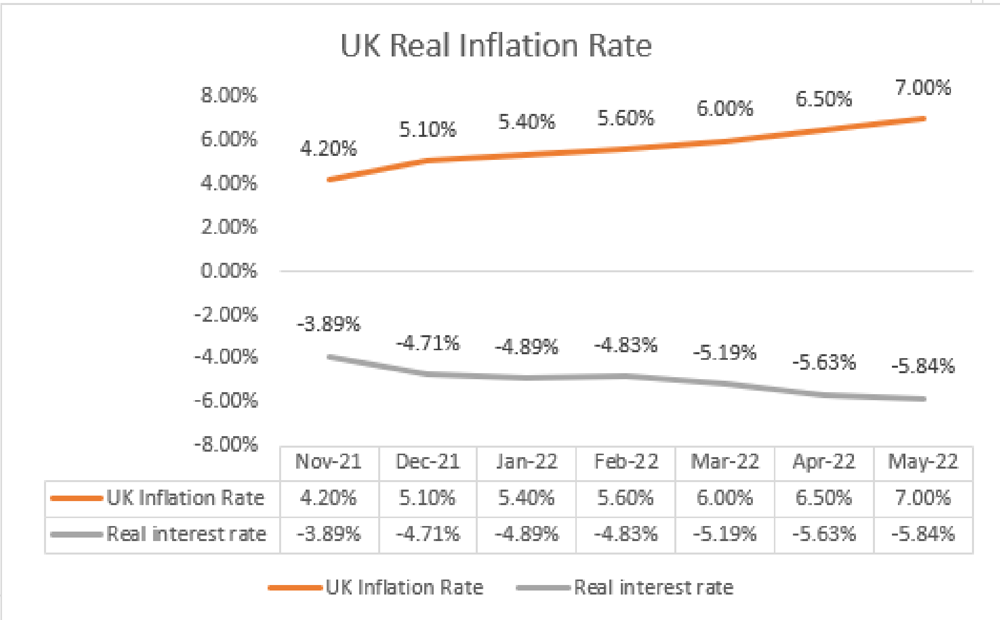
There is c. £1.75trn of UK consumer debt and £2.22trn of UK government debt and with UK debt/ GDP of 104%, it is understandable that central bankers are weary of risking a financial crisis by sharply increasing debt service costs.

But feet dragging on inflation has inherent costs. Rising UK inflation rates means far more rapid depreciation of the real value of cash deposits typically held in cash ISA accounts and money market cash deposits.

The last time UK inflation rose to near current levels, in 1990, UK base rates were raised to 15% to combat UK inflation at 9%. Back then the UK government and Bank of England decided a real interest rate of 6% was needed to cut inflation. It took until February 1994 for rates to fall to 5.25%.

As UK inflation rises, the purchasing power value of cash will reduce at present by 5.4% by the end of the year. The *real interest rate* adjusts for the expected money market returns on the cash. In the chart below we have assumed UK inflation rises from the current 5.4% to 7% by May which prices in the expected 50% jump in energy bills that Ofgem have flagged will occur owing to the catch-up movement in the energy price cap.

We have also priced in a rise to 0.75% in the UK bank base rate by May 2022.



	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22
UK Inflation Rate	4.20%	5.10%	5.40%	5.60%	6.00%	6.50%	7.00%
Real interest rate	-3.89%	-4.71%	-4.89%	-4.83%	-5.19%	-5.63%	-5.84%

source: CSS Investments Ltd

The chart above clarifies that a cash deposit is depreciating in real terms at a rapid rate of around 5.8% p.a. There is a *negative real interest rate* meaning the after adjusting for interest rates, a cash deposit is losing value.

Banks have not passed on the 0.15% rise in the Base rate on the 16th December 2021 to depositors. Are they obliged to pass on further rate hikes? Well, that is a moot point. Legally, they are not compelled to. In the short term they should pass on some of the expected rate hikes to depositors, depending on the tenure of those deposits. For example, a fixed deposit held on a 6 or 12 month fixed term would not get any interest change benefits.

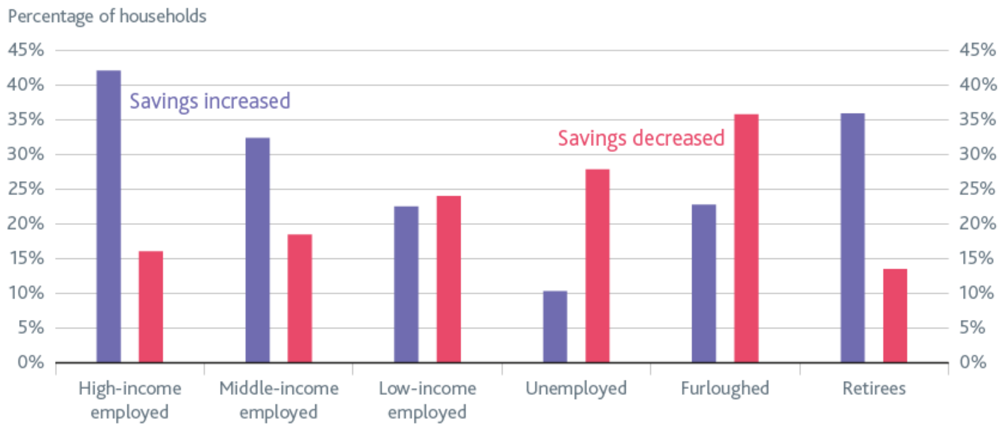
Cash ISAs and other money market funds are poor value in this context

Cash ISAs benefit from interest income that is paid free of income tax as opposed to a deposit account where interest income above £1,000 p.a. is declarable and taxable. A cash ISA is to be preferred to a bank cash deposit.

Notwithstanding the tax advantages, the very low nominal and negative real returns on cash ISA's leave investors very much worse off, the longer this current period of high inflation lasts.

A word on Child Trust Funds launched by the Blair government in 2005. According to HMRC there are over 6.1m CTF accounts in existence with an average value of c. £1,500- £1,700. The early CTFs are maturing now providing young people with a £9.7bn cash boost and an exit route out of low yield cash accounts.

The C-19 pandemic led to consumers holding more cash, given the lack of visibility over jobs, the use of of 'mortgage holidays', lower transport costs, lower leisure / travel costs, and more frugal financial behaviour. Net UK household spending over the pandemic dropped £80.5bn. According to Bank of England data as of May 2021 around £125bn of 'excess' savings had been accumulated, an amount 5 times greater than the previous max savings accumulation of £25bn over the 2012-2019 period.



Source: NMG Household Survey H2 2020 and Bank of England calculations.

The fact remains there is considerable consumer liquidity that is trapped in the financial system on negative real rates of return.

Given this quantity of surplus UK cash, it is hardly surprising to note various speculative manias, including the 'crypto-currency' boom. However for those wanting more orthodox options, away from low yielding cash accounts and cash ISAs we have presented a list of options below:-

a) Paying off credit cards, personal loans and high interest debt
b) Paying off / reducing the mortgage
c) Investing in a Stocks & Shares ISA
d) Investing in a SIPP or topping up workplace pension assets
e) Property purchase/ property refurbishment
f) Alternative assets such as vintage cars, wines, art, gold etc

Clearly a) and b) are good low risk options that will immediately improve the individual's financial profile and reduce expenses. Significant debt reduction is achievable during low interest rate periods that is a lot harder when interest rates rise. Options e) and f) are long term potentially viable options but ones that reduce liquidity significantly and increase expenses. In recent years, changing tax treatment of second homes has badly damaged the profitability of e) and led to tax headaches – a situation in which owners face a high effective tax rate on property and are locked in, due to the high capital gains tax on sale.

Option d) is certainly a very good approach early in one's working life and offers significant tax benefits worth up to £3,600 p.a.

What about Stocks & Shares ISAs?

If we focus on c) Stocks & Shares ISA as offering a middle approach, i.e. entailing some risk of capital loss and variable 'market returns' alongside a tax free income, our view remains, that subject affordability and suitability, the best advice is to make use of the annual £20k ISA allowance in favour of adding to financial assets.

An annual ISA allocation to the broad equity market will over a number of years provide cumulative income and capital appreciation as well as a liquidity option if necessary.

What evidence is there to support this? Since ISAs were launched there has been a steadily increasing phenomenon of ISA millionaires. HMRC reported on the 19th January 2022 that the UK has over 2,000 ISA millionaires with an average ISA of £1.41m, and there were 60 ISA millionaires with ISAs worth more than £3m. These ISA millionaire accounts were holding shares ISAs.

An ISA worth north of £1m takes at least 20 years, possibly 25 years to accumulate and requires patience, steady nerves, and devotion to the commitment of making that annual investment. Those things the ISA holder can control. Good investment decision making is also important and possibly a bit of luck as well.

Collins Sarri Statham can set up ISAs and advise you on your investments accordingly.

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