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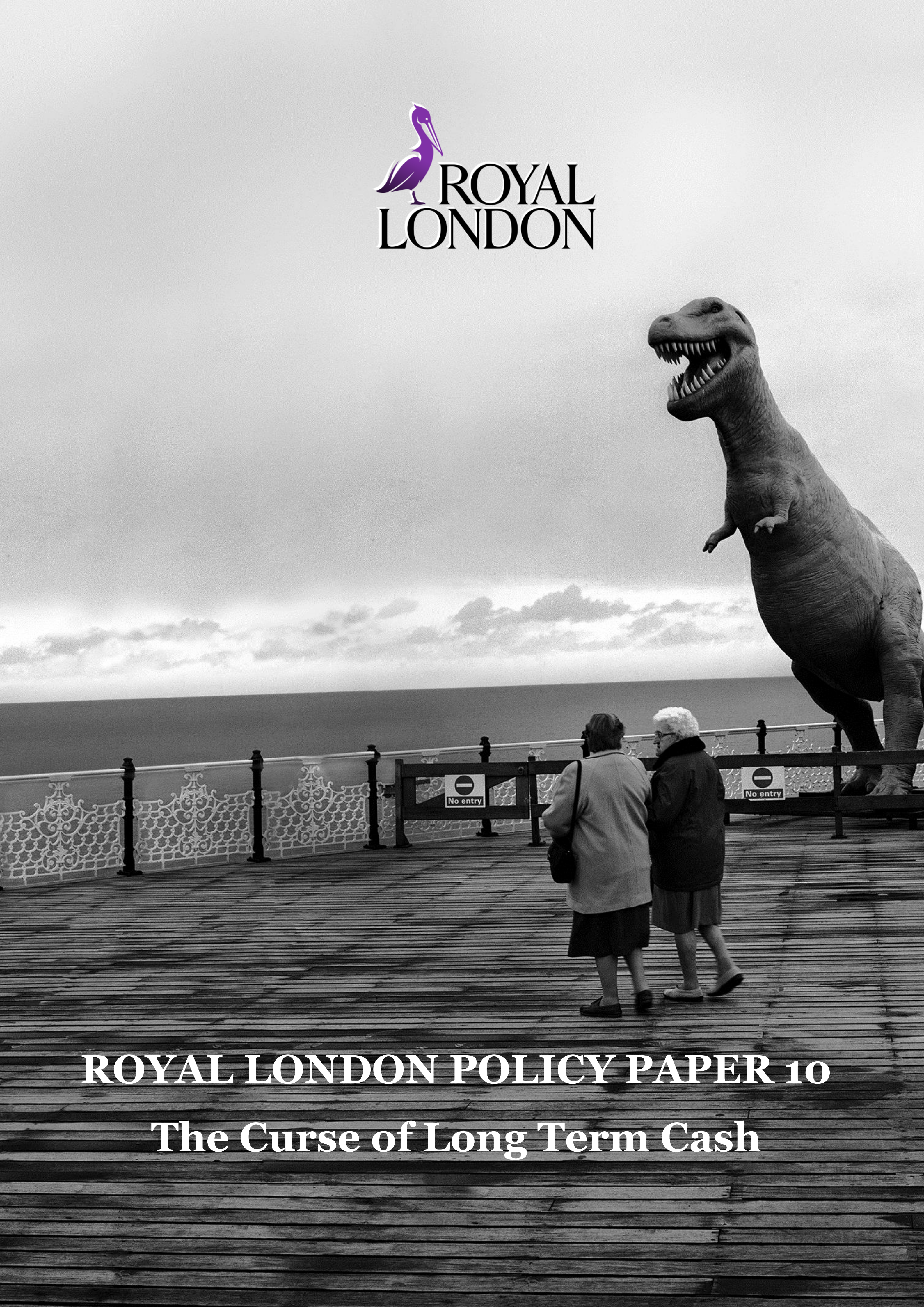


# ROYAL LONDON POLICY PAPER 10

## The Curse of Long Term Cash

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# THE CURSE OF LONG TERM CASH

## Executive Summary

The desire to hold wealth in the form of cash – such as bank accounts or Cash ISAs (Individual Savings Accounts) – is entirely understandable. Ready cash provides a buffer against unexpected expenditures, and at a time of market turbulence, holding wealth in cash can provide a measure of stability.

But when cash holdings turn from a short term buffer to a long term investment, the alarm bells should start ringing. Interest rates on cash deposits slumped to record low levels after the financial crisis and fell again after the UK's vote to leave the EU. As a result, when viewed over a ten year period, cash has not even achieved the very basic objective of keeping pace with inflation. By contrast, money invested across a wide range of asset classes – multi asset investment – has beaten inflation and outperformed cash by a wide margin.

**£1000 put into a deposit account 10 years ago would be worth less than £900 in today's money. £1000 put into a simple multi asset fund would have been worth more than £1500 in today's money.**

If cash investing was a small part of individuals' long term saving, then this might not be a major concern. But in reality large numbers of people hold a significant part of their long term wealth (outside pensions and housing) in bank accounts and Cash ISAs. With the advent of the Lifetime ISA, due to be introduced in April 2017, the use of cash as a long term investment vehicle is likely to expand.

In 2015/16 nearly three quarters of the £80 billion invested in adult ISAs went into Cash ISAs, and more than ten million Cash ISAs have received contributions in each of the last ten years. It is clear that these accounts are not being used purely as short term repositories for emergency cash, but are a key part of individuals' longer-term savings strategy.

The result of this behaviour is that millions of people are suffering negative real returns on their savings instead of the positive real returns they would have experienced through multi asset investment. With aggregate savings at low levels, making sure people get a good return on those savings becomes all the more important.

Furthermore, the problem seems set to get worse. The weakness of the pound since the referendum is helping to trigger a sharp rise in inflation. At the same time, the public policy response to the UK vote on Brexit means that interest rates are likely to remain 'lower for longer'. This means that money held in the apparently 'safe haven' of cash will continue to erode in terms of its real value, potentially at an accelerating rate.

Auto-enrolment is resulting in a significant increase in the number of people putting money into a pension and this money is often invested using a long term multi asset approach by default, not just in cash, which makes sense given our analysis. However, government policy is also encouraging an increase in the use of ISAs for long term investment by way of continual reductions in pension allowances and increases in the amount that can be saved in an ISA. This nudges people in the direction of a savings vehicle that forces the choice of investment onto the savers themselves. Too much of this money is finding its way into cash.

While a multi asset fund spreading exposure across equities, bonds and property can suffer from greater day to day or year to year fluctuations; these asset classes have historically offered higher returns than cash and are more appropriate for long term investment.

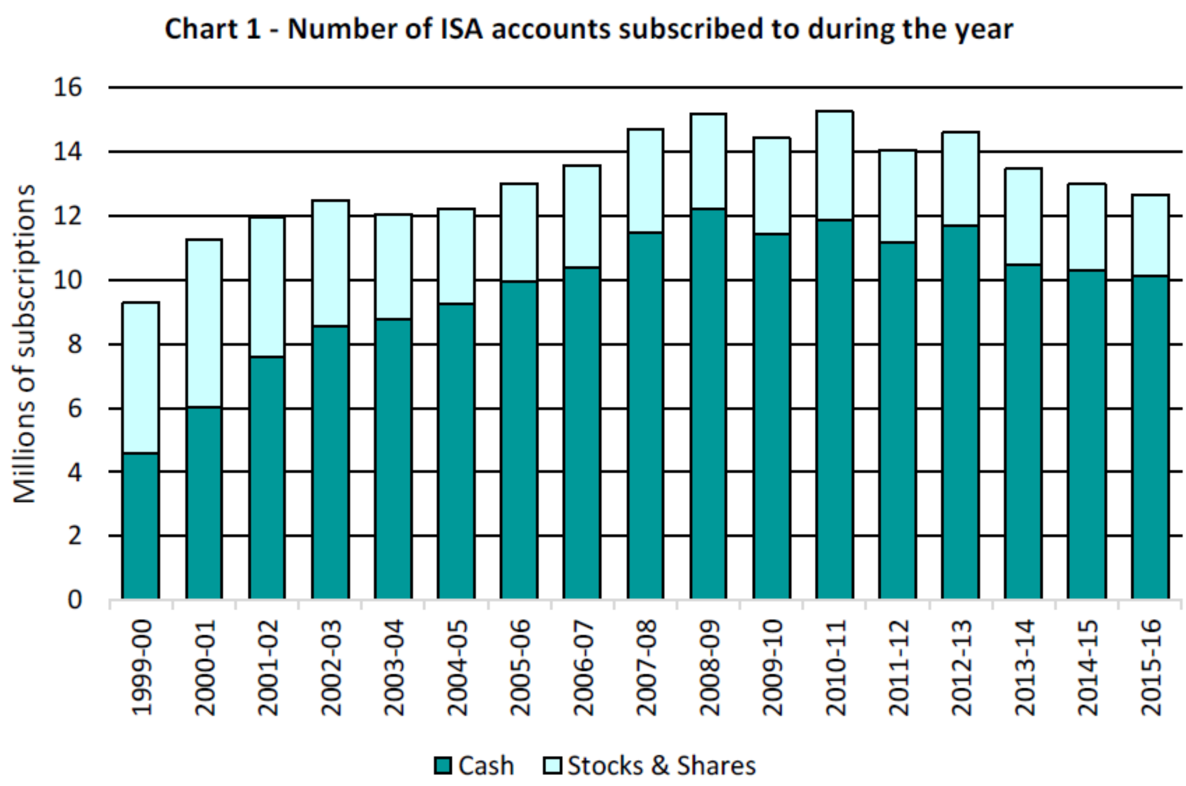
More needs to be done to wean individuals off the habit of using Cash ISAs as a long term savings vehicle. Otherwise, many more people will find later in life that their savings have shrunk in real terms and that the money runs out sooner than they expect. Long term savings require a long term investing approach, in a pension fund or multi asset ISA, in order to avoid suffering the curse of cash year after year.

**Royal London estimates that investors in Cash ISAs have missed out on more than £100 billion in tax free gains they could have made over the last ten years by investing in a multi asset fund.**

## 1. The popularity of Cash ISAs

The most popular vehicle for short term saving is the cash Individual Savings Account (ISA). The ISA was introduced in 1999 and has been repeatedly reformed since then, but the basic idea is that contributions into an ISA are made out of taxed income but investment growth or interest earned in the ISA and subsequent withdrawals are tax free. Whilst there are various different types of ISA (Cash ISA, Stocks & Shares ISA, Junior ISA, Innovative Finance ISA etc.), the Cash ISA is by far the most popular.

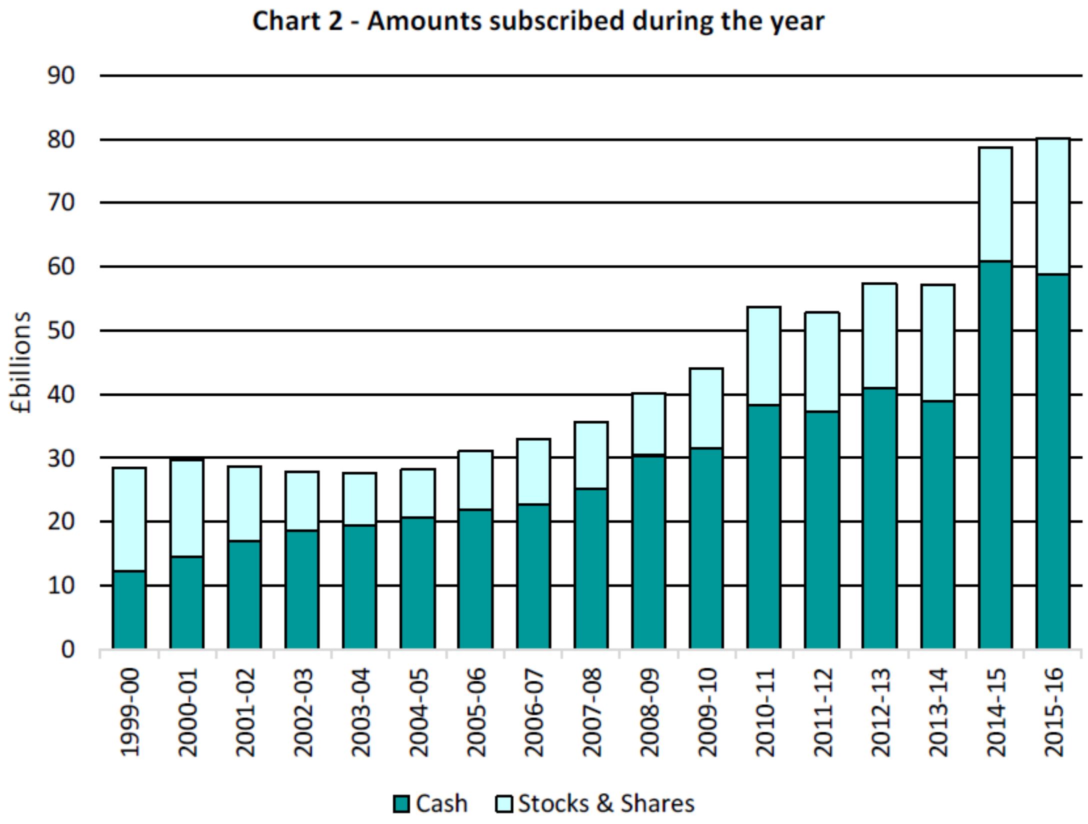
Chart 1 shows the number of Cash ISAs and Stocks & Shares ISAs which have been opened in each year since 1999.




*Source: HMRC Individual Savings Account Statistics, August 2016*

As Chart 1 shows, since 2000/01, the majority of ISA accounts in each year into which subscriptions were made have been Cash ISAs, with more than 10 million cash accounts subscribed to in each of the last ten years.

Although average amounts going in to Stocks & Shares ISAs tend to be larger than for Cash ISAs, most of money going into ISAs goes into cash, as shown in Chart 2. In 2015/16 of around £80 billion subscribed to adult ISAs, nearly three quarters went into Cash ISAs.




*Source: HMRC Individual Savings Account Statistics, August 2016*

## 2. ISAs and other savings vehicles

As well as saving through a Cash ISA, many individuals will, of course, be saving through other routes. This could include building up housing equity through home ownership and saving through a workplace pension, particularly with the advent of the 'automatic enrolment' policy.

However, a number of features of the policy landscape are encouraging even long term investors to put their money into short term vehicles such as Cash ISAs.

a) Limits on pension saving v. limits on ISA saving

The direction of policy on tax-privileged savings over the last decade and more has shown a very clear direction of travel away from long term vehicles such as pensions where funds cannot be accessed before retirement age and towards instant access vehicles such as ISAs which encourage a shorter term approach.

Table 1 shows the annual limits on contributions into ISAs up to the present year, whilst Table 2 shows the annual and lifetime limits on pensions.

**Table 1 – Adult ISA Subscription Limits**

| Tax year starting 6th April | Overall Subscription Limit | Cash ISA Limit |
|---|---|---|
| 1999-00 | £7,000 | £3,000 |
| 2000-01 | £7,000 | £3,000 |
| 2001-02 | £7,000 | £3,000 |
| 2002-03 | £7,000 | £3,000 |
| 2003-04 | £7,000 | £3,000 |
| 2004-05 | £7,000 | £3,000 |
| 2005-06 | £7,000 | £3,000 |
| 2006-07 | £7,000 | £3,000 |
| 2007-08 | £7,000 | £3,000 |
| 2008-09 | £7,200 | £3,600 |
| 2009-10 | £7,200[a]/£10,200[b] | £3,600[a]/£5,100[b] |
| 2010-11 | £10,200 | £5,100 |
| 2011-12 | £10,680 | £5,340 |
| 2012-13 | £11,280 | £5,640 |
| 2013-14 | £11,520 | £5,760 |
| 2014-15 | £11,880[c]/£15,000[d] | £5,940[c]/£15,000[d] |
| 2015-16 | £15,240 | £15,240 |
| 2016-17 | £15,240 | £15,240 |

[a] Applicable to those aged under 50.

[b] Applicable to those aged 50 and over from 6th October 2009.

[c] Limits until 30th June 2014

[d] The cash and overall subscription limits were raised to £15,000 from 1st July 2014 with the introduction of the New ISA (NISA).

*Source: HMRC Individual Savings Account Statistics, August 2016*

**Table 2: Lifetime and Annual Allowance limits for pension tax relief since 2006/07**

| Year | Lifetime Allowance | Annual Allowance |
|---|---|---|
| 2006/07 | £1,500,000 | £215,000 |
| 2007/08 | £1,600,000 | £225,000 |
| 2008/09 | £1,650,000 | £235,000 |
| 2009/10 | £1,750,000 | £245,000 |
| 2010/11 | £1,800,000 | £255,000 |
| 2011/12 | £1,800,000 | £50,000 |
| 2012/13 | £1,500,000 | £50,000 |
| 2013/14 | £1,500,000 | £50,000 |
| 2014/15 | £1,250,000 | £40,000 |
| 2015/16 | £1,250,000 | £40,000 |
| 2016/17 | £1,000,000 | £40,000[a] |

[a] *Annual allowance is tapered down to a floor of £10,000 for higher earners from 2016/17*

*Source: 'Royal London Policy Paper 8: Time to stop the salami slicing of pension tax relief'*

Tables 1 and 2 show an unmistakeable trend. The total amount which can be contributed into an ISA has more than doubled since ISAs were created in 1999, whilst the amount that can be invested wholly in cash has risen five-fold. The limits for 2017/18 have already been announced and will allow a total of £20,000 per year to be invested in ISAs, representing a further major signal from government that it favours this savings vehicle.

By contrast, the limits on tax-privileged savings into pensions have suffered repeated 'salami slicing' in the last decade. The lifetime allowance has been cut every other year since 2010, whilst the annual limit on contributions has been dramatically cut, particularly for higher earners.

We are not suggesting that individuals are rejecting pension saving *en masse* in favour of Cash ISAs, and certainly individuals who can benefit from an employer contribution into a workplace pension would still be strongly advised to adopt a 'pension first' strategy. But the direction of travel of public policy is clear, with long term more diversified forms of saving becoming less tax-privileged whilst more easily-accessed forms of saving where cash tends to be dominant are becoming more privileged.

The Government is, of course, entirely at liberty to restrict tax privileges as a means of improving its overall fiscal position, and is equally at liberty to tilt tax incentives in favour of some forms of saving over others. But if the result of this is more saving going into vehicles where cash is dominant and away from longer-term investment vehicles invested in a more diversified range of assets then, as we shall see in a moment, this could have serious consequences for the returns which savers will achieve.

b) Moving money out of pension saving into cash

The introduction of 'Freedom and Choice' in pensions in April 2015 represented a major liberalisation of the long term savings market. Prior to the reforms, individuals with modest amounts of saving held in a Defined Contribution pension had little alternative when they came to retire to converting that pension pot into an income for life via an annuity. But from April 2015 individuals were allowed to access their pension pot from the age of 55. If they wished, they could withdraw the whole value of their pension saving, subject only to paying income tax on any withdrawals beyond any tax free lump sum.

Whilst research suggests that many people have used their pension pots wisely to pay down debt or to go on investing for the long term through drawdown arrangements, a worrying minority appear to have surrendered their pensions and are now holding a large part of their former pension wealth in cash. For example, Citizens Advice research found that 29% of those accessing pension freedoms have transferred their pension pot into a bank account, with this proportion rising to 32% for those with pots over £100,000. If these figures are representative, it would seem that holding balances in cash is clearly not just the preserve of those with small pension pots.

c) The Lifetime ISA

A further step in public policy which is likely to lead to more money being held for long periods in cash is the creation of the Lifetime ISA (LISA) in 2017. This is a product designed specifically for the under 40s, first to enable them to save (with government support) towards the deposit on a first house, and then to build up a fund for retirement.

The LISA is a strange hybrid between the previous 'help to buy' ISA designed to support first-time buyers and the personal pension. The problem is that whereas saving for a deposit might be thought to be a short to medium term investment, saving over a 'lifetime' for retirement is surely a long term proposition. It is hard to believe that the optimal investment strategy for these two goals is the same.

We know that younger people are disproportionately likely to opt for cash ISAs over Stocks & Shares ISAs and the risk is that once the house deposit has been secured they will continue in the same investment vehicle for the long term. As we see in the next section, investing in cash for the long term could be very damaging to the long term prospects of this group.

## 3. The Curse of Long Term Cash

In any given year, different sorts of investments will deliver different rates of return. It is unwise to infer too much from a single year of data. But over time there are certain recurrent patterns which can be instructive. Chart 3 therefore presents data on the rate of return from each of seven different asset classes in each of the last ten years as well as an overall return from an illustrative 'multi asset' portfolio invested in a broad range of assets.

**Chart 3: Sterling-based annual returns from major asset classes 2007-2016**

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | EM Stocks +37.4% | Gilts +12.8% | EM Stocks +62.5% | EM Stocks +23.6% | Gilts +15.6% | EM Stocks +12.8% | Global Stocks +21.2% | Property +19.5% | Property +13.9% | EM Stocks +35.4% |
| 2 | Commodities +14.3% | Cash +5.7% | UK Stocks +30.1% | Commodities +20.5% | Property +8.1% | UK Stocks +12.3% | UK Stocks +20.8% | Gilts +13.9% | Global Stocks +4.4% | Commodities +33.3% |
| 3 | Global Stocks +11.2% | Inflation (RPI) +4.0% | Global Stocks +20.6% | Global Stocks +17.2% | Inflation (RPI) +5.2% | Global Stocks +12.1% | Property +11.0% | Global Stocks +12.2% | Multi Asset +1.8% | Global Stocks +30.3% |
| 4 | Cash +6.0% | Multi Asset -10.4% | Multi Asset +12.6% | Property +14.7% | Multi Asset +1.6% | Multi Asset +7.1% | Multi Asset +7.3% | EM Stocks +7.9% | UK Stocks +1.0% | UK Stocks +16.8% |
| 5 | Multi Asset +5.5% | Commodities -10.9% | Commodities +5.9% | UK Stocks +14.5% | Cash +0.6% | Inflation (RPI) +3.2% | Inflation (RPI) +3.0% | Multi Asset +6.5% | Inflation (RPI) +1.0% | Multi Asset +12.1% |
| 6 | UK Stocks +5.3% | Global Stocks -18.5% | Property +1.9% | Multi Asset +11.7% | UK Stocks -3.5% | Gilts +2.7% | Cash +0.5% | Inflation (RPI) +2.4% | Gilts +0.6% | Gilts +10.1% |
| 7 | Gilts +5.3% | Property -22.6% | Cash +1.0% | Gilts +7.2% | Global Stocks -6.9% | Property +2.3% | Gilts -3.9% | UK Stocks +1.2% | Cash +0.5% | Property +2.6% |
| 8 | Inflation (RPI) +4.3% | UK Stocks -29.9% | Inflation (RPI) -0.5% | Inflation (RPI) +4.6% | Commodities -12.7% | Cash +0.6% | EM Stocks -5.3% | Cash +0.5% | EM Stocks -10.3% | Inflation (RPI) +1.8% |
| 9 | Property -5.4% | EM Stocks -34.8% | Gilts -1.2% | Cash +0.6% | EM Stocks -18.4% | Commodities -5.4% | Commodities -11.2% | Commodities -11.8% | Commodities -20.3% | Cash +0.4% |

*Source: Royal London, as of January 2017. Each asset class is represented by standard indices sourced from DataStream. Multi Asset returns are based on the benchmark returns of Royal London Global Multi Asset Portfolio (GMAP) Balanced Fund.*

Looking first at 2016 it is clear that returns on cash were the worst of any of the asset classes under consideration. Whilst most asset classes delivered double digit returns (with the other exception of commercial property), cash delivered just 0.4%. Whilst this in part reflects the particular and extraordinary circumstances of 2016, it is clear that low absolute returns from cash are not a new phenomenon. In each year back to 2010, cash has returned less than 1%, consistently below the prevailing level of inflation. This means that wealth held in cash will have declined in real value, year on year.

There is no reason to think that returns on cash are likely to improve any time soon – indeed, a combination of rising inflation and long term low interest rates are if anything likely to make matters worse.

It is instructive to look at the other assets classes in Chart 3. Over the last decade the position of different types of assets has varied considerably. For example, commodities were the worst performers from 2012-2015 inclusive, but were also the second best performers in three of the years in the chart and they did very well in 2016. Conversely, emerging market stocks topped the table five times but were bottom of the league in twice.

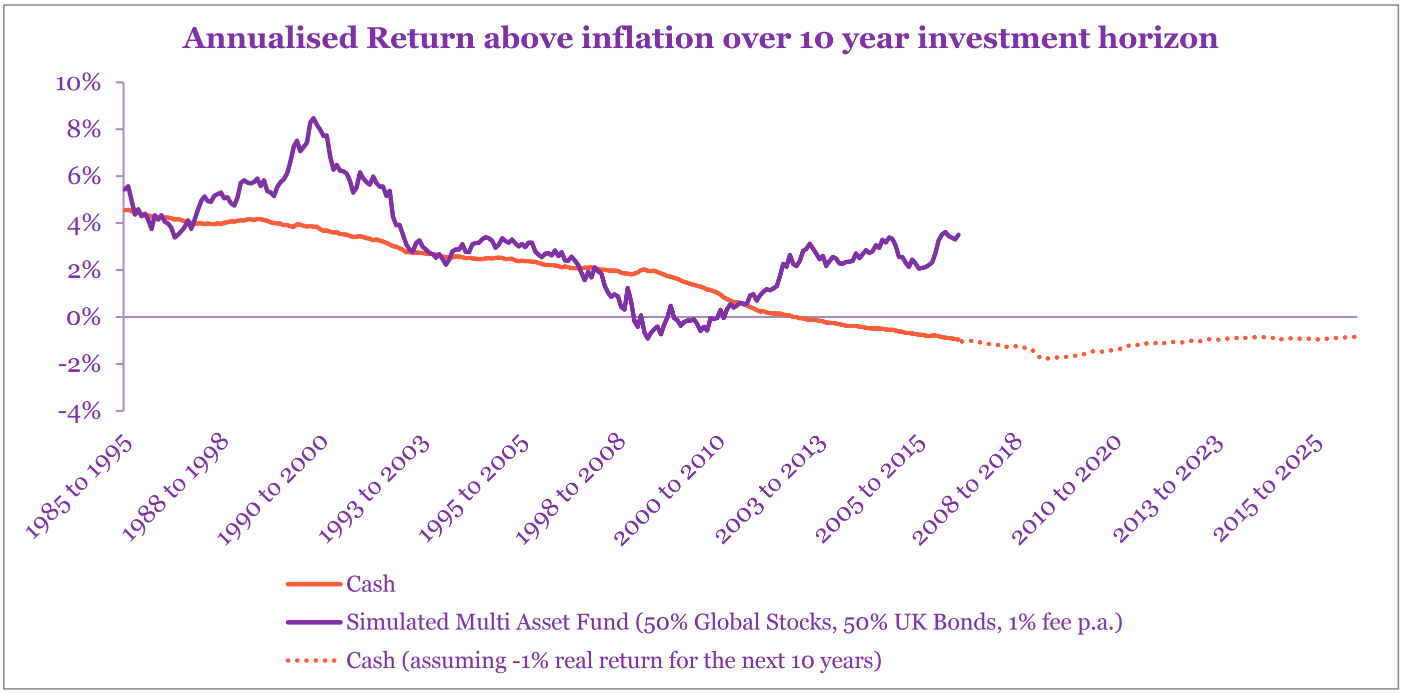
Chart 3 shows that there are good returns to be found in a range of different assets, and in most years these returns are far greater than those available from holding cash, but investing in just one asset class may cause unacceptable levels of uncertainty. For this reason, the chart also shows the performance of an investment in a basket of different asset classes. Whilst this never achieves the peaks of performance of the best preforming assets it also avoids the troughs when particular assets are doing badly. The multi asset approach, a commonplace way pension funds are invested, takes more risk than simply keeping money in cash but also generates more return over the long term, as would be expected. Crucially, a multi asset approach beats cash in every year since the financial crash of 2008.

Looking at the last ten years as a whole, the difference between long term investments held in cash and those invested across a range of asset classes is very significant. Over last 10 years cash hasn't even kept pace with inflation whereas investment in a simple multi asset fund would have comfortably beaten inflation. Specifically, £1000 put into a deposit account 10 years ago would be worth less than £900 in today's money, whilst £1000 put into a simple multi asset fund would have been worth more than £1500 in today's money.

Looking ahead, whilst we do not know with certainty what will happen to investment returns in the future, it is possible to look at market interest rates today for cash investments into the medium term. On this basis we can say that financial markets are assuming that £1000 in a deposit account over the next 10 years is expected to be worth just over £900 in current prices at the end of the period the period – so it looks like the bad news is set to continue.

This poor outlook is shown clearly in Chart 4 which shows the historic real rates of return over a rolling ten year period for cash and for a simple multi asset fund and also shows the projected real return on cash based on current market expectations about interest rates and inflation.

**Chart 4: Annual real returns from cash and multi asset investments over rolling ten year period and projected returns for cash based on market expectations**




*Source: Royal London, DataStream as of January 2017. Multi Asset fund returns are simulated based on a fund invested 50% into global stocks, 50% into bonds with 1% fee p.a.*

As Chart 4 indicates, not only have real returns on cash been in long term decline, but this situation is expected to remain poor with real returns turning negative from the 2002-2012 decade onwards. This is in marked contrast to returns on a simple multi asset fund which has substantially beaten inflation in most ten year periods since the mid-1980s.

With high levels and rising levels of UK public sector debt there is little incentive for policy makers to see interest rates rise (thereby increasing the cost of debt servicing). As long as interest rates are below the rate of inflation there is, in effect, a subsidy flowing from savers to borrowers, the government included.

Thinking about it another way, the Bank of England is unlikely to raise interest rates as much as they would have in the past given high levels of consumer debt and what is a particularly uncertain outlook for the economy, even if sterling weakness since the referendum causes the cost of living to rise. If the impact of the Brexit vote is a combination of higher-than-expected inflation and lower-than-expected interest rates then the decline in real returns on cash is likely to be even more severe than in the past.

If we specifically compare investment in a Cash ISA with investment in a multi asset fund we get a sense of the real terms losses which individual savers have faced in the last decade if they have used Cash ISAs as a long term savings vehicle and which they remain exposed to. We analysed government data on ISAs and estimate that funds accumulated in Cash ISAs have in aggregate lost over 9% of their purchasing power over the last 10 years. In a multi asset fund we estimate the same investments would have increased their purchasing power by more than 30%.

More detail of these calculations is shown in Tables 3a and 3b. The left hand panels in both tables show the aggregate amount held in Cash ISAs at the start of each tax year, new subscriptions and estimated withdrawals to give the next year's holding, taking an estimate of interest earned over the year into account. This gives an accumulated value of £251bn as of April 2016.

The right hand panel in Table 3a shows what the accumulated value would have been if the ISAs had kept pace with inflation, ending with an accumulated value of £277bn. Our analysis suggests that savers in Cash ISAs have seen inflation wipe off the equivalent of £26bn of purchasing power over the last decade.

## Table 3a: Cash ISAs compared with an investment keeping pace with inflation

| | Cash ISA example, earning interest on cash | | | | | Equivalent amount invested to exactly keep pace with inflation | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Tax Year | Holding at the start of tax year | Amounts Subscribed | Market Value after interest on Cash | Implied Withdrawal | Holding at the end of tax year | Holding at the start of tax year | Amounts Subscribed | Market Value if kept up with inflation | Implied Withdrawal | Holding at the end of tax year |
| 2006/07 | 107,571 | 22,677 | 136,195 | - 12,250 | 123,945 | 107,571 | 22,677 | 135,980 | - 12,250 | 123,730 |
| 2007/08 | 123,945 | 25,261 | 157,486 | - 18,392 | 139,094 | 123,730 | 25,261 | 154,128 | - 18,392 | 135,736 |
| 2008/09 | 139,094 | 30,383 | 176,651 | - 18,404 | 158,247 | 135,736 | 30,383 | 165,550 | - 18,404 | 147,145 |
| 2009/10 | 158,247 | 31,437 | 190,792 | - 18,462 | 172,330 | 147,145 | 31,437 | 185,828 | - 18,462 | 167,366 |
| 2010/11 | 172,330 | 38,197 | 211,624 | - 11,262 | 200,362 | 167,366 | 38,197 | 215,532 | - 11,262 | 204,270 |
| 2011/12 | 200,362 | 37,222 | 239,079 | - 40,192 | 198,887 | 204,270 | 37,222 | 249,449 | - 40,192 | 209,256 |
| 2012/13 | 198,887 | 40,901 | 241,040 | - 20,476 | 220,564 | 209,256 | 40,901 | 257,694 | - 20,476 | 237,217 |
| 2013/14 | 220,564 | 38,821 | 260,569 | - 32,110 | 228,459 | 237,217 | 38,821 | 282,333 | - 32,110 | 250,222 |
| 2014/15 | 228,459 | 60,951 | 290,702 | - 53,277 | 237,425 | 250,222 | 60,951 | 313,707 | - 53,277 | 260,430 |
| 2015/16 | 237,425 | 58,785 | 297,569 | - 46,925 | 250,644 | 260,430 | 58,785 | 323,724 | - 46,925 | 276,799 |
| | | | Change of Purchasing Power (£ million) | | - 26,155 | | | | | |
| | | | Change of Purchasing Power (%) | | -9.4% | | | | | |

## Table 3b: Cash ISAs compared with an investment in a simulated multi asset fund

| | Cash ISA example, earning interest on cash | | | | | Equivalent amount invested in a simple multi asset fund | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Tax Year | Holding at the start of tax year | Amounts Subscribed | Market Value after interest on Cash | Implied Withdrawal | Holding at the end of tax year | Holding at the start of tax year | Amounts Subscribed | Market Value after investment return | Implied Withdrawal | Holding at the end of tax year |
| 2006/07 | 107,571 | 22,677 | 136,195 | - 12,250 | 123,945 | 107,571 | 22,677 | 130,931 | - 12,250 | 118,681 |
| 2007/08 | 123,945 | 25,261 | 157,486 | - 18,392 | 139,094 | 118,681 | 25,261 | 145,048 | - 18,392 | 126,656 |
| 2008/09 | 139,094 | 30,383 | 176,651 | - 18,404 | 158,247 | 126,656 | 30,383 | 148,419 | - 18,404 | 130,015 |
| 2009/10 | 158,247 | 31,437 | 190,792 | - 18,462 | 172,330 | 130,015 | 31,437 | 191,119 | - 18,462 | 172,657 |
| 2010/11 | 172,330 | 38,197 | 211,624 | - 11,262 | 200,362 | 172,657 | 38,197 | 222,158 | - 11,262 | 210,895 |
| 2011/12 | 200,362 | 37,222 | 239,079 | - 40,192 | 198,887 | 210,895 | 37,222 | 265,622 | - 40,192 | 225,430 |
| 2012/13 | 198,887 | 40,901 | 241,040 | - 20,476 | 220,564 | 225,430 | 40,901 | 293,109 | - 20,476 | 272,632 |
| 2013/14 | 220,564 | 38,821 | 260,569 | - 32,110 | 228,459 | 272,632 | 38,821 | 317,800 | - 32,110 | 285,690 |
| 2014/15 | 228,459 | 60,951 | 290,702 | - 53,277 | 237,425 | 285,690 | 60,951 | 398,189 | - 53,277 | 344,913 |
| 2015/16 | 237,425 | 58,785 | 297,569 | - 46,925 | 250,644 | 344,913 | 58,785 | 407,397 | - 46,925 | 360,472 |
| | | | Change of Purchasing Power (£ million) | | - 26,155 | | | Change of Purchasing Power (£ million) | | 83,673 |
| | | | Change of Purchasing Power (%) | | -9.4% | | | Change of Purchasing Power (%) | | 30.2% |
| | | | | | | | | Gains over Cash ISA (£ million) | | 109,828 |

*Source: Royal London, DataStream, HMRC Individual Savings Account Statistics. Multi Asset fund returns are simulated based on a fund invested 50% into global stocks, 50% into bonds with 1% fee p.a. Numbers in £millions.*

The right hand panel in Table 3b assumes investment in a simple multi asset fund, ending with an accumulated value of £360bn, an increase of about £110bn when compared with the alternative of keeping the money in Cash ISAs.

Based on certain simplifying assumptions, investment of around £108 billion at the end of 2005/06 and the subsequent contributions each tax year would have needed to reach around £277 billion to maintain its real value. The actual value invested in Cash ISAs at the end of 20015/16 tax year by comparison is around £251 billion – more than 9% less in real terms. By contrast, an equivalent amount invested in a similar way via a multi asset fund would have grown to nearly £360 billion, a gain of more than 30% in real terms.

In aggregate, Royal London estimates that investors in Cash ISAs have missed out on more than £100 billion in tax free gains they could have made over the last ten years by investing in a multi asset fund.

## 4. Why don't more individuals invest in multi asset funds in ISAs?

As we have seen, Cash ISAs are undeniably popular, making up the vast majority of ISA subscriptions each year by number and around three quarters by value. It is clear that these accounts are not being used purely as short term repositories for emergency cash, but are a key part of individuals' longer-term savings strategy. The question is why?

We suggest three main reasons.

*The instant access trap.* If you tell someone they can access their money any time, they are more likely to invest in something offering a high degree of capital security. They can imagine themselves taking the money out soon and would not like to see it drop in value in the meantime. It is impossible for younger savers to access money in a pension fund so they are more willing be more adventurous in their investment choices, typically checking up on the value infrequently and being pretty much insensitive to short term volatility.

*The accidental long run.* An investor in Cash ISAs may set out expecting to access the money in the relatively near term to smooth out dips in income or put down a deposit on a property, say. In reality these eventualities may not arise and they may be reluctant to take money out for fear of losing its tax protected status. Before they know it, time has passed and funds have built up. The short run has become the long run. Lifetime ISAs, with their ambiguous short/long term savings objectives are likely to be particularly prone to this kind of time horizon confusion.

*Lack of good advice.* Many investors lack good financial advice and information. Perhaps they don't realise that since the separate contribution limits on Cash ISAs were abolished it has been possible to switch funds accumulated in a Cash ISA into a Stocks & Shares ISA without losing their tax-protected status. Perhaps they aren't aware that funds in a Stocks & Shares ISA can still be accessed quickly in case of emergency. Perhaps they are, understandably, put off by annual fees in Stocks & Shares ISAs – though the analysis in this report assumed a realistic 1% a year fee and we have assumed no benefit from active management in a multi asset fund.

**What we have called the curse of cash can be summed up in an apparent paradox. In the short run, cash is the safest asset class. In the long run, it is the riskiest.**

Cash offers short term security and capital preservation. However, large holdings of cash are vulnerable to bouts of unexpected inflation, like the 1970s, or long periods with interest rates well below the rate of inflation like today.

In comparison, individual asset classes like equities, property, commodities and bonds can suffer large day to day or even year to year fluctuations. However, each of these asset classes has comfortably beaten cash and increased the real value of savings over most ten to twenty year periods since records began. And by blending a mix of asset classes at a short term risk level to suit individual tastes, a multi asset fund can offer a smoother journey that an undiversified investment in any single asset class.

## 5. A long term role for ISAs

There will always be people who feel most comfortable with the short term security of cash or who legitimately have a short term savings goal and little appetite for loss. For these people Cash ISAs make a lot of sense, particularly when interest rates finally rise and the benefit of tax-free interest becomes more meaningful. Capital built up in the tax shelter of a Cash ISA can also be moved into a broader range of asset classes in a Stocks & Shares ISA later on should personal circumstances change.

That said, ISA is a savings vehicle that forces the choice of investment onto the savers themselves unlike pensions and we believe a large proportion of money sitting in Cash ISAs is there for the medium to long run and decreases in pension allowances and government incentives to save through ISAs are likely to increase this trend. Long term investments require a long term strategy. Savers in ISAs should aim to replicate the sort of asset mix commonplace in the pension world by using a well-diversified multi asset fund as their core holding.

## Conclusions

There is nothing wrong with holding wealth in the form of cash on a short term basis. For many people capital stability is important and access to ready cash is part of prudent financial planning. But when short term holding of cash turns into long term investment then we should be seriously concerned. Over the last ten years cash has consistently failed even to keep pace with inflation. As a result the hard-earned cash of ordinary savers, far from being secure, is being steadily eroded. And, for reasons we have discussed, this issue is, if anything, likely to get more serious in the coming years.

No single asset class is likely to provide the combination of stability and return which most individuals would seek. But investment in a well-managed multi asset fund can diversify risk whilst including investment in higher yielding assets. Since the financial crash of 2008, such a strategy would have consistently outperformed cash in each and every year. The cumulative difference between the two approaches is the difference between turning £1000 from 10 years ago into less than £900 today with a Cash ISA investment as against an estimated pot of over £1500 in a multi asset fund.

Having gone through a decade of historically low growth in real income, individuals have precious little discretionary cash available to save. For that reason it is all the more important that they achieve the best possible risk-adjusted return on the money that they do save. Putting money into cash for the long term has been a deeply damaging strategy and is likely to continue to be so.

There are several key conclusions from this analysis:

- At an individual level, investors should be alerted to the fact that cash is not 'safe' as a long term investment; on the contrary, cash is likely to see a steady erosion in the real value of savings over the next few years; individuals need to be made aware of the potential gains from investing in a diversified multi asset fund;
- At a policy level, auto-enrolment is resulting in a significant increase in the number of people putting money into a pension and this money is usually invested by default using a long term multi asset approach.
- However, government policy is also encouraging an increase in the use of ISAs for long term investment and too much of this money is finding its way into cash.
- More needs to be done to wean individuals off the habit of using Cash ISAs as a long term savings vehicle. Otherwise, many more people will find later in life that their savings may have shrunk in real terms and poor returns mean the money runs out sooner than they expect. Long term savings require long term investing, in a multi asset pension fund or ISA, in order to avoid suffering the curse of cash year after year.