Cash is no longer king

Low interest rates have corrupted investors' judgement, warns Roger Montgomery

THANKS TO THE RESERVE BANK OF Australia lowering its economic growth forecasts; unemployment rising to 6.4% so wage growth is unlikely to threaten inflation; and our leaders unable to approve a budget, cash interest rates are now at levels normally associated with recessions.

Cheap credit globally, because of massive money printing in Europe, Japan and the US, means that our banks are able to obtain funding for their lending businesses at ultra-cheap rates. In return, the rates offered to depositors are producing negative real returns. In other words, when you subtract the inflation rate from the interest rate you obtain a negative "real" number. By putting your money in the bank you are losing real purchasing power – the interest won't cover the rise in the cost of living. The restaurant you can afford today, you will not be able to afford next year.

The official cash rate is just 2.5% and such low rates not only reduce your purchasing power, they tend to do things to investor behaviour that can only be described as turning it risky.

For example, when rates are normal and there's a positive real interest rate after inflation, you can calmly park your money in cash knowing the rise in the cost of living can be covered. Armed with this comfort, you are free to make rational assessments about the returns and risks when investing in assets such as shares and property.

But when rates are as low as they are today, the rationality deserts investors and the standard measures of risk are corrupted. Investors are willing to pay higher prices for assets than they otherwise would because the actual or potential income from those assets is better than what is being offered in cash.

The problem is accentuated when a generation of baby boomers nearing retirement all need income at the same time. It is accentuated even further when an event such as the GFC causes investors to fear risky assets and disproportionately increase their allocation of assets to cash.

So a generation of people need income and they have a ridiculously large amount of money in the safety of cash. The only problem is that the cash is not earning what it used to. It used to be that if you had scrimped and saved all your life and accumulated $1 million you could retire not just comfortably but truly "rich" – in monetary terms anyway. Today, however, $1 million earns about $34,000 in pre-tax income.

By some international definitions, "poverty" is having a disposable income less than half that of the median household. In Australia, for a couple with two children, that is $752 a week or $39,104 a year.

If you have retired and your only source of income is your investments, then $1 million in cash produces an income lower than the level defined as the poverty line. Cash is not king; it is but a peasant.

I believe these low real returns have corrupted investors' perceptions of risk. Take, for example, the risk premium attached to shares. This is called the equity market risk premium and it is the excess return, over the risk-free rate, that investors should seek to compensate them for taking on the extra risk of stockmarket investing. We can debate whether or not the equity market risk premium has changed or whether it is just the decline in the risk-free rate but the effect of lower interest rates is that investors have been forced into stocks and property despite their rising prices

You can see the effect in the stockmarket today. When McAleese – a recently listed transport company at the centre of an investigation which hauled its Cootes petrol tankers off the roads for the third time in NSW to address safety concerns – reported that its profits would be at the upper end of guidance, its shares soared 32% in a day. When Domino's Pizza reported its "best ever" result, its shares jumped 13% to record highs. The extreme "up" moves reflect a generational, pre-retirement fear of missing out and being left in cash earning an impoverished return.

The risk-free rate of return is actually a negative one offering only the certainty of wealth destruction. In response, investors are corrupting their own rational approaches to risk in both shares and property, and this too will ultimately end badly. Only after the correction, however, will investors look back and wish they had the cash.

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