

Is Cash King?

A total of NZ\$1.7b is being paid out to South Canterbury Finance investors by the Government under the retail deposit guarantee scheme. The bulk of these funds will flow back to retail investors who are now faced a decision about what to do with the cash.

Some might ride their luck again and invest in the highest interest rate they can find with no regard for the risk. The more prudent will pay off non-deductible debt such as the house mortgage and therefore effectively earn themselves higher returns for no risk.

The majority will count their blessings for the bail-out and head for the nearest bank to put their funds on deposit. That seems like a sensible solution right? Especially since the economy remains tough both here and overseas and financial markets are volatile.

At the moment investors can expect to earn a return of 5.50%p.a. from a 1 year term deposit. This is about what you can expect to earn from cash on average over time. This means a \$10,000 investment will make you \$550. However, before you get to spend it the bank will deduct tax at your marginal rate. Thankfully changes to personal and PIE tax rates as at 1 October make this less of a burden than it was. For someone paying tax at a marginal rate of 28% (previously 33%) this still means your \$550 gain is reduced to \$396 in the hand. It's a little bit better if you are paying the lower tax rate of 17.5% (previously 21%) since you get \$455.

What is often forgotten however is the impact of inflation. That is, how much your dollar will actually buy you in a year's time. The Reserve Bank has estimated that inflation will be 4.4% over the next 12 months due to largely to the impact of various indirect taxes. So your total cash of \$10,396 will actually only buy you the equivalent of \$9,958 worth of goods in today's dollars (it is just above break-even for someone on the lower tax rate).

So by investing in that headline interest rate of 5.5% and keeping your money "safe" in the bank you actually end up losing money over the year in real terms. This is why growth assets such as shares and property should play an important part in your savings and investment portfolio. Growth assets provide some protection against inflation and offer the opportunity to achieve capital gains without being taxed. Perhaps you should look again at just how much "risk" you are really taking with those hard earned savings.

