CCLA

GOOD INVESTMENT

With your cash reserves now earning less, extra prudence is required

Amid the events of 2020, a further reduction in the interest on your savings at the bank, building society or National Savings and Investments (NS&I) may well have gone unnoticed. Initially, at least.

Savings rates were already near historic lows, and those who depend on their savings' income will have winced when further reductions hit home. Savings rates, and indeed the income paid by money market funds like CCLA's Public Sector Deposit Fund (PSDF), have dropped since the start of the pandemic.

Councils need to exercise caution when investing their short-term cash. It is of fundamental importance to keep their sights firmly on objectives such as security, diversification, and liquidity, despite the temptation to seek higher returns.

What is behind the low rates of interest paid on savings?

When the Bank of England (BoE) cut interest rates, it was steeling the economy for the current downturn. Its' main instrument to do so was through the Bank Rate, the single most important interest rate in the UK. Set by the BoE's monetary policy committee, it is a tool which tackles inflation and drives growth by adjusting the balance of what we, as a country, are spending versus what we save.

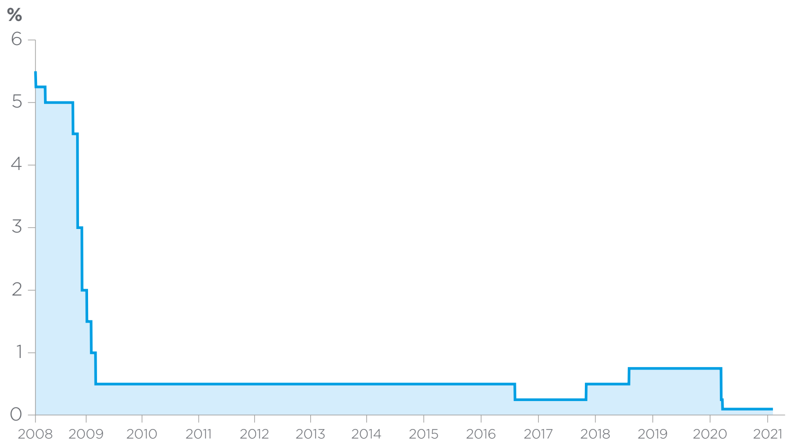
The Bank Rate determines the interest rate which the BoE pays commercial banks in return for their deposits. It is the feeder rate for banks, who in turn charge people to borrow money or pay savers on their bank deposits. It has the same sway over sterling money markets, where the PSDF makes its investments.

Last March, the BoE reduced the Bank Rate twice, by a total of 65 basis points to 0.10% from 0.75%. As you can see in the chart below (see Chart 1), it currently stands at the record low. Many high street banks immediately reduced their rates to reflect the move.

As we had invested the PSDF's assets across several maturities, even those as long as one year, the yield for PSDF did not instantly change. These existing investments helped to delay the reduction in the PSDF's flow of income. These are now maturing and being reinvested in today's ultra-low interest rate environment.

The impact of the cuts in the Bank Rate is the main reason why the PSDF's income has fallen, but there are two other important components.

Chart 1
Changes in the Bank of England's Official Bank Rate

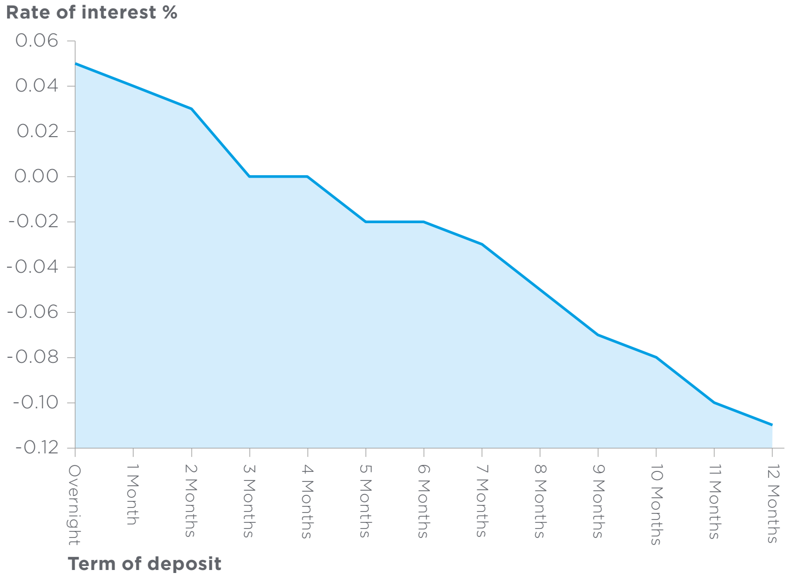


1. Future direction of rates

Money market returns can be further swayed by how interest rates are expected to move:

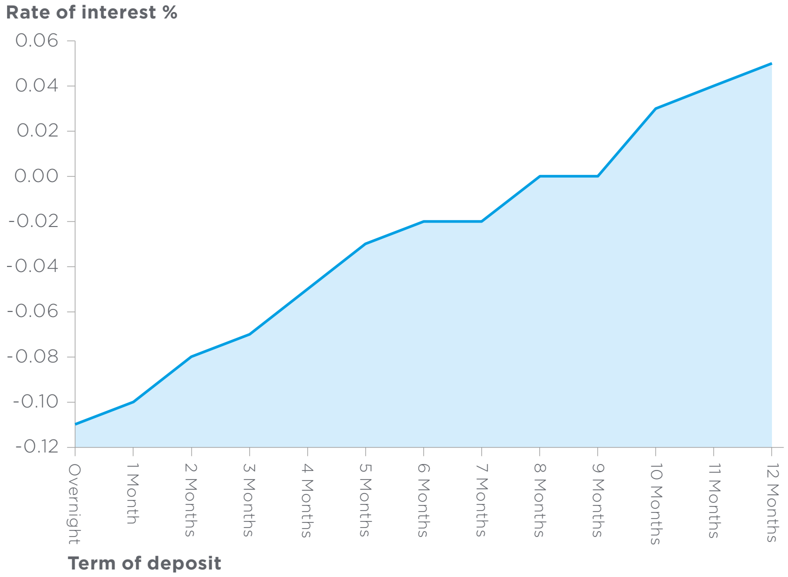
- if interest rates are considered likely to fall, the returns on a longer-term investment might be lower than a shorter-term investment because of its duration. This is known as a downward sloping yield curve (see Chart 2).

Chart 2
Example downward sloping yield curve



- if the expectation is that interest rates will rise in the near future, the returns on a longer-term investment will be higher than for a shorter-term option. This is known as an upward sloping yield curve (see Chart 3).

Chart 3
Example upward sloping yield curve



The BoE is indicating that the prospect of a rate increase is a distant one[1], so we see a low chance of an upward sloping yield curve any time soon. In practice, this means that we are not able to enhance the level of income our fund can pay by making longer-dated investments, as these are in fact offering returns of less than the yield we can earn on an overnight basis.

2. Awash with cash

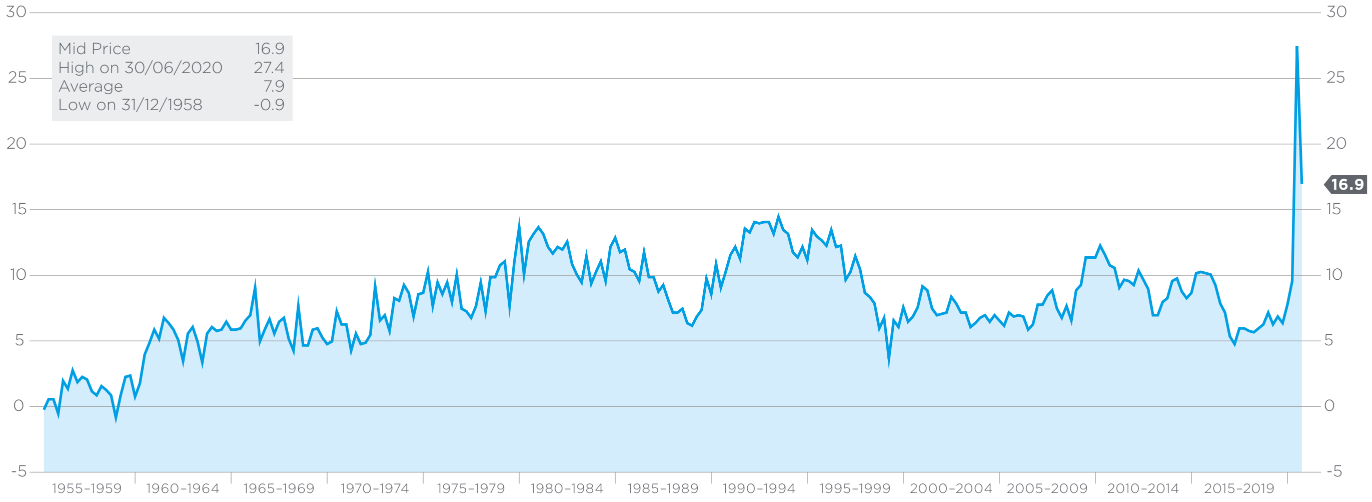
At a time when so many are struggling to make ends meet, it may be hard to believe that money markets are saturated with a large supply of cash. But there are two important reasons for this.

- Firstly, as part of its package of crisis response measures, the BoE injected vast quantities of cash, or liquidity, into financial markets, as well as opening generous schemes designed to allow banks to borrow cash from the central bank at very low interest rates. Therefore, their demand for borrowing from funds, such as the PSDF, has shrunk substantially. That has led to a fall in the level of interest rate banks are willing to pay on deposits.
- Secondly, the UK household savings rate (see Chart 4) reached record highs on aggregate last year. Historically, savings do tend to increase during recessions as families tighten their belts in preparation for expected falls in income. This time, a fall in economic confidence has been coupled with lockdown restrictions. With vast sectors such as travel and hospitality closed, households have been forced to save. Meanwhile, the furlough scheme has helped to keep personal incomes relatively stable even as economic activity has collapsed, another supportive factor for savings.

This savings boost has meant retail banks' deposits have surged, further reducing their need for borrowing from funds such as the PSDF.

[1] "The Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably." (November 2020 BoE Monetary Policy Committee minutes)

Chart 4
UK Household Saving Ratio %, Bloomberg Finance



UKSVRATI Index (UK Household Saving Ratio %) Quarterly 31/03/1955-30/09/2020

Banks are also having to take on high volumes of savings which were held in the government NS&I. In November, the NS&I cut the interest rate on its popular savings account to just 0.01%. This resulted in savers withdrawing more than £6.2bn from the NS&I, with much of this flowing into building societies, according to the Buildings Societies Association. This has further saturated an already overflowing banking system with liquidity.

As ultra-low interest rates will likely persist, what options are left for local councils?

First and foremost, councils should maintain their focus on security, diversification, and liquidity. It is important not to sacrifice one of these attributes in the expectation of more attractive returns.

With interest rates near zero, any stellar opportunities for generating returns on cash deposits without adding risk are scant. By giving up security and diversity, the potential for losing some or all of the cash deposited will increase markedly. Councils must question whether taking on this extra risk offers greater relative rewards, or whether it might be better to live with a tiny bit less interest.

Given the economic picture and the huge amount of uncertainty which persists, the level of risk to which depositors are exposed is far higher than usual. That is why councils need to be confident about where their cash is housed.

The PSDF is a UK-domiciled money market fund. Its prime objective is the preservation of principal and liquidity by investing in a diversified portfolio of high-quality sterling deposits and instruments. The fund has an approved list of over 50 of the world's strongest financial institutions to lend to. This list is under constant review by CCLA, and typically fund investments are spread across 25 to 30 institutions at any given point in time.

Councils can take further comfort from the fact that the PSDF has been awarded the strongest AAAmmf rating from Fitch Ratings. This reflects its adherence to strict regulatory rules ensuring diversity and liquidity.

It is this focus which comes first in CCLA's management of the PSDF and it is why councils can be sure that their investments benefit from CCLA's low-risk approach. There may be opportunities to earn additional income on medium to long-term investments if the authority has cash or reserves which can be set aside for a longer period.

CCLA has the same values and principles as its clients. In a world of uncertainty, councils can take additional comfort in our active stewardship programme which seeks to push for improvement in the companies we invest.

Disclosure

This document is a financial promotion and is issued for information purposes only. It does not constitute the provision of financial, investment or other professional advice.

To ensure you understand whether a CCLA product is suitable, please read the prospectus and consider the risk factors identified therein.

CCLA strongly recommends you seek independent professional advice prior to investing. The Public Sector Deposit Fund is a UK short-term LVNAV Qualifying Money Market Fund.

In addition to the general risk factors outlined in the prospectus, investors should also note that purchase of PSDF shares is not the same as making a deposit with a bank or other deposit taking body and is not a guaranteed investment.

Although it is intended to maintain a stable net asset value per share, there can be no assurance that it will be maintained. Notwithstanding the policy of investing in short-term instruments, the value of the PSDF may also be affected by fluctuations in interest rates. The PSDF does not rely on external support for guaranteeing the liquidity of the fund or stabilising the net asset value per share. The risk of loss of principal is borne by the shareholder. Past performance is not a reliable indicator of future results. The value of investments and the income derived from them may fall as well as rise. Investors may not get back the amount originally invested and may lose money. Any forward-looking statements are based upon CCLA's current opinions, expectations and projections. CCLA undertakes no obligations to update or revise these. Actual results could differ materially from those anticipated.

Investment in a CCLA managed fund is for public sector eligible investors only. Holders of a CCLA managed fund are not covered by the Financial Services Compensation Scheme.

The CCLA managed fund is authorised in the United Kingdom and regulated by the Financial Conduct Authority as a UCITS Scheme and is a Qualifying Money Market Fund. CCLA Investment Management Limited (registered in England and Wales, number 2183088, at Senator House, 85 Queen Victoria Street, London, EC4V 4ET) is authorised and regulated by the Financial Conduct Authority.

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