Beware the US cash temptation: Are SA investors missing the bigger global investment picture?

By Hein Klee

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In recent months, the allure of high interest rates has made it increasingly difficult for South African investors to resist putting their money into US cash.

Source: Pexels

Many appear to have been tempted to channel a substantial chunk of their portfolio in this way, enticed by the approximate 5% return coupled with little volatility or short-term downside risk.

Source: Supplied. Hein Klee, head: International, Wealth Management SA.

At face value, this seems like a no-brainer. After all, why would one risk the unpredictable swings of the stock market when you can sit back and enjoy a steady 5%? Unfortunately for many of these investors, the apparent safety and relatively solid returns of US cash obscures a number of other, less appealing, considerations that require their attention.

To begin with, history has repeatedly shown us that cash returns seldom keep pace with inflation in the long run. This means that, while your money might be growing nominally thanks to the US Fed, its purchasing power is likely to still be eroded over time.

It's also paramount to remember that the 5% currently on offer by these cash investments is a gross figure. High-net-worth investors in South Africa, in particular, must bear in mind the implications of taxation on those returns.

With marginal tax rates for these investors likely to be 42% or higher, these seemingly lucrative returns will be nearly halved in net terms upon 'cashing out'. So, while ploughing all your money into US cash may appear to be a robust investment strategy, in the long run, it's more likely to yield returns that are considerably below the inflation mark.

This simple truth was confirmed by a comprehensive study undertaken by Goldman Sachs in which they compared the percentage of time, over various periods, in which returns delivered by US cash and US large-cap stocks, specifically the S&P 500, have beaten inflation.

Not unexpectedly, the findings reveal that stocks have consistently outperformed cash as inflation beaters across all investment time frames ranging from as short as one month to 20 years.

Of particular interest is the relationship between the returns differential and time in the market. The longer the investment horizon, the more pronounced this outperformance by stocks becomes. Perhaps more importantly, the results reveal that, while stock-market investments may be risky in the short term, in the long term they offer more certainty of positive, inflation-beating outcomes.

Smart timing and diversification"

Interestingly, it appears that you don’t even have to be a hugely successful large-cap investor to consistently beat US Treasury returns over time. Another piece of research by Bloomberg and Goldman Sachs confirmed this.

It created a hypothetical portfolio view looking at a $12,000 annual investment contribution from 2000 to 2023. In the first scenario, it assumed the individual managed to perfectly time their entries and exits from the S&P500 over the period.

The result was an investment value of over $1.191m. In the second scenario, the S&P500 investor demonstrated the worst possible timings, entering at the high points and exiting at the lowest.

Still, the hypothetical investor managed to rake in a not-so-shabby $913,901 over the 23 years. That’s around $300,000 less than the perfectly timed portfolio, but it still beats the hypothetical investment placed in three-month US Treasury bonds for the same period, which managed to grow to a relatively paltry (by comparison) $332,936.

Tax implications and investment choices

For the South African investor, introducing taxation into these scenarios paints a starker picture. Even considering the 25% capital-gains tax you would likely have to pay on liquidation of a large-cap portfolio, the growth of that investment would still generally outperform the gross performance of cash over the same timeframe.

Factor in the 42% income tax that would be deducted from cash returns, and the gulf in performance between stocks and cash widens substantially.

Importantly, this isn't a clarion call to abandon US cash investments. On the contrary, in today's economic climate, US cash is a worthy diversification tool and can serve as an effective stabilising factor against the inherent volatility of global equity markets.

However, parking your entire portfolio in cash because it is a 'safe' option that is currently offering reasonable returns is more than likely going to cause you to miss out on opportunities for the much more appealing growth typically delivered by large-cap US stocks over time.

We all know that when it comes to investments, putting all your eggs in one basket is never a prudent strategy – even if it appears to be a very safe basket. For South African investors looking offshore, a balanced blend of large-cap stocks and cash ensures not only capital preservation, but also an opportunity for meaningful growth.

The bottom line: don't allow the siren song of US cash to cause you to shoot yourself in the proverbial foot. Diversification, as always, remains the key to long-term investment success.

ABOUT THE AUTHOR

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