Making cash investments

Cash is an asset class which is typically seen as a safe investment with nary a risk, reports JERMAINE NG.

A KEY role of investing is to not invest in something that you do not understand. Most investors are faced with three fundamental investment choices: cash, stocks and bonds. There are variations on each investment option which can sometimes be confusing, and push investors to not follow the rule above.

To help with this, the BT-Citibank Young Investors’ Forum will start by looking at cash this week, and the other two options in the following weeks.

Perhaps we should start by defining “cash”. For the purpose of investing and savings, cash – or cash equivalents – is defined as notes and coins, or balances in the bank account, says Ang Ser-Keng, senior lecturer of finance at the Singapore Management University’s Lee Kong Chian School of Business.

Cash is an asset class which is typically seen as a safe investment with nary a risk. What differentiates it from other asset classes is that it usually ensures that the investor has a specific return. It also matures quickly – as short as three months.

How and where can we invest our cash?

“Very broadly, cash can be invested in stocks, bonds, money markets or placed in bank deposits,” says Mr Ang.

Bank deposits accounts can generically be classified into demand deposits and time deposits. “Demand deposits allow savers to draw their monies out at any time with no restrictions or penalties – these could be savings or checking accounts,” says Mr Ang. The latter provides the ability to write cheques to make payments.

Time deposits, on the other hand, require savers to keep the monies with the bank for a specific period of time – such as three, six, nine or 12-month intervals.

“For this certainty, the bank pays a higher interest for deposits and there is usually a penalty for early withdrawal,” he says.

If deposits do not really appeal to you, you might want to consider investing in money market securities as an alternative.

What differentiates cash from other asset classes is that it usually ensures that the investor has a specific return. It also matures quickly – as short as three months.

There are “short-term instruments that have a maturity period of less than a year”. They are highly liquid and represent very high-quality instruments, says Mr Ang. Examples include government bills and Negotiable Certificates of Deposits.

“Another alternative would be money market funds that afford the benefits of diversification across different instruments,” says Mr Ang.

Not to be confused with money market accounts, money market funds seek to maintain a net asset value of $1 per share while earning interest at the same time. While low-risk, these also yield lower returns and may not be as feasible as a long-term investment option.

Insurance can also be an indirect investment. “Insurance is an indirect way of investing in stocks, bonds or placing it in deposits or money markets,” says Mr Ang. “The premium that is paid to the insurance company would need to be invested to produce the returns (interest) that the insured expects from the insurance policy.”

As a fresh investor, you must take note that cash is highly liquid – it is one of the most liquid asset classes that anyone can have in his portfolio.

So cash-based investments are good for retaining liquidity, or “the ability to convert the instrument to cash quickly and cheaply, at the lowest transaction cost, whenever it is needed”, within your portfolio.

“One of the things that is crucial for an investor is to have a good sense of how much transaction fees or penalty is involved when liquidating that asset or if there is a way to cash out of the investment,” says Mr Ang.

Another thing to note is that different accounts have different fees levied.

“Each bank would charge a fee if the depositor has amounts less than minimum sums,” says Mr Ang. “In addition, some banks charge for each cheque book that is issued. Some saving accounts provide for higher interest rate if you continue to deposit amounts on a continuous basis (usually monthly), failing which you will earn very minimal interest rate.

It is also important not to confuse savings with investing in cash.

“Technically, one does not ‘invest’ cash as savings is not equal to investing,” says Mr Ang. “Savings connote placing money in the bank account where a depositor takes risk on the safety of the bank receiving those deposits.”

“In some cases, the government provides guarantees against losses resulting from bank failures,” Mr Ang adds. “Investing, on the other hand, requires the investor to take additional risks, such as market risks and firm-specific risks.”

While many people tend to see cash as simply a back-up tool to turn to in times of emergency, it does have the capabilities to hold a strong position in one’s portfolio assets.

It is always useful to set aside a certain percentage of one’s portfolio in cash equivalents, mainly because of the stability and certainty it provides. This asset class is indubitably safer and less risky than investing in other asset classes.

Another advantage is that it prevents you from liquidating assets from other classes when you have a large upcoming expense.

For example, if you have to pay for a house or a car, it may not seem like the best option to liquidate some of your portfolio – especially if the market is bearish.

“(Cash equivalents) can be readily converted to cash whenever needed,” says Mr Ang, which is preferable to liquidating part of your long-term investment portfolio.

On the downside, of course, cash equivalents yield relatively poorer returns. “In many cases, interest is below inflation,” said Mr Ang.

Singapore’s consumer price inflation rate stood at 3 per cent in February, and inflationary pressures are expected to be sustained as energy and commodity prices continue to climb. What this means is that cash investments are left poorly funded in a season of escalating price levels.

Also, cash equivalents are “still subject to the safety of the bank”, says Mr Ang, because “there is a limit to which the government will guarantee deposits”.

Sounds mind-boggling? Worry not, for it simply means having to do ample question-asking before sectioning a portion of your money in cash equivalents.

It is also important to research and query each bank and financial institution to see which fits you best – after all, it is your money at stake.