

Maximising returns on cash with security

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Maximising returns on cash with security



Cash Conundrum: Maximising returns on cash with security

Cash as an asset class has always been a key element in our clients' financial plans and it is usual to set aside sufficient capital in cash-based savings to meet anticipated outflows likely to arise over at least the next five years, although often even longer than that. In addition, we have always taken time to help clients to determine what amount of cash they need to keep on deposit to enable them to 'sleep well at night', recognising that emotions play a big part in most personal financial plans.

It is one thing allocating sufficient capital to cash, but quite another to ensure that it is both producing a decent return and that the capital is secure. As many investors are realising during the current banking and economic turmoil, cash investments are only as secure as the institution with which they are placed. Declared (and potential) trading losses arising among banks are continuing to cause uncertainty and doubt over the creditworthiness of institutions traditionally regarded as 'blue chip'. Many investors just want to be sure that they can get a return of their original capital, rather than high interest rates.

With official interest rates at unprecedented lows to counteract the massive contraction in economic activity which has followed the banking crisis, general returns from all cash-based investments have plummeted to rates not seen for many decades.

Clients have been asking us to provide guidance and advice on how best to maximise the security of their capital allocated to cash and the interest that it can produce. This white paper is the culmination of our review of the problem and possible solutions. Specific cash solutions are examined in more detail in separate briefing notes.

Please call us if you wish to talk through the issues in this document or any other concerns that you have about your financial situation.

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The Banking Crisis

When historians review 2007-09 they will probably point to the period as one of the most volatile ever to affect the global banking system. Let's just remind ourselves what happened:

- Nationalisation of Fannie Mae and Freddie Mac...
- One investment bank (Lehman Brothers) went bust...
- Another (Merrill Lynch) was taken over in a rescue bid...
- The world's biggest insurer (AIG) was rescued from insolvency...
- In the UK, the second biggest mortgage lender (HBOS) was acquired in an emergency takeover...
- and then the US Treasury announced the biggest rescue package in history
- Northern Rock and Bradford & Bingley were taken into public ownership
- RBS and Lloyds sold majority stakes to UK government
- Fortis facing state-sponsored rescue scheme – partially nationalised
- Dexia – bailed out by French, Belgian & Luxembourg governments
- Citigroup buys banking arm of Wachovia
- Anglo Irish Bank nationalised
- Icelandic banks nationalised.

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You'd be forgiven for thinking that capitalism is dead and that we are all going to hell in a handcart! But is it really different this time or just what happens (admittedly this time on a very large scale) when risk is not properly priced and the collective memory forgets the lessons of the past?

In fact there have been rather a lot of banking crises over the past 30 years. In a recent working paper¹ from the International Monetary Fund (IMF) the authors identify 124 systemic banking crises over the period 1970 to 2007. These included: Italy (1981), United States (1988), Norway, Sweden and Finland (1991), and China and Russia (1998). Given all this, perhaps we should expect bank blowups as a fact of life and accept that they are always going to happen. If so, investors need to focus first on security of capital and secondly on the return on capital, which is actually the opposite of what most investors and savers do.

¹ IMF working paper: Systematic Banking Crises - Luc Laeven & Fabian Valencia 2008

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Managing cash

Cash as an asset class offers liquidity and stability and is important for the following reasons –

- Having cash readily available provides comfort and reassurance
- Meeting planned cash outflows, e.g. tax bills, school fees, holidays etc.
- Meeting unexpected cash outflows

As an asset class it is often overlooked as being truly defensive although it still requires management. The events of the last 18 months have highlighted that the same philosophy of diversification applied to achieving medium and long term returns from a portfolio needs to be applied equally to cash.

Cash and inflation

Although cash has historically proven to be a poor store of purchasing power over the very long term, there have been shorter periods, such as the past ten years, when the real return from cash has been much higher than that from risky assets like equities, mainly due to the overvaluation of equities at the beginning of the period. The real returns from cash over various time periods to the end of 2008, compared with the main other asset classes, are shown in Table 1 below.

Table 1: Annual average real return from principal asset classes – years to end 2008

Gross before tax - lowest in red – highest in blue

Asset Class	2008	10 years	20 years	50 years	109 years
Cash	4.2	2.4	3.5	2	1
Index-linked gilts*	-2.1	1.9	3.9	N/A	N/A
Gilts	11.7	2.4	5.5	2.3	1.2
UK Equities	-30.5	-1.5	4.6	5.7	4.9

Data source: Barclays Equity Gilt Study 2008.

*IL gilts were not available until 1982. All returns based on gross income re-invested

*Past performance is not an indicator of future returns

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It is also interesting to look at the real return from cash over a number of ten-year periods. Table 2 shows ten such periods commencing in 1908. This suggests two things: first, that the real returns from cash are quite volatile over shorter time frames; and second, the margin of outperformance compared to other asset classes is relatively small.

Table 2: Ten year average annual real return from cash compared with other asset classes

Gross before tax - lowest in red – highest in blue

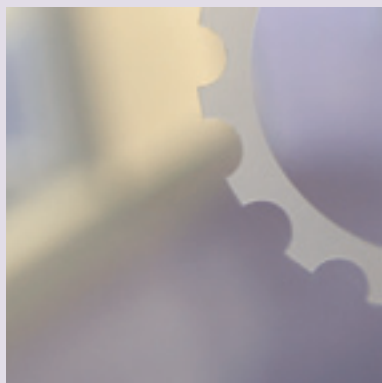
	Equities	Gilts	Index-linked Gilts	Cash
1908-18	-3.5	-7.4	N/A	-4.8
1918-28	10.3	7	N/A	6.9
1928-38	3.6	6.7	N/A	2.4
1938-48	3.9	0.8	N/A	-2.6
1948-58	7.1	-4.5	N/A	-1.8
1958-68	11	-1.4	N/A	1.9
1968-78	-3.5	-3.3	N/A	-2.7
1978-88	12.4	5.8	N/A	3.8
1988-98	11.1	8.7	6.0	4.7
1998-08	-1.5	2.4	1.9	2.4

Data source: Barclays Equity Gilt Study 2008.

*IL gilts were not available until 1982. All returns based on gross income re-invested

*Past performance is not an indicator of future returns

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In the current economic climate, where inflation is expected to decline in the short term, real returns on cash may still be available even though official interest rates are at historic lows in nominal terms. The following table (Table 3) presents the grossed up equivalent (GUE) returns required to maintain the purchasing power of cash for a higher rate tax payer (HRT) and a lower rate tax payer (LRT).

Table 3: Grossed up equivalent interest rates required to maintain purchasing power after tax

Inflation rate (%)	0.5	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5
GUE HRT (%)	0.83	1.67	2.50	3.33	4.17	5.00	5.83	6.67	7.50
GUE LRT (%)	0.63	1.25	1.88	2.50	3.13	3.75	4.38	5.00	5.63

Data source: FEL

For private investors there is often a dilemma as to which inflation rate should be used. The headline inflation rate for February 2009, as measured by the retail price index (RPI), indicated an annual inflation rate of zero. The government and the Bank of England's preferred measure of inflation, the consumer price index (CPI) (which excludes mortgage interest rates), indicated that the annual rate of inflation was 3.2%. Given that our clients' individual inflation rates are likely to be higher than those published by the Office for National Statistics, the real returns (i.e. when compared to their own expenditure escalation) that they can achieve on their cash holdings is likely to be much lower than the figures in tables 1 and 2 would suggest, particularly over the very long term.

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When it comes to cash as an asset class, there are three important considerations to remember:

- Preservation of invested capital and its return
- Provision of liquidity
- Yield or total net return after costs

Preservation of capital

When you place capital in a bank you effectively become an unsecured creditor of that organisation and the security of your capital depends primarily on the strength of the balance sheet and the business risks that the organisation undertakes. With a building society, depositors are members of the society, although still exposed to its business risks.

Such risks have been brought sharply into focus by events over the past eighteen months. First, in 2007 Northern Rock became the first UK bank to suffer a 'run' since the demise of Overend, Gurney and Company in 1866², when the wholesale funding on which its aggressive mortgage business model was based dried up virtually overnight. Only when the government stepped in and guaranteed deposits did the run stop. Then the Icelandic banks started to crumble. Icesave, the UK internet savings bank arm owned by Landsbanki³ (which also owned Heritable Bank in the UK, which was then passed to ING), went bust in 2008 causing claims for millions of pounds in compensation by thousands of savers. Those with more than £50,000 invested are still waiting for compensation.

Kaupthing in the Isle of Man (IoM) had its assets sequestered by the UK government using anti terrorism legislation, causing the bank to be in default on almost £0.5bn invested through offshore investment bonds for many UK residents. Although it is expected that IoM savers will receive a full refund in due course, this has thrown up further concerns about the ability of compensation schemes to 'step up to the plate' when a payout is needed. Most recently, members of the Dunfermline Building Society learned about their organisation's exposure to the financial crisis, resulting in a quick takeover by the Nationwide Building Society and underpinning by the UK government.

² <http://insolvency.mercerhole.co.uk/tags/overend-gurney/>

³ <http://www.guardian.co.uk/money/2008/oct/07/banks.savings>

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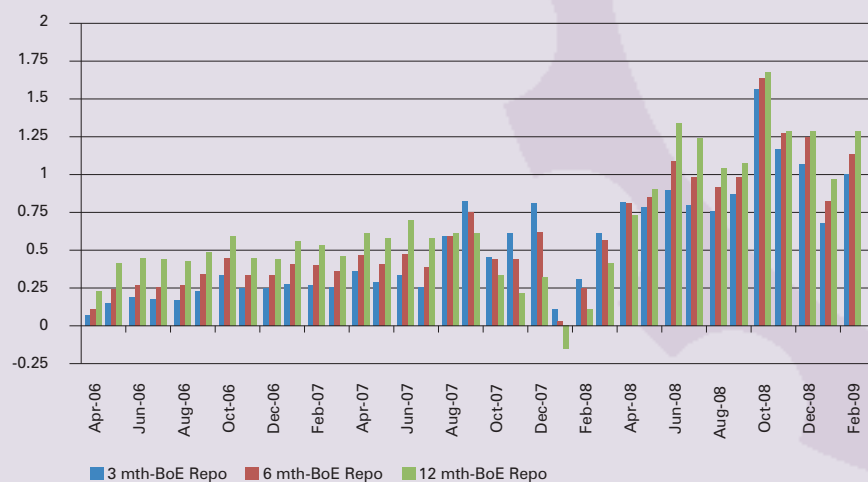
Provision of liquidity

The nature of cash as an asset class implies that it must be accessible when required and so the cash holding chosen must deliver this liquidity easily and relatively quickly. In the current climate, when liquidity is commanding a premium, those that can supply it can benefit from this additional margin.

Liquidity has dried up significantly in the last 18 months as trust and confidence evaporated in the wholesale money markets. The clearest evidence of this has been the widening of the spread between the Bank of England repo rate and the key money market rates at which banks lend to each other. Exhibit 1 highlights how the premia of key interbank money market rates (three-month, six-month and 12-month) have increased significantly over the Bank of England repo rate and demonstrates the extent to which liquidity has tightened in these markets.

Exhibit 1: Money market rates over Bank of England repo rate

Change in the premium of interbank money market rates vs the Bank of England repo rate - April 2006 to February 2009



Data source: Bank of England

Even though the Bank of England and other central banks have been injecting liquidity into the system and cutting official rates to historic lows, the premia of interbank rates over the repo rate continued to rise during April.

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Yield/total net return after costs

In its simplest form deposited cash is an asset class which involves lending one's capital to a financial institution in return for interest. The interest rate paid will be affected by a number of factors including:

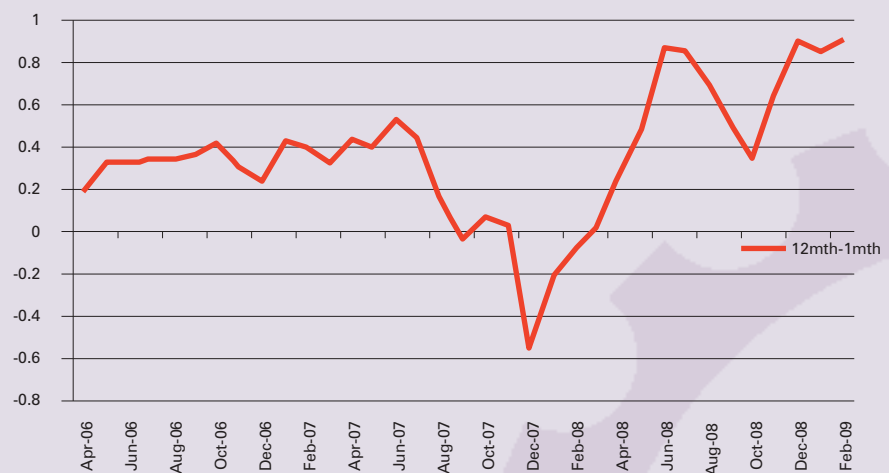
- general market interest rates based on supply and demand for short term capital
- competition from other asset classes for capital, e.g. gilts issued by the government
- the security of the organisation taking the deposit
- the liquidity terms, i.e. when the capital can be reclaimed by the depositor.

Cash is just like any other asset class in that risk and return are usually closely associated, although this fact had not, until recently, been fully appreciated by investors (or their professional advisers!). Returns are heavily influenced by the general economic conditions. In Exhibit 2 we plot the ultra short yield curve for cash rates for each of the last three years. You will note that longer term rates have been gradually improving at the expense of shorter term rates, indicating greater competition for funds. The premium of 12-month rates over one- month rates has widened to almost one percentage point after being broadly unchanged (rangebound) throughout 2006.

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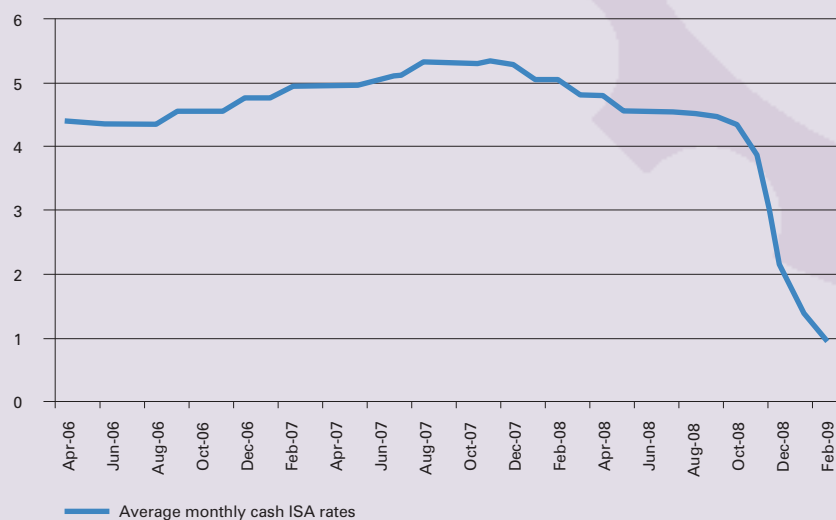
Exhibit 2: Difference between 12 month and 1 month interest rates (%)



Data source: Bank of England

Similarly, the low nominal rates available for maturities shorter than one month highlight the need to be more rate-conscious than ever, especially when one considers the dramatic decline in cash ISA rates seen on average in the last eighteen months as observed in Exhibit 3.

Exhibit 3: Average monthly cash ISA rates from banks and building societies



Data source: Bank of England

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What is the solution? (Answer: it depends)

Strategy 1: Deposit accounts? OK up to £50,000 for UK-based accounts although depositors need to be aware of changes to the financial compensation framework

Following the recent turmoil, the compensation landscape has experienced some important changes that need to be taken into account when considering placing cash with banks and building societies. The Financial Services Compensation Scheme (FSCS)⁴ has implemented significant changes to the criteria for compensation. The key benefits to depositors are that compensation is available for a total of £50,000 for all the deposits held under the same banking licence. For joint account holders the total compensation would be £100,000. Cash ISAs would also be counted as part of the £50,000.

Deposits in the Channel Islands or Isle of Man are not covered by the UK compensation scheme; neither are those outside the European Economic Area (EEA). Branches of foreign banks may have higher compensation limits, an example being ING Direct where the Dutch government will protect deposits up to €100,000 although this amount of protection may only be available until October 2009⁵.

Tip 1: Ensure existing deposits are within onshore and offshore compensation criteria.

⁴ <http://www.fscs.org.uk/>

⁵ <http://www.dnb.nl/openboek/extern/id/en/all/41-117052.html>

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Although the FSCS compensation limit has increased, it only applies to each authorised entity and it may be a valuable exercise to review existing deposits with each entity to ensure that they do not exceed the £50,000 threshold⁶. For example, the Bank of Scotland/HBOS licence covers AA Financial Services, Bank of Scotland, Birmingham Midshires, Halifax, Intelligent Finance and Saga. Having £10,000 in each of these six organisations would mean that, should a compensation event arise, there would be a loss of £10,000.

For those with deposits in the Channel Islands the protection is varied⁷, with no compensation scheme available in Jersey, while the IOM and Guernsey provide protection along lines similar to the UK's FSCS. However, there is some doubt as to whether these schemes have sufficient resources to meet potential claims, as demonstrated with the failure of Kaupthing in the IoM last year. In Gibraltar, the situation is slightly different, with the compensation scheme covering an individual investor for the greater of £18,000 or €20,000. However, where banks and building societies operate as branches of UK deposit takers then the UK FSCS will apply.

Achieving the appropriate level of diversification with regard to banking licences, especially in the current climate, can be time-consuming in terms of ensuring that deposits are consistent with the compensation scheme's criteria, monitoring the institutions, monitoring the rates they are paying and doing the administration required to access numerous accounts.

⁶ <http://www.moneyfacts.co.uk/article/who-owns-whom-listings.aspx>

⁷ http://www.investoroffshore.com/html/offshore_banking/offshore_banking_deposit_guarantees_insurance_and_protection.html

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Strategy 2: National Savings – safe but very low returns and investment limits

National Savings & Investments⁸ also offers safe, and in some cases tax-free, products for holding cash, although there are limits to the amounts that can be invested and some of the investment terms may be longer than required for liquidity purposes. For example, each issue of index-linked certificates that have maturities of three years and five years is limited to an investment of £15,000, although all the returns are tax-free. Maturing certificates may be reinvested into current issues without affecting the limits for new cash. It is also possible for one to invest as a bare trustee for one's spouse or civil partner, so as effectively to double the investment limits. It is also possible to invest on behalf of a child under seven and for children aged seven or over in their own right.

An alternative route for achieving returns linked to inflation would be the purchase of index-linked gilts; there is no cap on the amount invested and although the income will be taxed at the investor's highest marginal rate, any appreciation in the principal (which is also linked to inflation) will be exempt from capital gains tax. Conversely any loss arising on disposal may not be set against other gains arising. Due to daily price fluctuations, investors who buy or sell in the secondary market (i.e. other than buying at issue and holding to redemption) may experience higher or lower returns than those invested for the entire life of a given stock.

⁸ Current rates can be found from the NS & I website at <http://www.nsandi.com/interest-rates/index.jsp>

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There are other National Savings products that are not tax-exempt but the rates are close to zero and such accounts should only be considered for the very conservative. Premium bonds may also be attractive as any winnings are tax-free, although the maximum holding per individual is £30,000 and the odds of winning have recently been reduced.

Tip 2: Post Office Financial Services is not the same as National Savings.

It is also important to bear in mind that the cash management products offered by Post Office Financial Services do not carry the same security as National Savings as the former comes under the Bank of Ireland banking licence, while the latter is backed by the Treasury. The Irish government is currently guaranteeing the Bank of Ireland and so this might provide comfort, although the UK government may have the deeper pockets.

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Strategy 3: Money market funds – useful for amounts >£50,000 and non domiciles but look under the bonnet

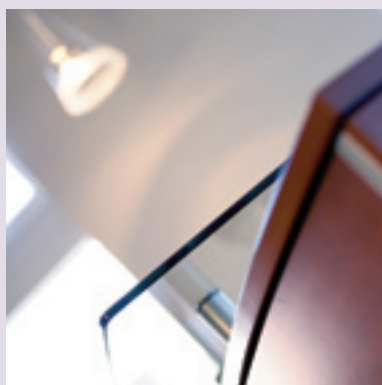
Behold the fool saith, “Put not all thine eggs in the one basket” - which is but a manner of saying, “Scatter your money and your attention;” but the wise man saith, “Put all your eggs in the one basket and... WATCH THAT BASKET” - Mark Twain

For significantly larger amounts and to diversify more widely, money market funds (MMFs) are an interesting alternative or enhancement to deposit accounts and National Savings in attaining both the return of capital and liquidity. MMFs were once only available to institutions although they have now opened up to private clients. MMFs are available in euros, USdollars and sterling. Their emphasis on capital preservation and high levels of liquidity have led to them seeing significant inflows in the last 18 months.

The principal providers of MMFs are members of the Institutional Money Market Funds Association (IMMFA) which sets strict guidelines to ensure that investors are assured of capital preservation and high levels of liquidity. All IMMFA funds are AAA rated by one or more of the major credit ratings agencies and the MMFs’ portfolios are regularly reviewed by these agencies; while the providers’ own research teams undertake due diligence and analysis of current and potential investments for these funds.

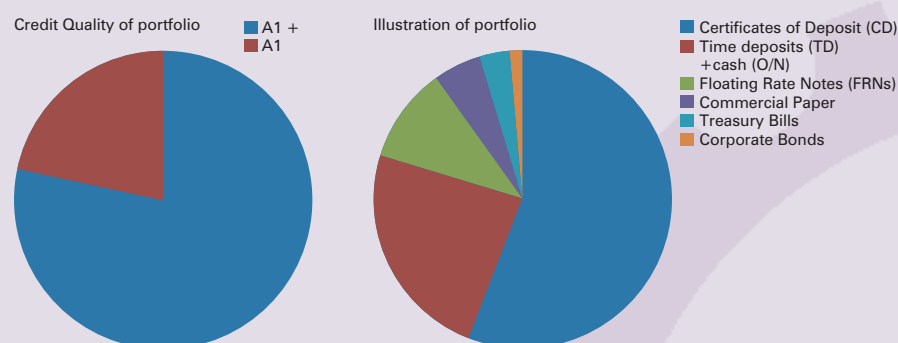
This due diligence means that investors’ cash is placed in a highly diversified portfolio of short-dated money market instruments that include certificates of deposit, commercial paper, bank deposits and short dated eurobonds issued by high quality organisations; no single holding in the fund can exceed 5% of the total portfolio. The weighted average maturity (WAM) of the fund should not exceed 60 days although currently many providers have reduced this significantly. The returns on these funds are benchmarked to seven-day London Interbank Bid Rate (LIBID) – the rate at which banks deposit their money with each other. Despite the strict guidelines for investments, the returns among the 26 IMMFA members offering sterling funds ranges from 4.3% to 5.5% in the 12 months to 31st January 2009, with income reinvested. However, more recent data for the

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seven-day annualised yield shows the average is closer to 1.9%. Exhibit 4 provides an illustration of a leading money market fund that demonstrates the credit quality, spread of instruments and issuers and weighted average maturity.

Exhibit 4: Composition of a leading money market fund



Issuer	Maturity	% of Total
Abbey CD	15/04/2009	3.40
HSBC call a/c	N/A	2.10
Radobank CD	21/04/2009	2.75
Barclays Bank TD	30/04/2009	1.35
Calyon TD	15/05/2009	3.75
Deutsche Bank CD	28/04/2009	4.00
BBVA FRN	11/05/2009	2.25
BNP Paribas Bond	18/04/2009	1.75
Wal-Mart CP	02/05/2009	1.65
Bank of Nova Scotia CD	06/05/2009	4.25
Total as % of portfolio		27.25
Weighted Average Maturity of portfolio		23 days

Data source: FEL internal research

The investor is reliant on the MMF provider adhering to a conservative investment mandate and there have been cases where a small number of providers on both sides of the Atlantic have faced difficulties by placing funds in asset-backed securities. In the U.S, a small number of funds have 'broken the buck' i.e. been unable to maintain the stable net asset value (NAV) of \$1. For sterling-denominated funds, those that have come close to 'breaking the quid' have seen their parent organisations inject funds at their discretion to maintain the NAV of £1 in some cases.

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MMFs are structured as OEICs and are usually non-UK situs (Dublin being the most common location) and fall under the respective jurisdiction's regulations. As these funds comply with a European regulation known as UCITS III, client funds are segregated so that, in the event of the provider defaulting, the fund holdings are secure as long as the underlying instruments pay out on maturity.

There are usually two classes of share: distributor and accumulation. The accumulation class rolls up the income while the distributor class aims to maintain a stable net asset value of £1 and distributes the income which is declared as a daily dividend by the company. The 2009 budget announced changes to the taxation of 'dividends' from offshore funds. The new position is that any offshore fund which holds more than 60% in cash or fixed income type investments will now be taxed as interest, rather than dividends as was the case previously. This change reduces the tax-efficiency of such offshore funds for higher rate taxpaying UK-resident and -domiciled individuals, as they will now pay the same level of tax as they would on an offshore or onshore deposit account. However, non-UK domiciled individuals and trusts will still be attracted to such funds as they will avoid such income being classed as UK source (and as such taxed at 40%/50%), and therefore not taxable if either the residency test or remittance charge annual levy are met.

From the perspective of the investor, the MMF provides a highly diversified placement of cash in one holding, saves the time of seeking out the underlying instruments in which to place their cash and, where the distribution is paid (but not remitted to the UK) to UK non-domiciled individuals and trustees, provides a more tax-efficient way of earning interest. However, it is also important to ensure that the underlying portfolio in the MMF is as 'pure' as possible. With 23 providers to choose from, Fiscal Engineers can help to identify the most appropriate fund in which to invest at the lowest possible cost.

Tip 3: MMFs provide a diversified way to obtain capital preservation and liquidity as well as tax flexibility and efficiency for non domiciled UK resident individuals and offshore trustees.

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Strategy 4: Government liquidity funds – high security but high minimums

Some fund management providers have taken one step further in creating ultra conservative funds that only invest in short-dated AAA rated government related instruments. These funds have been a recent innovation in response to investor demand for maximum safety and liquidity rather than return.

The portfolios for these funds include AAA rated government 'paper' and government-backed 'repos'. Repos are standard money market instruments by which investors can lend cash and in return hold collateral, in this case UK government securities. In the event of default by the borrower, the lender keeps the securities. Repos are used by central banks as well as private sector banks as a means to deploy and raise cash. The extensive use of repos also ensures that the fund is liquid and keeps the holding period as low as a few days.

These government liquidity funds require higher minima for investment of at least £1m, although we can provide access for our clients from £100,000. Returns for these funds, according to the IMMFA, are less than 1% but still higher than National Savings and because they are benchmarked against the overnight LIBID rate they are likely to be quicker at staying current with any changes in interest rates. This is likely to be very helpful when interest rates eventually rise. Just like a MMF, the investor can place cash in a diversified portfolio of AAA rated liquid government linked instruments very efficiently and the return is classed as non-UK source.

Tip 4: Useful alternative/addition to MMFs where highest level of security is required.

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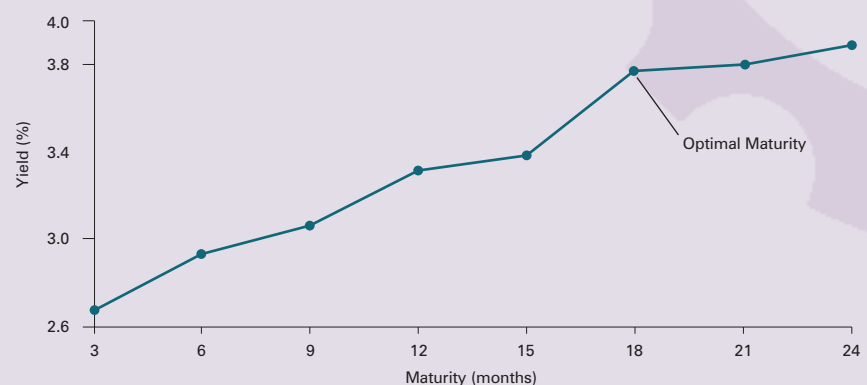


Strategy 5: Ultra-short fixed income fund – useful home for funds awaiting investment or disbursement

These are another recent innovation to the UK market, although such funds have been available in the United States for many years. Ultra-short funds invest in a pool of both deposit and fixed income instruments which have a term until maturity of no higher than two years, with the weighted average being around one year. Eligible investments include bank notes and deposits, corporate notes (short term liquidity provided to big corporations), commercial paper and fixed income instruments issued to governments etc. Only high-quality issuers are considered, in order to ensure maximum liquidity in the fund's assets. The fund is typically limited to 3% exposure to any underlying instrument to ensure adequate diversification.

The manager selects the underlying cash and fixed income investments based on their yield in relation to what is known as the 'yield curve'. The yield curve is a projection of the interest yield arising from a range of fixed income instruments over various time frames. The manager will extend the maturities of underlying holdings when there is an anticipated reward for doing so. Hence with a steep yield curve, the average maturity period of the underlying holdings will increase as shown in the chart in Exhibit 5 below.

Exhibit 5: Finding the Optimal Maturity – steep yield curve

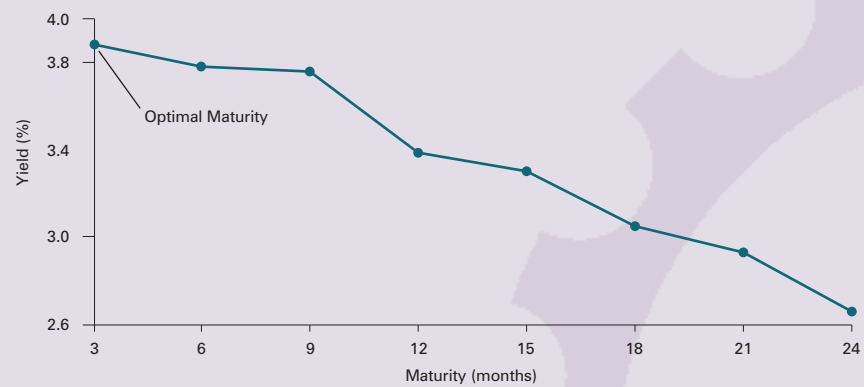


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When the yield curve becomes inverted, the manager will move to cash equivalent holdings with very short holding periods, typically 1-3 months, as longer maturities would not provide additional return. Exhibit 6 below displays this graphically.

Exhibit 6: Finding the Optimal Maturity – inverted yield curve



Data source: Dimensional Fund Advisors

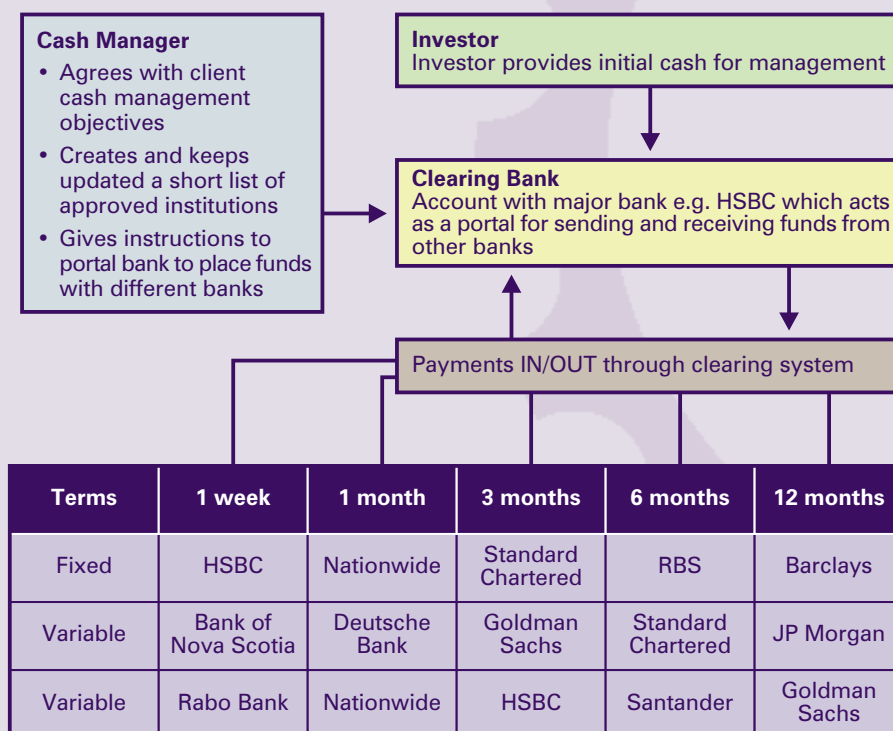
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Strategy 6: Cash management service – excellent for most investors

Given the variety of vehicles now available to private clients; a cash management service can provide the means to structure one's cash portfolio that is consistent with the same principles applied to the diversified portfolio created to meet long term goals. In addition to MMFs and ultra short-dated bond funds, cash management services can also provide access to a diversified portfolio of highly rated bank deposits that have been identified through rigorous due diligence. Access to such a service can start from as little as £50,000. Clients will also benefit from having access to rates comparable to money market rates. Exhibit 7 provides an illustration⁹ of how this type of service is typically structured.

Exhibit 7: Cash management service typical composition



Data source: FEL

⁹ Banks stated are purely for illustration purposes and the actual institutions used will depend on a number of factors.

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As with the MMF, the provider of the treasury service undertakes due diligence on the investor's behalf to ensure that funds are placed across a variety of highly rated and competitive deposit takers. However, unlike MMFs, the investor has the flexibility to decide how active a role they may wish to take with the allocation of their cash. For example, the investor might wish to place restrictions on the banks that the manager may use or dictate the mix between variable and fixed rates. Alternatively, and subject to liquidity needs, the investor can leave all decisions to the manager.

Another feature of this service is that investor protection is maximised. This is because, in the case of the UK protection scheme, the £50,000 limit applies to each institution used in the service. Therefore, if ten different UK licensed banks were used to hold £50,000 each, the entire £500,000 would be subject to UK investor protection. If the service were held in joint names then this would provide £1m of protection.

Such treasury services are available either onshore or offshore as required. In addition, it is also possible to arrange such a service through an offshore insurance bond. Thus, a high level of tax-efficiency is possible, regardless of the tax status of the investor, although this may affect the level of investor protection available.

Tip 5: Diversify cash holding – don't back one horse.

Wise words to leave you with

"How little you know about the age you live in if you think that honey is sweeter than cash in hand" – Ovid

We would concur: it is as true now as when Ovid first said it over 2,000 years ago.

If you would like to discuss how we might be able to assist with your cash management needs please do get in touch. Our fee only advice is conflict-free and value for money and we'll ensure you make the most of your hard-earned cash.

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