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Elston Insights

Explaining reinvestment risk

- Interest rates have peaked in the UK
- As interest rates fall, so do risk-free returns
- Opportunity costs also potentially increase

The trade-off between risk and return

There is always a trade-off between risk and return. In theory, where risk is defined as volatility, the higher the risk taken relative to a risk-free asset, the higher the return.

What is the benchmark for a risk-free return?

Where the risk-free return is defined as cash rates there are two benchmarks for this which are very closely aligned. First is the policy rate set by the Bank of England Monetary Policy Committee (MPC) (known as the Bank Rate or Base Rate) for interest it pays to commercial banks on overnight deposits with the Bank of England. Second is the Sterling Overnight Index Average (SONIA) "based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors."[1] The former influences the latter.

Near-nil policy rates

Following the Global Financial Crisis in 2008, central banks reduced policy rates to near zero to support the clean up of the financial system. The Bank of England rate declined from a pre-crisis peak of 5.75% to 0.50% in March 2009, and further to a Covid-induced low of 0.10% in March 2020. Savers in cash deposits, cash ISAs and money market funds where punished with near-nil returns. Investors in risk assets were rewarded – although with a bumpy ride, as always.

Equity markets disappoint

Following the post-Covid recovery, equity markets reached a high in December 2021, before starting to tumble with the onset of inflation, the Russia/Ukraine war and rapidly rising interest rates. From June 2022 to August 2023, lack-lustre recent returns in the equity markets following the Covid and inflation rollercoasters changed investor's perceptions. Equities seemed to provide investors with return-free risk. By contrast, money markets promised risk-free returns.

[1] https://www.bankofengland.co.uk/markets/sonia-benchmark

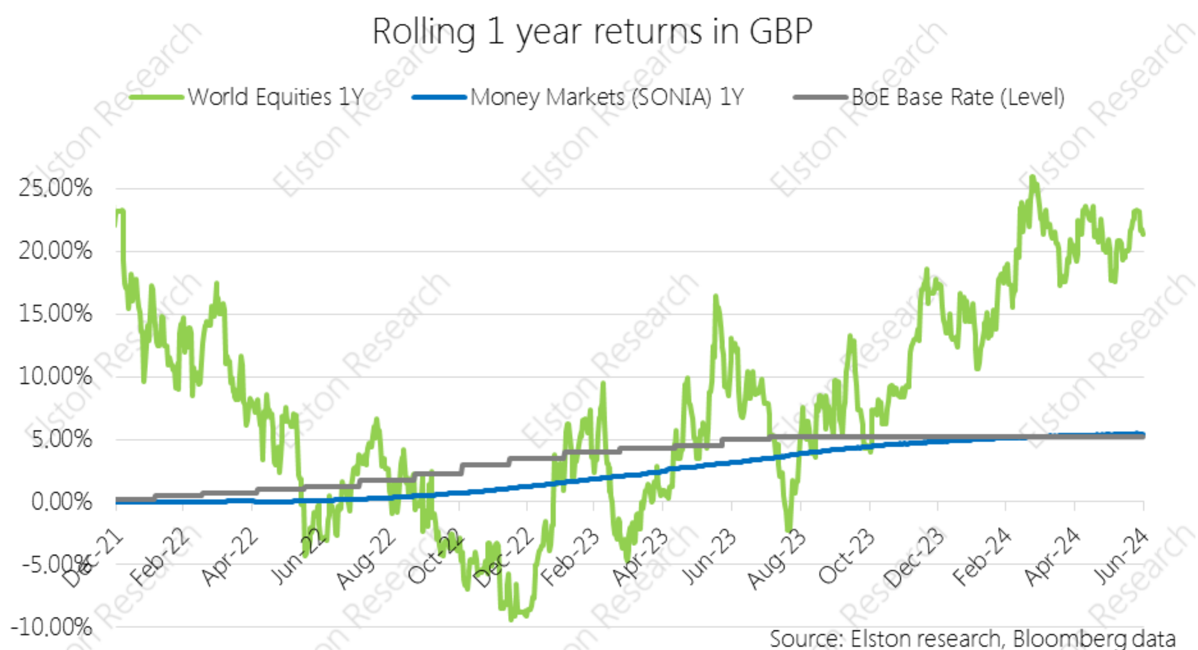
The return of money markets

Money markets are very short-term investment grade bonds and commercial paper with less than 1 year maturity (typically 90 days) and are what banks have to invest part of the regulatory capital to maintain a strong balance sheet. As the Bank of England ratcheted up policy rates to rein in inflation, SONIA and the yield on money market funds also increased to a current peak of 5.25%.

Equity markets struggled relative to cash

Looking at rolling 1 year returns since December 2021 it's visible how from mid 2022 to mid 2023, equity market 1Y returns struggled to sustain returns above cash rates (SONIA).

Fig.1. 2022-23 were a challenging time for equity markets year-on-year, relative to money markets

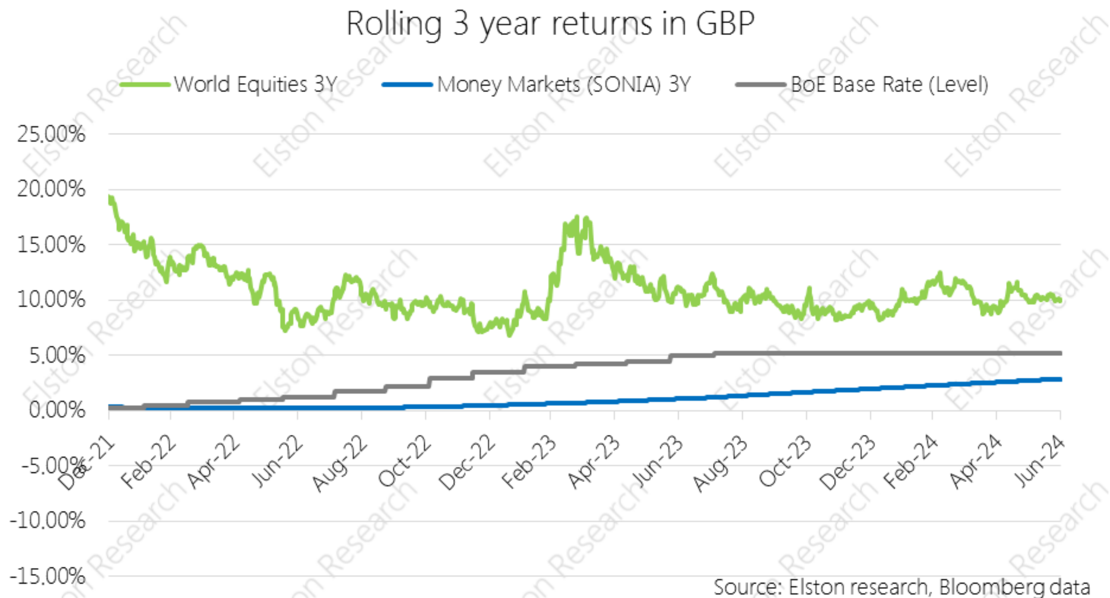


A medium-term perspective: equities win

However, advisers and investors familiar with equity market volatility understand the difference between short-term, medium-term and long-term risk-return.

From a medium term perspective, since December 2021 rolling 3 year equity returns remained above cash rates (SONIA) for the entire period for investors willing and able to accept investment risk, equities win – their return "premium" is evidenced.

Fig.2. Annualised 3 year returns show a consistent return premium

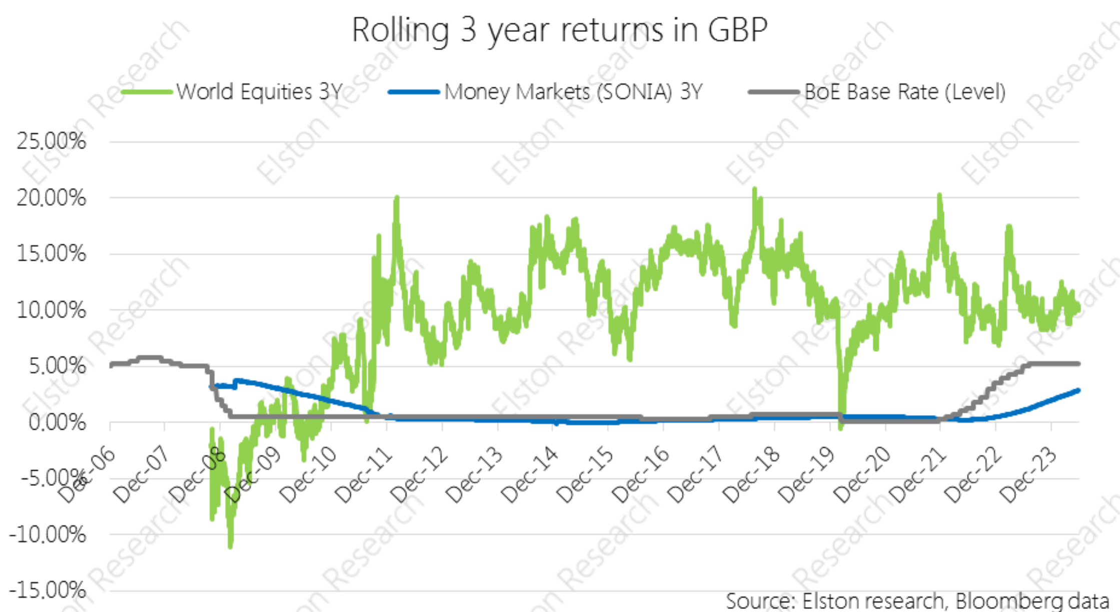


From a medium term perspective, since December 2021 rolling 3 year equity returns remained above cash rates (SONIA) for the entire period.

The long view

Looking further back, the post financial crisis era 2008-10 3 year annualised returns also looked challenging (and cash provided no interest either), but overall, for those willing and able to accepted the associated volatility, equities consistently outperform cash over the medium and long-term. The chart below shows Base Rates and Equity Market returns from 2006.

Fig.2. Annualised 3 year returns since 2006



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Understanding re-investment risk

Bank of England policy rates have now peaked at 5.25%, and the next interest rate movements are likely to be downwards in 0.25% increments towards a medium-term policy rate of 3% or so in the next two years, in our view.

This means that money market funds will offer diminishing marginal returns as investments are reinvested at lower rates. This is called "reinvestment risk" – where the returns on an investment are increasingly lower both in absolute terms and as an opportunity cost relative to other investments.

Where next?

Investors who had a medium or high risk tolerance, but were put off by short-run equity market volatility and joined the "dash for cash" are now increasingly exposed to reinvestment risk as Bank of England rates start to decline. For those clients, advisers should reassess suitability and determine whether reinvestment risk could affect their long-term financial plans.

For investors with a low risk tolerance, Cash Deposits, Cash ISAs and Money Market Funds may indeed remain a preferred option if those investors are unwilling and or unable to tolerate higher levels of volatility associated with equity risk.

Either way, understanding reinvestment risk is as important as understanding equity market volatility, and a review would be prudent as interest rates come down.

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Further Reading

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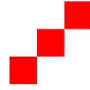

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