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Are you holding too much in cash?

Falling inflation and rate cuts could change how savers think about their money

Cash is often regarded as a safe haven in personal finance. It's accessible and protected from stock market fluctuations, and rising interest rates have made savings accounts more attractive. However, while a cash buffer offers security, holding too much can quietly diminish your wealth through inflation and missed investment opportunities. This article will help you evaluate whether your cash holdings are supporting your financial goals or holding you back.

Security and liquidity are the primary reasons people hold cash. A safety net for emergencies or short-term goals is a cornerstone of financial planning. In turbulent times, this instinct to retreat to cash grows stronger. Higher interest rates on savings accounts reinforce this choice, making it feel like a proactive financial decision.

SILENT EROSION OF INFLATION

The biggest risk of holding excess cash is inflation. If the interest rate on your savings is lower than the rate of inflation, your money is losing purchasing power. For example, if your cash earns 4% but inflation is 5%, your money's real value falls by 1% each year. Over time, this cumulative effect can be significant, representing the opportunity cost of not investing in assets that have historically outpaced inflation.

For money you may need in the short to medium term, several options offer potentially better returns than a standard savings account. Fixed-term deposits provide higher interest rates for locking your money away for a set period. Money market funds invest in high-quality, short-term debt and offer liquidity. Short-term government bonds (gilts) are another low-risk alternative that pays a fixed level of interest.

ROLE OF TAX-EFFICIENT WRAPPERS

Using tax-efficient accounts is vital for maximising returns. A Cash Individual Savings Account (ISA) allows you to earn tax-efficient interest on your savings within the annual current £20,000 allowance (for the 2025/26 tax year). This is crucial for higher-rate taxpayers who may exceed their Personal Savings Allowance (PSA).

The PSA allows basic-rate taxpayers to earn £1,000 in savings interest tax-free, while higher-rate taxpayers get £500. Additional-rate taxpayers receive no PSA. With higher interest rates, many savers now face tax on their interest, making an ISA an effective way to shelter cash. For long-term goals, pensions offer substantial tax relief and tax-efficient growth.

A core principle is to maintain an emergency fund of readily accessible cash for unexpected events such as job loss or urgent repairs. A common guideline is three to six months' worth of essential living expenses. However, this rule isn't universal. Those with stable incomes might need less, while self-employed individuals or those with dependents may prefer a buffer of 9 to 12 months.

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UNDERSTANDING BEHAVIOURAL BIASES

Psychological biases often influence financial decisions. Loss aversion, where the pain of a loss feels twice as strong as the pleasure of a gain, can lead to an irrational preference for holding cash. Inertia also plays a role; it's often easier to do nothing and let cash build up. Overcoming these biases requires a conscious effort to make logical, proactive financial decisions.

The Financial Services Compensation Scheme (FSCS) protects up to £85,000 of your money per person, per authorised financial institution, as from 01/12/2025 this limit has increased to £120,000, and applies only to complainants. If you hold more than this amount with a single banking group, it's wise to spread your cash across different institutions to ensure full protection.

Your time horizon is the most crucial factor. If money is needed within five years, cash or low-risk instruments are usually the right option to hold it. For goals beyond five years, such as retirement, investing in a diversified portfolio provides your money with the best chance to grow and outpace inflation.

TAKING STEPS TO REBALANCE

If you suspect you have too much cash, first quantify what percentage of your non-pension assets are in cash. Then, define your needs by calculating your ideal emergency fund and adding any planned major expenses for the next one to two years. Any amount above this is "excess cash" that could be invested. Consider drip-feeding this surplus into the market over several months to mitigate risk and ease the transition from cash to investments.

To clarify your position, ask yourself: What is the purpose of my cash? Is my emergency fund the appropriate size for my situation? Am I utilising my annual ISA allowance? Understanding your feelings about risk is also vital. Does a market drop cause you anxiety, or do you see it as a buying opportunity? Based on the answers you give, we can help you develop a strategy that aligns with your goals and comfort level. ■

READY TO DISCUSS WHETHER YOU'RE HOLDING TOO MUCH CASH?

Navigating savings, investments, and taxes can be complicated. We make sure we understand your goals and help you create a personalised plan. To discuss your circumstances or for more details, please contact us.

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