A note on the recent flight to cash in South Africa

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Introduction

This note briefly reviews the impact of changes in share prices on the preference for liquid assets of South African investors. Changes in investor sentiment are reflected in reallocations of assets between equity, fixed-interest securities, cash and bank deposits and money-market instruments, and by the ebb and flow of funds to the unit trust industry.

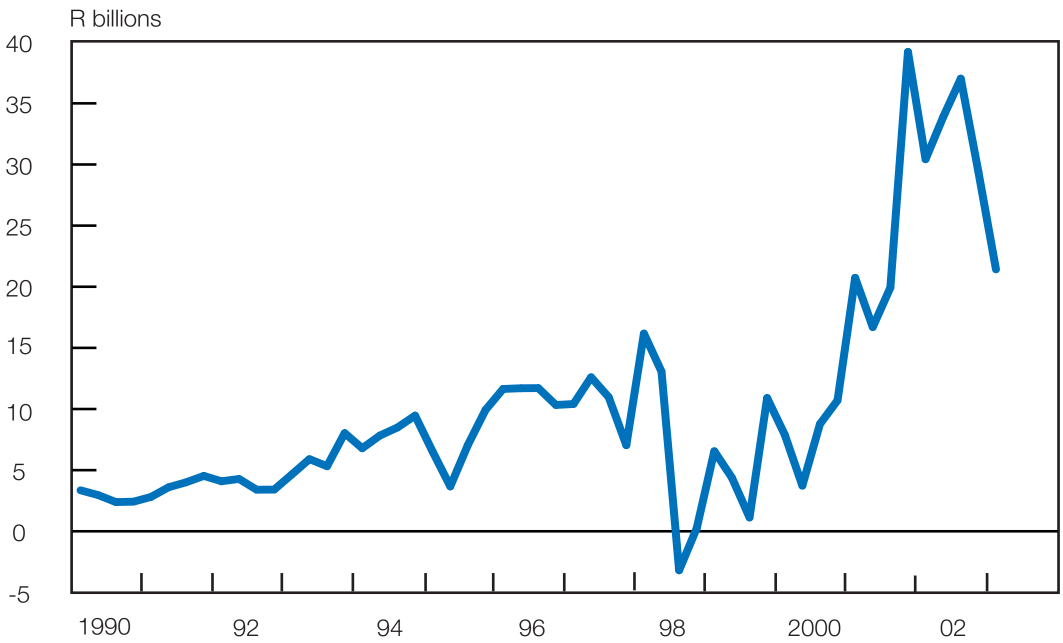
1 The views expressed are those of the author and do not necessarily reflect the views of the South African Reserve Bank.

Changes in the asset composition of unit trusts

Cash holdings amounted to approximately 42 per cent of the total market value of assets managed by the unit trust industry in March 2003. Cash holdings by all non-bank financial intermediaries (i.e. long-term insurers, private and official pension and provident funds and unit trusts) amounted to about 12 per cent of their total assets in December 2002. Non-bank financial intermediaries' cash holdings as a percentage of the market capitalisation of the JSE Securities Exchange SA also amounted to 12 per cent in the fourth quarter of 2002 and as a percentage of the M3 money supply to almost 30 per cent on occasion during 2001 and 2002. This strengthening in the demand for liquid assets contributed to an acceleration in M3 growth from a year-on-year rate of 7 per cent in the fourth quarter of 2000 to 19 per cent in the second quarter of 2002.

The unit trust industry performed fairly well when assessed in terms of the *valuation gap* between the market and the book value of assets under management (see Graph 1). The market value of assets adjusted for current liabilities and domestic intra-industry assets exceeded the book value of assets managed by unit trusts almost

Graph 1 Valuation gap*



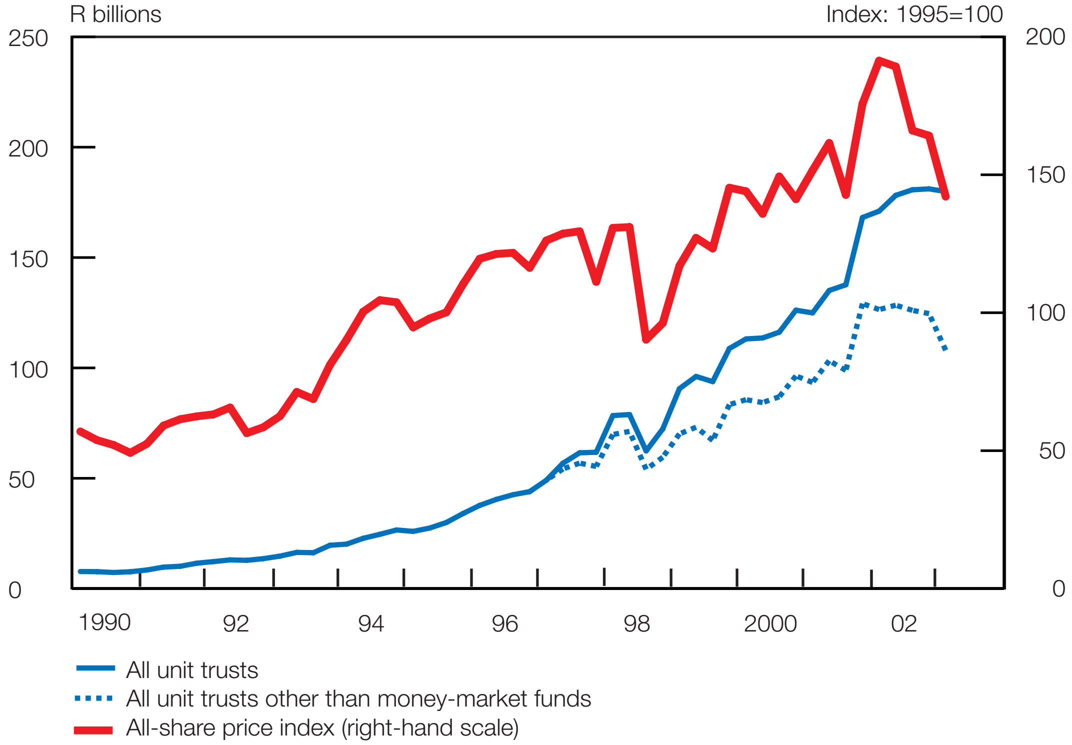
* Market value minus book value of total assets under management

uninterruptedly since 1990, except in 1998 when share prices declined sharply. After the correction of 1998, the market value of assets under management increased in the fourth quarter of 2001 to a level that was well in excess of total book value.

The valuation gap between market and book values narrowed in 2002 when share prices declined again. In 1998 the monthly average level of the all-share price index declined by 39 per cent from May to September and contributed to an absolute change of almost R20 billion in the valuation gap from the first to the third quarter. The monthly average level of the all-share price index declined by 28 per cent from May 2002 to March 2003. On balance, the valuation gap shrank by R18 billion from the fourth quarter of 2001 to the first quarter of 2003, i.e. by about the same amount as in 1998 despite the value of funds under management in 2002 being more than twice as high as in 1998.

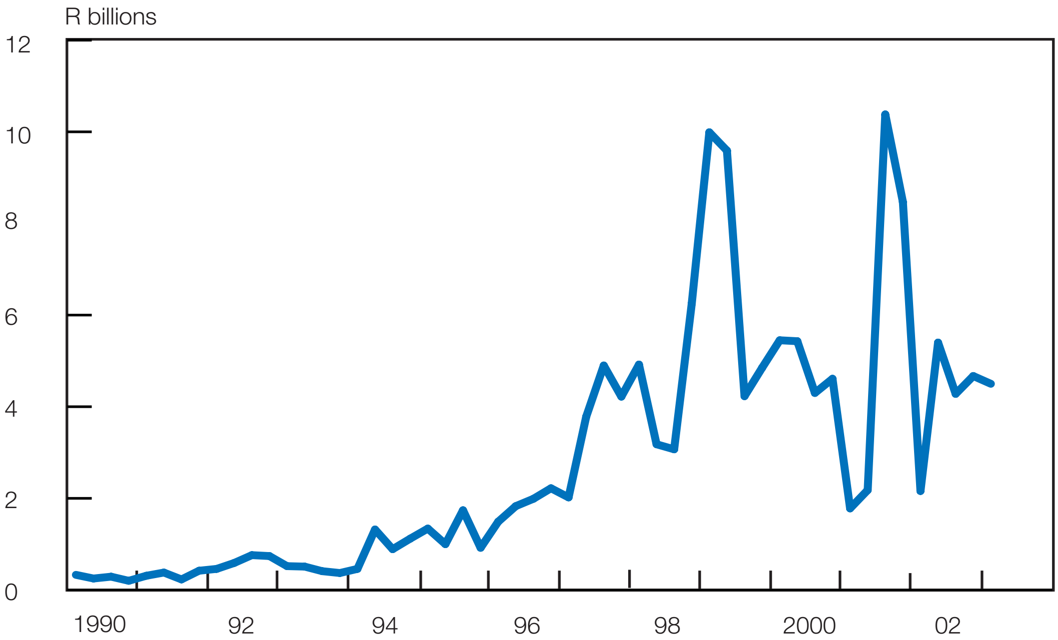
A significant change in the response of the *market value of assets under management* to the fluctuations of share prices is evident from Graph 2. The smaller negative effect of a downward correction in share prices in 2002/03 compared with 1998 may largely be attributed to investors' strong accumulation of highly liquid assets.

Graph 2 Changes in share prices and the market value of assets managed by unit trusts



As shown in Graph 3, investors' *net transactions* (i.e. sales less repurchases) in units of unit trusts were far more volatile in the period after 1998 than in the preceding years. Since 1998 investors apparently attempted to synchronise their net purchases of units with share price movements. With the benefit of hindsight, they erred somewhat with the timing of their investments and failed to capitalise on the recovery in share prices after 1998. In 2001, however, the increased acquisition of units and increased exposure to assets other than cash paid off temporarily, but part of these gains were forfeited during the slump in the share market in 2002.

Graph 3 Net sales of units by unit trusts*

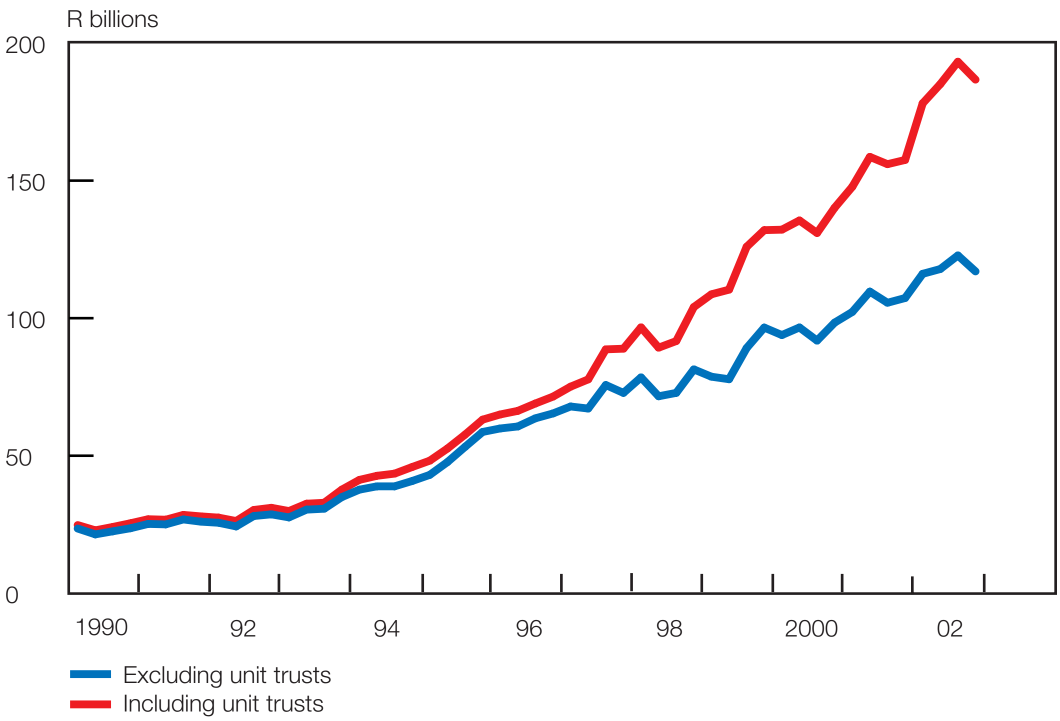


* Sales minus repurchases

Non-bank financial intermediaries

The flight to cash by investors in the unit trust industry contributed significantly to the increase in the *overall holdings of cash, bank deposits and money-market instruments by non-bank financial intermediaries* as indicated in Graph 4. The increased

Graph 4 Holdings of cash, bank deposits and money-market instruments by non-bank financial intermediaries



preference for cash was facilitated by the introduction of money-market funds in 1997. In 1998, the holdings of cash and bank deposits of unit trusts, including money-market funds, accounted for some 21 per cent of cash and bank deposits held by non-bank financial intermediaries. Since then, holdings of cash and other cash-like assets by unit trusts rose exponentially and accounted for 37 per cent of the total cash and other equivalent assets held by non-bank financial intermediaries in the fourth quarter of 2002.

Summary

The current high cash component of the asset portfolios of unit trusts clearly provides some cover or hedge against possible adverse share price movements. Losses suffered on their share investments certainly enhanced investors' precautionary and speculative demand for cash as an asset class. This also partly explains the strong growth in the monetary aggregates up to the middle of 2002. However, if share prices were to recover in the near term a portion of the cash holdings of unit trusts is likely to be redirected to equity investments.