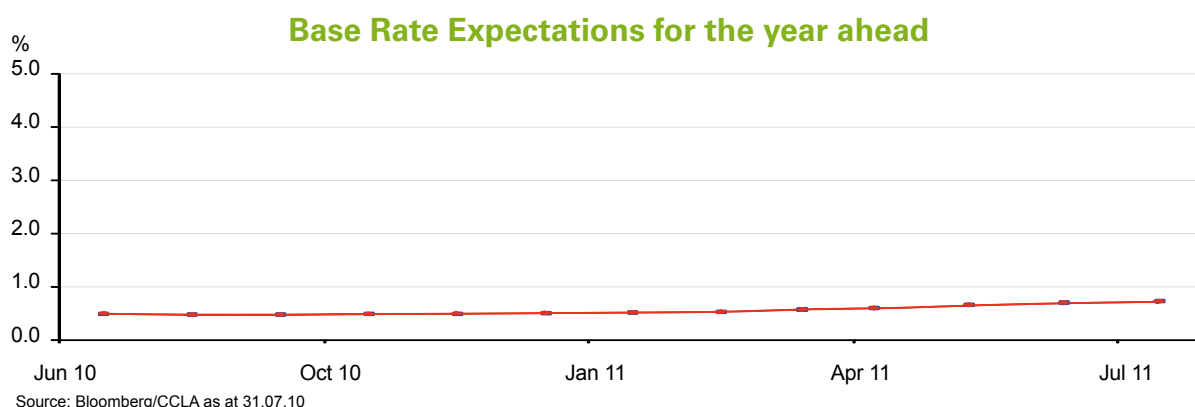


Official interest rates in the United Kingdom have been held at 0.5% since March 2009, an extended period and a painful one for many charities who have high cash balances and who have been reliant on investment income to make a reasonable contribution to overall inflows. The problem has been made worse by a rise in inflation which has meant that modest nominal interest rates have become negative in real terms; assets held in cash are not maintaining their spending power.

Interest rates have remained low because until now the economy has been weak and the recovery has been too frail to cope with increased borrowing costs. Recent economic growth data however has been better with early indications suggesting that output might have risen more substantially in the second quarter, at a rate above expectations. The question now is whether this improvement in growth rates is likely to be the catalyst for interest rates to rise in the months ahead.

The answer is probably not, furthermore even if interest rates do move higher this year the rise will be modest. The problem remains the robustness of the recovery. Sadly one quarter of stronger growth does not mean that now all is well. If we look hard at the data we can see that much of the growth was due to a catch-up in sectors such as construction from a weather-impaired first quarter of the year. In addition, looking forward we can see that some of the factors which have supported recovery will be less helpful later in the year. Stock rebuilding, to replenish inventories run down after the credit crisis, is coming to a close whilst cuts in government expenditure will increasingly take a toll.

The graph below shows consensus expectations for the path of interest rates over the year ahead. It shows a modest increase - but not one of a scale that alters the situation to any meaningful extent.



Now of course, expectations are only that and can change to reflect new circumstances but the clear message at the moment is that the attractions of cash – low risk and easy accessibility – will only be available at the cost of low returns.

For investors willing to accept some risk on their deposits then higher rates are on offer from time to time. In the main these come from two categories of borrower, those where credit quality has fallen and those seeking market share.

With regard to credit quality, a number of financial institutions have seen their credit rating reduced as a result of poor trading conditions and losses on loan exposures. The effect of this is that they have become excluded from the wholesale money markets dominated by professional investors and so have been forced to seek funding elsewhere from those less concerned about – or less aware of- their lower standing. Only three UK building societies now meet our credit standards.

The other main group is made up predominantly of banks hoping to gain or rebuild market shares by offering higher interest rates to target customer groups. A higher deposit rate today is an opportunity to start a client relationship and perhaps for a product sale later.

What both groups have in common is that they are most interested in term deposits – that is, locking-in the investor for a year, or longer if they can. This is attractive from the companies' perspective because longer term money actually costs more, but investors tend to compare term interest rates with those available on cash and so think they are getting a better deal than they actually are, and of course with money locked-in they have some insulation against any adverse future developments.

More important though is whether the lock-in periods are attractive from the investors' standpoint. When considering a term deposit with a counterparty the key consideration must be their financial strength, but not when the cash is invested, rather when it is wanted back. Cash is a market where risks are asymmetric, where the upside is relatively modest – a small improvement in income - but where the downside can be a significant loss of capital. Those placing cash for fixed periods have to be confident that even in times as challenging as these that their investment will really be as secure in the future as they believe it is today.



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Please note that the content of this report should not be interpreted as investment advice.

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