Aspera Update

Intelligent, Independent Investment Management

The What And The Why
Part 3: Cash

"There's nothing wrong with cash. It gives you time to think."

Robert Prechter Jr.

You might think a discussion of cash would be short and sweet. We all want more cash. There. Done. Ah, were it only so simple. As much as we'd all like more bills in our wallets and a larger balance in our checking accounts, many investors feel uneasy when more than a small amount of their investment portfolio is sitting in cash. In this installment of our continuing "What And Why" series, we'll be talking cash. I'll attempt to explain when and why we hold cash as well as why I never worry about the cash portion of our portfolios.

People tend to overcomplicate the issue of cash. Most of us have been brainwashed to believe that we need to be fully invested at all times. We were told that our cash needed to be working for us in the stock or bond market to help us achieve our dreams of island ownership, Swiss bank accounts, topiary gardens, and a live-in masseuse. I fell for the same spiel very early in my career. Fortunately, it didn't take me long to start questioning conventional wisdom and refine my thinking (though I still want the live-in masseuse).

So, who do we blame for the brainwashing? I'll suggest that the financial industry is the primary guilty party. Why does the industry urge you to stay fully invested and to "buy-and-hold for the long term?" Simply put, the asset management industry makes more money when your portfolio is invested. Keeping your portfolio in cash hurts their bottom line since they can't charge you much for managing cash. Generally speaking, fees on cash-like products will be lower than bond funds which will be lower than equity funds. It doesn't cost the fund industry anything to move your money over from cash to an equity fund, so the higher fee falls straight to profit and helps boost management bonuses. If your advisor depends on commissions for his income, he also has an incentive to keep your money in higher-fee products. It's not a coincidence that the asset management industry never advises you to move out of equity and bonds and into cash.

Aspera Financial, LLC is an independent registered investment advisor.

Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

Every client portfolio is separately managed.

The securities and strategies discussed in this Update may not apply to every client portfolio.

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What Is Cash?

When we think of cash, the most obvious image that comes to mind is the dollar bills (twenties and hundreds for us) in our wallets and purses. Bills and coins are the most obvious form of cash, but we can easily expand our definition to include checking accounts, money market accounts, savings accounts, money market mutual funds, and very short-term Treasury bills. **Very broadly speaking, we can think of cash as any security or account which offers maximum safety (tiny risk of principal loss at worst) and maximum liquidity (the ability to easily and inexpensively convert to dollar bills)**.

Much of the time, our portfolio cash will be parked in money market mutual funds. These are mutual funds which typically invest in a variety of high-quality, short-term securities like Treasury bills and commercial paper. After fees, the yields on these funds are pretty close to zero today, offering very little compensation for even the small risk that they incur. As a result, most of the “cash” in our portfolios at the moment is actually cash. You can think of it as a checking or savings account with no yield.

When I discuss cash I often refer to cash substitutes. I consider a cash substitute to be a security which serves the function of cash but which is slightly less liquid and/or slightly more risky than traditional cash. An example would be very short-term, AAA-rated corporate debt. Relatively more stable foreign currencies are another example. These offer the potential for a higher (though still modest) return than cash, but they are a touch more risky than cash. **Like cash, we view cash substitutes as a source of funds to be redeployed in better opportunities when they develop**.

Common Errors

Many investors struggle with the notion of holding cash in their portfolios. In my opinion, they make some basic mistakes which lead to worry, second-guessing, and poor decision-making.

- If they have a lot of cash and the market moves higher, they kick themselves. Frustrated, they invest their cash after the market has already run. Cash wasn’t popular in 1999 or 2007 (when it should have been), and it’s once again starting to get a bad name.
- If the market drops, they self-flagellate for being fully invested and having so little cash. Frustrated and/or scared, they sell their investments to raise cash after the market has already dropped.
- Investors tend to oversimplify. When they see that they’re earning 0% on their cash, their natural inclination is to put that money to work to generate some type of yield. Humans with a pulse are especially prone to such pressure. This reach for yield is often done without a thorough understanding of the risks being incurred and can lead to significant losses.
- Due to laziness, fear, or a gullible adherence to the asset management industry’s mantra of always being invested, investors choose to remain fully invested at all times and just ride out the storms.

Looking back over the post-war period in the U.S., remaining fully invested worked most of the time. However, it isn’t fool proof. Any investor who has kept his or her money parked in a U.S. equity index fund hasn’t made a dime in the last 12 years. You would have done just as well or better without incurring any principal risk if you’d just kept your money under the mattress (of course, substituting dollars for gold was the optimal choice). Still, patient buy-and-hold equity investors have generally fared better than their fidgety counterparts who repeatedly buy near the top and sell near the bottom.

Cash and Risk Tolerance

We’ve all discussed this, but it bears repeating. **Your risk tolerance does not dictate how much of your portfolio is held in cash at any point in time**. The standard industry operating procedure is to keep clients fully invested at all times regardless of valuation or the risks present. Advisors misleadingly or naively speak of historical asset class performance as though the same return is guaranteed in the future.

Yes, yes. They all say that past performance isn't necessarily indicative of future performance, but they don't really believe that. They use asset allocation and retirement planning models which explicitly assume that the future will look like the past. They're talking out of both sides of their mouths.

This is not how I operate. **I do not target a particular asset allocation for my clients based on their risk tolerance. Conservative clients may not own any bonds, and aggressive clients could be sitting entirely in cash at some point. In fact, as detailed in our Investment Policy Statements, I have the flexibility and discretion to take all of our portfolios to 100% cash, including the aggressive portfolios**. Of course, we're unlikely to ever sit 100% in cash, given the breadth of investment options available. The purpose of our 0-100% cash "constraint" is to emphasize that flexibility is crucial to our investment discipline, and to stress that we are not targeting any particular asset allocation.

Our Approach To Cash

The following sums up our approach to cash:

- Our cash weighting is a function of the investment climate and the opportunities available

  Risk management is a critical component of portfolio management, and I control portfolio risk in a variety of ways. As bullish as I may be on any security or idea, there is always some probability that I will be wrong or that events will unfold differently than I expect. For that reason, **there is a cap on how much we'll invest in any one idea, theme, or security. So, in order to be fully invested and hold zero cash, there have to be a certain number of compelling ideas available across a variety of securities, sectors, countries, and/or asset classes**.

  When there are plenty of distinct compelling opportunities available, we will not hold much cash. When there are few opportunities or the opportunities are overly concentrated, we will hold more cash.

  Essentially, we invest as much of our cash as we can given the opportunities that exist, the investment climate, and risk management constraints. What's left over is our cash position. My preference is always to be fully invested, but I have no intention of investing our money in securities that I believe are overvalued just to tell you that you're fully invested or well diversified. The former is a sure path to loss while the latter leads to mediocrity, at best.

- Cash = Dry Powder

  I often refer to cash as our dry powder. This reference goes back to the days when battles were fought with cannons, and gun powder had to be kept dry to be effective when called upon. Similarly, any cash that we hold is always ready to be deployed immediately as opportunities arise. Most recently, we went into early 2009 with a good deal of dry powder and were ready to take advantage of some of the best bargains I'd seen in a long time.

  To generate strong long-term returns, you only need to make a handful of significant (and correct) decisions over many years. My performance over the last 15 years was primarily driven by three key decisions. I made a very large bet on oil and energy service stocks back when oil was under $15/barrel, I avoided the carnage from the bursting of the tech/telecom bubble, and I've been heavily involved in the precious metals space for the past decade. Successful investing involves patiently waiting for compelling opportunities as well as avoiding disaster.

  Significant investment opportunities are being created all of the time. They may take years to fully form and become compelling, but they are constantly evolving. The ability to patiently wait for such opportunities is one of my key investment strengths. **In the "what have you done for me lately" world in which we live, patience is a luxury that few investment professionals enjoy. My ability to hold a large amount of cash at any given time and for extended periods is critical to our long-term performance**. It is one more tool which helps prevent me from doing anything stupid with our money, and it allows us to wait for fat pitches.

- Cash is never a bad thing

  You've heard me say this many times, and you'll hear it many more. Cash is never a bad thing. Yes, we will at times have a healthy amount of cash during a market rally, and this will negatively impact our relative returns in the short term. I spend zero time worrying about this. **What I am concerned about at all times is whether we're positioned appropriately given the opportunities available and the risks that exist looking out over the next few years. Cash is only a bad thing if you or your investment advisor are too timid to put it to work when exceptional opportunities do arise**.

Impact On Returns

Clearly, the more cash we hold that earns 0%, the more of a drag it will be on our results over time, assuming of course that asset prices are rising. The flip side, of course, is that cash helps performance during market pullbacks. **By definition, our investment philosophy and approach to cash will lead to frequent and significant deviations from broader benchmarks**. We will strongly outperform at times, and we will significantly lag at others. We may make money when equity markets fall or lose money when they rise.

To better understand my comfort with cash, it's critical to understand that I am NOT trying to mimic or beat some benchmark (like the stock market) every quarter or year. I certainly expect us to do well on a risk-adjusted basis over the course of a full bull and bear market cycle relative to appropriate benchmarks, but our core investments are made with a horizon well beyond one year. I have no particular skill in divining precisely how the markets will treat our investments in the short-term, particularly in the current environment in which government and central bank intervention have an outsized influence over short-term returns.

A Note for 401K Assets

Some clients have 401K plans with investment choices essentially limited to U.S. equities, bonds, and cash. These plans are mostly or wholly in cash at the moment and may remain so for some time. It's important to understand that these accounts should not be viewed in isolation.

For example, a client with a moderate risk tolerance may have two accounts of equal size -- a 401K plan and a traditional IRA. If the 401K has limited investment choices, it may be sitting entirely in cash currently. In isolation, this appears extremely conservative for a moderate risk individual. The IRA however, may be fully invested in volatile risk assets. By itself, this would appear to be rather aggressive.

All discrete accounts must be combined and analyzed as one portfolio, which is precisely how they are managed. In our example, the conservative 401K and the aggressive IRA work together to produce an appropriate moderate risk exposure for the overall portfolio. As a reminder, this analogy applies to every client with multiple accounts. Multiple accounts are managed as a single portfolio. This will lead to large but meaningless differences in performance between the individual accounts.

What Is Our Acutal Cash Position?

To best understand your cash position, you first need to know what portion of your portfolio is actually invested. This information can be found on page 6 ("Detailed Gross/Net Exposure) of your Quarterly Statement. This page details the net economic exposure of your portfolio as well as the effective amount of cash that is held.

"Actual" cash is the amount that you would find reported on your monthly brokerage statements (Schwab, Fidelity, etc.). It's an unadjusted figure and can be calculated simply by taking the amount of cash in your portfolio and dividing it by the total value of your portfolio.

"Effective" cash, however, is a much more meaningful number from a portfolio management perspective. This number takes into account the true economic exposure of each security in the portfolio. Consider the following alternatives:

1. We could invest our entire portfolio in SPY, which is an ETF that tracks the S&P 500 index. We would earn the same return as the S&P 500. Our actual and effective cash would both be zero. We are fully invested.
2. We could invest half of our portfolio in SSO, which is an ETF which provides a return equivalent to 200% of the S&P 500. The other half would remain in cash. On a daily basis, our entire portfolio would earn the same return as the S&P 500, just as in the first example. Our actual cash would be 50% of the portfolio, but we would effectively be fully invested (effective cash is zero).
3. We could invest our entire portfolio in SSO. On a daily basis, we would now earn 200% of the return of the S&P 500. Our actual cash would be zero, but our effective cash would be MINUS 100%. We would effectively be 100% leveraged. This would be equivalent to us borrowing an amount equal to the entire value of our portfolio in order to double our bet on the S&P 500.

I realize that this is a little technical. The Appendix in the back of each Quarterly Statement attempts to explain net and gross economic exposure more clearly. **The key point to understand is that simply looking at the amount of cash in your portfolio may not be giving you a true picture of your risk exposure. The reality is that your exposure to risky assets is probably higher than indicated by the amount of cash sitting in your account**.

Conclusion

Cash is not a bad thing, regardless of whether the markets are climbing or falling. Cash is only a problem if your portfolio manager isn't able to pull the trigger when attractive opportunities arise, or if he is unable to sit tight when compelling opportunities are absent and risk is high.

Don't worry about cash. You don't have too much, and you don't have too little. Whatever cash you have in your portfolio is just the right amount.

Best,

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