The Cash Conundrum

Cash can play many roles in an investment portfolio – as a risk management tool to buffer against market downdrafts, as tactical dry powder earmarked for a future investment opportunity, or as a vehicle to fund short-term liquidity needs. Over full market cycles, however, holding too much cash can act as a drag on overall portfolio performance.

With that said, key questions arise when managing cash within a client's portfolio. Where does the responsibility of determining the appropriate cash allocation end? Is an asset manager that tactically allocates cash as part of their investment strategy a help or a hindrance to the Financial Advisor that determines the overall cash position?

Our perspective on determining an appropriate cash allocation follows:

Who's Responsible?

From the perspective of managing a client's overall investment portfolio, it is our opinion that it is the Financial Advisor's responsibility to manage the tactical cash component. Investment managers within the various style boxes that increase their percentage of cash to protect principal may only confuse the allocation process. We believe that asset managers should be fully invested in accordance with their investment strategy and hold nominal cash positions of generally between 3-5%. After all, asset managers are selected by Financial Advisors and paid a management fee to execute their strategy regardless of the economic environment.

High Allocation, Lackluster Performance

Asset managers that hold too much cash generally sacrifice performance over time. Our proprietary research shows that typically equity mutual funds with a cash allocation of 10% or more lag their peers in terms of performance over longer time periods. We tracked 395 U.S. equity Funds through Morningstar with cash allocations of 10% or more as of 4/14/15. More than 78% of those Funds underperformed the S&P 500 for the trailing 5-year period

While cash can act as a risk management tool in falling markets, it can hinder performance in both rising and normal markets. It must be remembered that the S&P 500 Index, on average, rose in approximately 8 out of every 10 years over the past 50 years.

We believe determining the appropriate level of cash should be left to the Financial Advisor rather than an asset manager that manages a slice of a broader portfolio. Asset managers should manage to their objective and not tactically allocate cash. The Financial Advisor, on the other hand, has a different responsibility.

Determining an Effective Cash Allocation

It is widely believed that conventional asset allocation among stocks, bonds, and cash is typically driven by two considerations: the expected returns of the asset class and the expected correlations among asset classes. The following assumptions are used:

- Stock returns are either based on long-term history or an assumption that long-term valuation multiples will be reverting to the mean.
- Long-term returns on investment grade bonds are assumed to be their yields-to-maturity.
- Correlations are taken from history and assumed to persist.

But how do we model expected returns for cash?

With respect to this consideration, most asset allocation models miss the forest for the trees. In our quest to improve models – through better data and more complex calculations – we often confuse precision with accuracy.

For increased precision, we might consider a national average of deposit rates, instead of the one year Treasury, or we might survey the euro-dollar deposit futures strip to build an arbitrage-free cash yield forecast. Increased precision, however, misses a key point at the expense of model accuracy.

Consider Cash as Dry Powder

Even with abnormally low yields, cash should not be overlooked as a tactical weapon for taking advantage of market dislocations. Investors holding cash can scoop up bargains when panicky markets serve up opportunity brought about by indiscriminate selling.

The value of holding cash in today's asset allocations is often a function of capitalizing on opportunities resulting from market volatility rather than the income derived from the cash equivalent. Cash has option-like value by allowing savvy investors with clear standards for assessing compelling long-term value to benefit from market declines.

This "dry powder" value renders many conventional asset allocation models not precise, but far more accurate.

So, what to do?

- First, remember that most financial models are only partial representations of reality due to overall market complexity. Understand how they fall short.
- Second, use market scenarios instead of closed-form equations to determine how much cash to hold. In "down-market" scenarios, holding cash can add value, not just in loss avoidance, but in potential outperformance through deployment into securities when rebounds occur.
- Finally, make sure you have defined in advance (before you panic with the rest of the market) your trigger point for using your tactical cash – a market level, a valuation standard, something with real economic consequence – so that opportunities brought about by market volatility doesn't pass you by.

We believe incorporating opportunistic cash metrics can lead a Financial Advisor to construct a more dynamic cash allocation that is built upon opportunity rather than income and current yield. Therefore, even with its historically low yield, cash can be of great value to improving long-term outperformance. That said, Financial Advisors should make sure the investment managers they use in their clients' portfolios are not performing a duplicative cash allocation function but are fully invested at all times.

About Barrow Street

Barrow Street Advisors LLC is a registered investment advisor and is an affiliate of Barrow Street Capital LLC which is an investment management firm that manages value-oriented private and public equity strategies.

Headquartered in Stamford, CT the firm serves pension funds, sovereign funds, endowments, foundations, family offices and high net worth individuals. Since its inception, Barrow Street Advisors LLC and Barrow Street Capital LLC have invested approximately $550 million of equity in private equity and public equity strategies.

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