To Hold Cash or Not?

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August 10, 2004

Warren Buffett, Michael Price, Mario Gabelli, Walter Schloss, and Charles Royce are not the typical guest lecturers at a business school class. Then again, the Columbia University Graduate School of Business isn't just any business school, and professor Bruce Greenwald's class is anything but ordinary. Greenwald teaches the value investing course at Columbia and also authored *Value Investing: From Graham to Buffett and Beyond*. In part two of this five-part series, Greenwald tells Fool contributor Matt Logan what to do when no bargains are to be found.

TMF: Mason Hawkins, Jim Gipson, Bob Rodriguez, **Berkshire Hathaway's** (NYSE: BRK.A) (NYSE: BRK.B) Chairman Warren Buffett -- I could name plenty more standout managers -- are sitting on a ton of cash. And then you have someone like Bill Nygren, whom I spoke with a couple weeks ago. He said he's not going to sit in cash right now. He'd rather hold some fairly valued, high-quality names, because he doesn't want to fall behind.

Greenwald: I think that actually the right answer to this is that when you don't know what to do, that's what modern portfolio theory is for. It tells you what you should do is buy a mix of the market and cash, because you just don't know. The value fraternity is so strongly biased in favor of cash, that I think Nygren's answer is more the right one.

I'd say to this student of mine, "Look, what you should do is pick a mix of cash and the market. And even if it's a global market, you're investing in a global market." He'd say "No, no. It's gotta be cash because if everything is overvalued, you're stupid. You're stupid to buy overvalued stocks, on average."

Every so often value investors -- like Warren Buffett in 1968, like Bill Ruane in 1986 -- will come out and say there are just no stocks here worth buying. It's just not worth doing. So, what I wanted to have that student do was look over the next three years at how buying the market would have performed relative to holding cash in those cases. And in almost every case, buying the market beat the cash alternative.

We've never had valuations of the market as high as they are now. And you can do calculations that indicate that the market return is somewhere between 6% and 7%. And they've always been higher than that. But in general, you don't just want to throw away the market because you don't see particular values. Especially if you're an equity manager -- what's your risk? It's deviation from the market. So if you have nothing to do, you might as well minimize risk and buy a full market portfolio, and that's that.

If you're managing, like Seth [Klarman] is, family money, then you're very risk averse. And when you don't know what to do, you'll hold mostly cash. But it's a decision that you want to make in broader terms than, "Oh, I don't see value. I should do cash." So I think Nygren is essentially right about this one. I think Bill, for his position as an equity manager, it's a risk-minimizing thing for him to do, too.

TMF: Is the flip side of that, though, that Seth Klarman and other folks holding lots of cash are just a little too focused on short-term paper losses?

Greenwald: No, no. They're not too short-term. The thing is, they're too risk averse. Seth is the world's most risk-averse person. The problem with the stock market is if it goes down 30%, you lost the 30% forever. So if you're an absolute return person, the fact that -- supposed that there's a 50-50 chance of up 40 and down 30. Well, that's a pretty good average return, right? So if you were just average return and you thought over the long term it would average out, you'd go ahead and buy some mix of the market in cash. But if you really are managing family money, and they're living off it, and they live psychologically off sort of the value over the next two to three years, they don't want to risk the 35% loss. I don't think it's just short-term risk. I think if you wait long enough, you're right. If you have a 30-year horizon, it may be short-term risk. But I don't think anybody thinks long-term is a 30-year horizon. If you've got a four- or five-year horizon, it could be a very risky thing to do. Just look at what happened between 1965 and 1980. Actually, that's a 15-year horizon, where stocks were lower at the beginning of 1980 than they were at the beginning of 1965.

TMF: So it comes down to your risk tolerance and to your time horizon, which is basically what everything comes down to for investment managers.

Greenwald: Right. But I think the right way to think of it is how you're being measured, which determines your risk tolerance. If you're being given institutional funds that the institution wants to allocate to equity, you got a different risk profile on the returns on those funds than if you're managing a family's entire wealth where they care about absolute returns.

Tomorrow: Bruce Greenwald shares the dos and don'ts of shorting stocks.

Read Matt Logan's complete interview with Bruce Greenwald:

- Value Investing 101
- To Hold Cash or Not?
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Fool contributor Matt Logan owns shares in Berkshire Hathaway, but none of the other companies mentioned. The Motley Fool has a disclosure policy.

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