Passive
Capital Management

The Comfort of Cash:
Short-term Security vs Long-term Erosion of Purchasing Power

Many investors have felt the temptation to exit the stock market over the past 12 months and hold cash or cash equivalents. The current global financial turmoil is being compared to the Great Depression of the 1930's. There doesn't seem to be much positive news on the horizon and government intervention is creating uncertainty around future expectations. Preservation of capital has become the objective for a majority of investors as fear and doubt prevail. Switching to cash may appear to be a safe strategy but, in reality, you are actually trading one risk for other risks.

1. Market-timing risk: If you are thinking of selling all of your equities and just holding cash you are, in my opinion, on the verge of making a bad decision. With the benefit of hindsight, equities should have been sold in late 2007 when the S&P was at 1562. You got it wrong once so how do you know that you will correctly time (guess) when to re-enter the market? History shows us that recoveries in equity markets are often quick and can be dramatic with the largest changes in stock prices occurring around the beginning of a rebound. Missing out on just a few days can have disastrous effects on the value of your portfolio. A study done in 2005 at the Ross School of Business at the University of Michigan showed how damaging it could be to the value of a portfolio when just a small percentage of days with market gains were missed. ***From 1963 to 2004 an index of U.S. stocks gained 10.8% annually. If you missed the best 90 days in that period (less than 1% of the total days), the annual returns fell to 3.2%, over a 70% shortfall. That's a lot of money left on the table.*** Furthermore, the same emotions that lead investors to flee the market come back into play when they are trying to decide when to buy equities again. The fear that drove them out of the market will make them hesitate, waiting to see some stabilization or signs of recovery. Of course, those are only seen in hindsight, oftentimes after a significant bounce-back has already occurred. In 2004, ***Dalbar Inc, a financial-services market research firm that focuses on investor behavior, found that from 1984 to 2004, when the S&P grew by 12.9% annually, the average investor earned annual returns of only 3.5%. This disparity was primarily due to market-timing penalties***. ***Lost opportunities can be very costly.***

2. Safety risk: Recently, some investors who thought their money was safe in a money market were shocked to discover that was not the case. The Reserve Primary Fund, the oldest and one of the largest money market funds, "broke the buck" in September 2008. The value of the fund fell below $1.00. Investors were barred from making withdrawals as the fund tried to recoup its losses. This fund, which reached approximately $63 billion, was marketed as extremely conservative but its managers were taking on more risk than investors knew in order to earn higher returns. Auction rate securities (ARS) were sold as cash equivalents to many investors and grew to be a $200 billion market by the beginning of 2008. They were attractive because they offered slightly higher interest rates and were supposedly liquid. When the auction markets failed in February 2008, most of the assets were frozen and many remain so. Illiquidity can be a costly risk and is not always obvious to see. ***Some of the benefits of ARS proved to be illusory and, once again, the market taught us that returns are a function of systematic risk.***

3. Loss of purchasing power: Now that you have the cash, where do you put it? Interest rates are very low so parking funds in savings accounts or CDs is almost a sure bet that, after taxes and inflation, you will have less money than you started with. The risks of outliving your money, and/or losing purchasing power then become very real. Charitable giving may have to be adjusted or the amount of your estate you hoped to leave to your heirs may be significantly less than you planned.

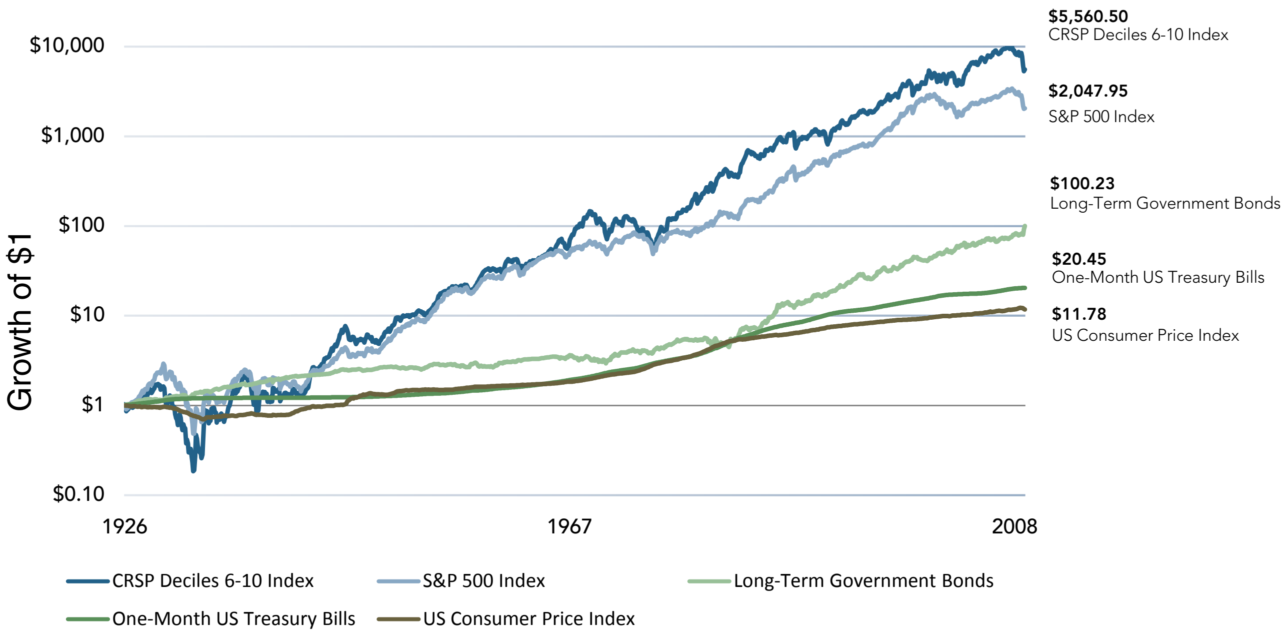
Risk has many dimensions. Investors must consider the long-term consequences of assuming one risk for another. Markets go through up and down cycles but over the last 81 years (1927-2008) the S&P has provided compound annual returns of 9.6%. Those returns came despite the Great Depression, multiple wars, the energy crunch, the technology bubble, the collapse of the saving and loan industry and terrorist attacks. Even during recessions, historical returns remained positive, compounding at about 0.5% per month on average, due to the fact that the majority of losses occurred in the 3 months prior to the recession. Capitalism continues to do its job of rewarding investors who commit capital to its industries. **One important fact that is easy to lose sight of when markets are in decline is that for every seller, there is a buyer.** That buyer believes they just made a great purchase at a wonderful value.

Most of us have already borne the risk of owning equities. Now we should stay the course in order to reap the benefits. In equity markets, volatility is the norm but history shows that capital markets are resilient and over the long-term, have continued to reward investors (see Growth of $1 chart below). We can ride out periods of volatility and enjoy the long-term rewards by keeping emotions in check, focusing on our long-term goals and adhering to a disciplined investment strategy. No one can predict with any degree of certainty when the equity markets will improve but ***having the appropriate asset allocation, being diversified, re-balancing when necessary and keeping costs to a minimum will help increase the odds of having a successful investment experience.***

I believe that risk is best managed by a prudent asset allocation, not by trying to time short-term market movements.

Growth of $1

Monthly: January 1926 - December 2008



Sources: Returns 2.0; Bonds, Bills, And Inflation, Chicago: Ibbotson And Sinquefield, 1986; CRSP data provided by Center for Securities Research and Prices, University of Chicago; The S&P data are provided by Standard & Poor's

Index Services Group. The indices are not available for direct investment; therefore its performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results, and there is always the risk that an investor may lose money.

Note: S&P 500 Index is a proxy for domestic large cap stocks.
CRSP Deciles 6-10 Index is a proxy for domestic small cap stocks.

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