Seth Klarman on the Painful Decision to Hold Cash

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It wouldn't be overstating the case to say that investors face a crisis of low returns: less than they want or expect, and less than many of them need. Investors must choose between two alternatives. One is to hold stocks and bonds at the historically high prices that prevail in today's markets, locking in what would traditionally have been sub-par returns. If prices never drop, causing returns to revert to more normal levels, this will have been the right decision. However, if prices decline, raising prospective returns on securities, investors will experience potentially substantial mark to market losses, thereby faring considerably worse than if they had been more patient.

The alternative is to remain liquid, defy the steady drumbeat of performance pressures, and wait for the prices of at least some securities to drop. (One doesn't need the entire market to become inexpensive to put significant money to work, just a limited number of securities.) This path also involves risk in that there is no certainty whether or when this will occur; indeed, securities prices could rise further from today's lofty levels, making the decision to hold cash even more painful. Meanwhile, holding out for better returns involves a (potentially lengthy) period of very low (albeit certain) positive returns available from today's short-term U.S. Treasury instruments.

While we have strong suspicions, it cannot be said with certainty which path will prove wisest. What is clear is that just about everyone will choose the former one. Those in the investment business compete on the basis of short-term, relative (not absolute) investment performance, and prefer to follow the herd (at the price of assured mediocrity) rather than stand apart (risking severe underperformance). From a business perspective, how much better to be actively deploying capital, even if the investments are mediocre, than to be stalled in neutral; the employees keep busy, while the clients confuse decisions with diligence, activity with insight, and a fully invested posture with a worthwhile portfolio.

Most investors would make the same choice. Human beings are only endowed with so much patience, after all. Few are able to look past near-term returns, and today anything appears to offer better returns than cash. Also, given their relative-performance-oriented, competitive nature, investors loathe the possibility of underperformance that comes from sitting on the sidelines; they find it better to be in the game (unless, of course, the market drops). Most significantly, they remain highly skewed toward the greed end (how much can you make?) and away from the fear end (how much can you lose?) of the spectrum of investor emotions. In short, investors remain the consummate yield gluttons, seeking high return without regard for the likelihood of actually achieving it or for the risk incurred in the process.

Betting that the markets never revert to historical norms, that we are in a new era of higher securities prices and lower returns, involves the risk of significant capital impairment. Betting that prices will fall at some point involves opportunity cost of uncertain amount. By holding expensive securities with low prospective returns, people choose to risk actual loss. We prefer the risk of lost opportunity to that of lost capital, and agree wholeheartedly with the sentiment espoused by respected value investor Jean-Marie Eveillard, when he said, "I would rather lose half our shareholders. . . than lose half of our shareholders' money…."

Some argue that holding significant cash is gambling, that being less than fully invested is akin to market timing. But isn't a yes or no decision the crucial one in investing? Where does it say that investing means always buying something, even the best of a bad lot? An investor who can't or won't say no forgoes perhaps the most valuable tool available to investors. Charlie Munger, Warren Buffett's long-time partner, has counseled investors, "Look for more value in terms of discounted future cash flow than you're paying for. Move only when you have an advantage. It's very basic. You have to understand the odds and have the discipline to bet only when the odds are in your favor."

Investors expect corporate managements to make carefully reasoned decisions, such as whether or not to commit their capital to build new factories, hire additional staff or acquire a competitor. A corporate management that invested capital at low expected returns just because they had the funds at their disposal and nothing immediately better to do would inevitably arouse investor ire. Why, then, should any investor (hedge fund, mutual fund or individual) always deploy 100% of their capital into marketable securities, applying none of the analytical rigor or intellectual honesty they would demand of the underlying corporate managements? As we said last year, why should the immediate opportunity set be the only one considered, when tomorrow's may well be considerably more fertile than today's.