

The Case for Cash

To be fully invested in this environment is to say that the reward that awaits is worth the risk assumed. We feel a little like Indiana Jones in a dark, abandoned temple, unsure when a big rock might come rolling our way. Maybe he had more confidence in the treasure that lay hidden within. (We apologize for the cinema metaphor and can only claim living adjacent to Hollywood as an excuse.) Never in our careers have we seen such paucity. We can best exemplify the dearth of opportunity by listing what is in favor in the financial markets: stocks small and large, growth and value, domestic and foreign; real estate, commodities including precious metals and energy; bonds including government and high-yield. Show us an asset class or industry group that is out of favor. We know of a couple: the U.S. dollar and cash. To the former, we believe that there are longer-term structural issues that will make currencies other than our own more attractive although we can see why the dollar may rally in the foreseeable future. Cash has all the qualities of an out-of-favor asset class: the expected return is low, the investor majority disparages its virtue, and clients usually do not condone its use. But it is neither for these reasons nor for laziness that cash has become a large part of our portfolios at First Pacific Advisors. Rather, it is our strict adherence to the principle of paying a discounted price for a good asset that brings about its existence. We will not make conscious decisions that may erode capital. Not that this makes it right and if Warren Buffett jumped off a cliff we wouldn't follow, but it is interesting to note that he increased his own cash liquidity at Berkshire Hathaway in 2003 to \$36 billion, or 19.9% of assets, up from 7.5% the year before.

Let us put the cash in perspective for you because we believe that the opportunity cost of holding cash today is as low as it's been in the last three decades. As we have discussed in prior client letters, we believe that the U.S. stock market is likely to compound in the mid-single digits. The penalty for holding 30% in cash in today's environment is 1.65% per year, assuming a 7% return on stocks over the next five years (at the higher end of our expected range) and a 1.5% return on cash – a price we are willing to pay. However, we are sure of one thing, that the environment will change. We will not have such a large commitment to cash ad infinitum. We believe it's the prudent by-product of the lack of ideas resulting from our investment process. There will be investment opportunities again. Furthermore, today's unsustainably low 1.5% return on cash sits at a 45-year nadir. We expect short-term money-market funds to average 3% over the next five years, still far less than the 6% to 10% range of the last twenty years.

It is not always so easy to sell a stock at the same time you wish to buy a stock, especially if you traffic in less liquid investments as is frequently the case with small- and mid-cap stocks. We would rather make sure that we have the capital easily accessible when an investment opportunity arises. We are shopping for just a few good ideas. We see packed aisles in the Relative Value (R-V) store, inventory piled to the rafters and no membership fee required. The Absolute Value (A-V) store down the street is our preferred establishment but its shelves are unappealingly bare. The old "A-V" only requires patience as its club dues but that can have a high cost. With an economy that has bounced back and the bull market seemingly in place, the R-V shoppers have made and may continue to make a pretty penny. As A-V patrons, the dues for patience that we pay today may have a high cost if the stock market continues its run over the near term.

Sincerely,

Steven Romick
April 23, 2004