GMO Asset Allocation Insights

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Cash: One Investor's Trash is Another Investor's Treasure

Rick Friedman

Normally bonds play the protective role in portfolios. Given today's low rate world and the potential for rate rises, bonds are not well-suited to do so at the moment. Most investors also prize cash[1] for its defensive properties, recognizing cash as a liquid and stable store of value. Meaningful cash allocations, however, are frowned upon given cash's low returns, which lead to "cash drag" over long periods. With interest rates near record lows, the distaste for cash is as intense as ever. This view, though, overlooks the fact that cash provides critical optionality to patient investors, allowing them to play offense when assets are priced attractively. Risky assets and long-duration bonds are priced to deliver underwhelming returns based on GMO's forecasts, making cash more important than usual.

"Cash Is Trash"

In today's low interest rate world, many investors believe that "cash is trash." This aversion to cash is understandable. Typically, cash returns do not keep up with stocks and bonds. Between 1900 and 2016, cash (represented by US Treasury bills) rose 0.8% real per year while US stocks and bonds increased 6.4% and 2.0%, respectively.[2] These low relative returns make sense because cash is a "safe" asset bearing no credit, equity, or significant interest rate risk.

Cash, however, isn't riskless. Holding cash during elevated periods of inflation or low rate environments (with positive inflation) can lead to the erosion of purchasing power. US cash delivered negative real returns during the high inflation period in the 1970s and more recently between 2000 and 2016 when cash generated -0.5% per annum.[3] Holding any cash at today's negative real rates will continue to act as a headwind to the compounding of wealth. In response to the Global Financial Crisis (GFC), we have even seen negative nominal rates for cash holdings in Europe and Japan. Even if rates rise, a permanent cash allocation will lead to a "cash drag" relative to a fully invested stock/bond portfolio.

[1] The definition of cash can vary from actual physical hard currency to 3-month T-bills to money market funds. After the Reserve Fund "broke the buck" during the Global Financial Crisis, the SEC put Rule 2a-7 into place to ensure that money market funds (a common view of cash-like portfolios) hold conservative exposures from maturity and credit rating perspectives. Money market funds must have a maturity of 60 days or less with no more than 3% of assets invested in securities that do not fall within the first or second highest credit ranking tier. The rule also placed increased liquidity requirements on these funds. As asset allocators, we tend to think of cash a bit more broadly than the narrow definition employed by money market funds. Cash and cash equivalents (collectively "cash" for discussion purpose in this commentary) are highly liquid, have limited correlation to risk assets, and limited interest rate or credit risk. There may be a role for bearing modest liquidity risk in a cash and short duration allocation. We'll discuss this opportunity in future commentary.

[2] Elroy Dimson, Paul Marsh, Mike Staunton, "Credit Suisse Global Investment Returns Yearbook 2017," February 2017.

[3] Ibid.

Not surprisingly, large cash exposures introduce significant career risk to even the most disciplined value investor, particularly after years of rising markets in which being "all in" has been beneficial. The human desire for action over inaction (or patience in the case of investing) leads investment managers and asset owners alike to view holding cash as a form of "doing nothing." Yet, why do some managers open themselves to the possibility of disappointing their clients in the short term by allocating to low-yielding cash?

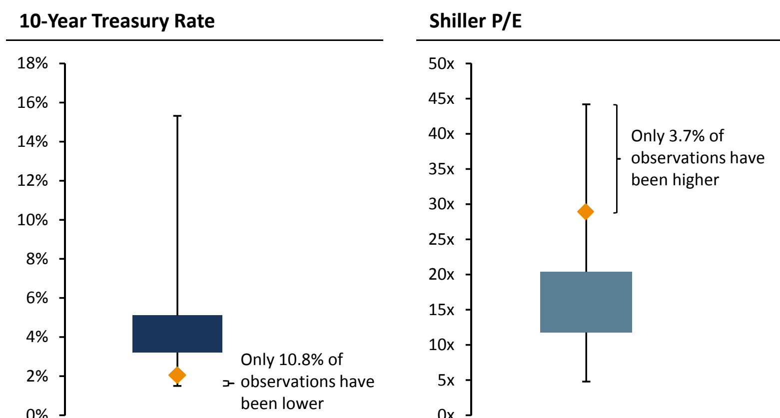
The Treasures of Cash

With qualities like high liquidity, no correlation with risk assets, and no interest rate or credit risk, cash provides numerous benefits to long-term investors. Cash serves a defensive role, acting as a stable store of value and providing flexibility to meet future spending needs. During deflationary environments, cash increases in real value. While cash will not keep up with longer-duration bonds in these periods, it will buffer against equity declines that may come due to a drop in earnings. In adverse market environments (inflation shocks aside), cash serves as an important diversifier, essentially a shock absorber. Of course, cash also provides income, albeit modest most of the time.

Perhaps the most beneficial quality of cash, though, is the optionality it offers, allowing the patient investor to play offense. Cash acts as dry powder (a call option with an infinite maturity) because it confers the right, but not the obligation, to buy risk assets at more attractive levels. Normally, bonds play this protective role even better by rallying as risk assets sell off. Sometimes, however, both stocks and bonds are expensive. With price multiples stretched and interest rates low, today is one of those times. As Exhibit 1 indicates, at the end of February 2017, bond yields were near record lows while the Shiller P/E ratio stood at an even more aggressive extreme. With the S&P 500 trading at 29.8x on a Shiller P/E basis (more expensive than at the peak of the bubble that led to the GFC) and 10-year Treasuries offering a paltry 2.4% at the end of February, the world is full of expensive assets. A scenario in which both bonds and stocks decline due to higher discount rates and/or risk premiums is certainly possible.

At the end of February, GMO's forecast for cash was essentially in line with that for bonds. Bonds, however, carry an additional risk – valuation risk. If yields were to mean revert immediately to long-term normal levels (which we think is highly unlikely), 10-year Treasuries would decline approximately 20% by our calculations.

Exhibit 1: Bond Yields and the Shiller P/E

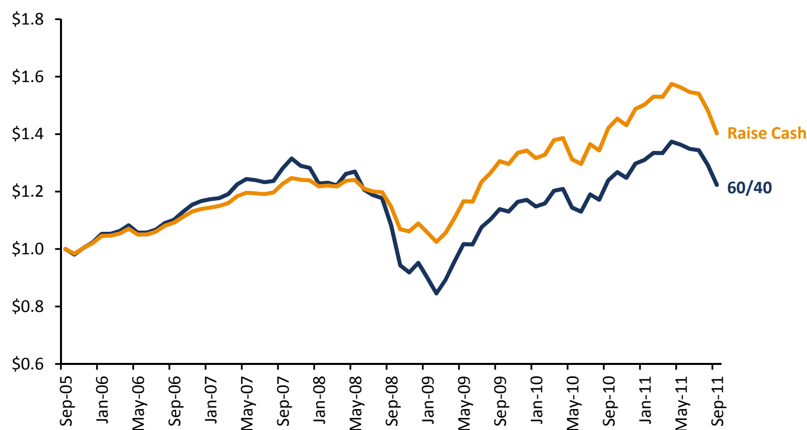


As of February 2017
Source: Robert Shiller dataset from 1871 to February 2017

In these situations, the ability to hold cash rather than bonds is especially valuable. Setting aside capital when markets are expensive ensures that investors will be able to buy assets when attractive investment opportunities present themselves.

The following stylized example illustrates the combined power of dry powder's role in limiting drawdowns and offering flexibility when assets are attractively priced. The chart compares the growth of a dollar invested in a static 60% stock/40% bond (60/40) portfolio through the GFC to a more dynamic, valuation-sensitive approach. The "Raise Cash" line in Exhibit 2 tracks a portfolio that responded to expensive valuations by pulling 10% from equities in favor of cash in each of the three years leading up to the large drawdown in late 2008. We then assumed the Raise Cash portfolio had the fortunate timing to redeploy that 30% in cash back into equities during the second quarter of 2009 when valuation signals were more attractive. The Raise Cash portfolio lagged as markets moved from expensive to even more expensive levels, trailing the benchmark 60/40 portfolio by over 5% in late 2007. That would have been the period the valuation-sensitive Raise Cash manager began to hear opposition to a meaningful cash allocation in the portfolio. However, any cash held coming into the fall of 2008 proved to be very beneficial in limiting the impact of the sharp drawdown of risk assets. Over the cycle, the Raise Cash approach yielded nearly 15% more wealth and delivered a smoother ride relative to the static 60/40 portfolio. Of course, this illustration would have looked even better had risk assets been allocated to nominal bonds in lieu of cash during this period.

Exhibit 2: Static Growth vs. Valuation-Sensitive Growth



Source: GMO

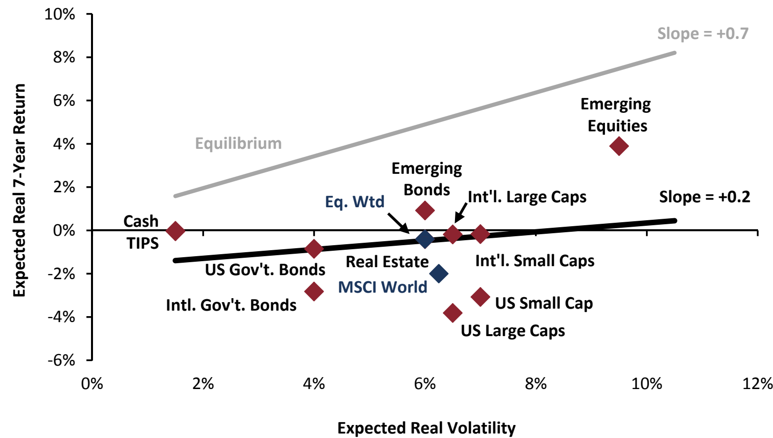
This example echoes the actual experience and thought process behind GMO's asset allocation strategies during the GFC. We aim to grow wealth responsibly over time. While we know we must bear risk and short-term portfolio declines to generate returns, we seek to limit the corrosive impact large drawdowns have on compounded returns. As assets became pricier in the mid-2000s and our forecasts declined, we added cash and cash equivalent strategies to our portfolios. These exposures proved efficacious in limiting drawdowns in our portfolios in 2008, and allowed us to ramp back up our risk exposures in late 2008 and early 2009 when assets were more attractively valued.

"Doing Nothing" Is Particularly Valuable Today

Given its optionality, cash's worth depends on both the current valuation levels of risky assets and their future volatility. The value of cash depends on how attractive an investor thinks opportunities

in the future will be relative to today. We use our 7-Year Asset Class Forecasts to help assess the attractiveness of liquid assets around the world. The dark line in Exhibit 3 plots our current forecasts relative to a long-term expected real volatility for each asset class. The higher and steeper the line is on the page, the more we believe we are being paid to take risk. After seven years of superlative aggregate returns, we view the opportunity set as quite muted. The line is low and quite flat.

Exhibit 3: Today's Muted Opportunity Set



As of 2/28/17
Source: GMO
The expectations provided above are based upon the reasonable beliefs of the Asset Allocation team and are not a guarantee. Expectations speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update such expectations. Expectations are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in the expectations above.

These forecasts reflect the returns we believe an investor may receive from buying and holding the current opportunity set for the next seven years. The true opportunity set, however, is not static. Tomorrow's opportunity set will be different than today's as asset prices change. We expect low to negative returns for most asset classes as they reprice to fair valuation levels.

As long-term investors focused on delivering attractive absolute returns, we are willing to endure the pain of short-term underperformance relative to a fully invested 60/40 portfolio if asset prices remain at or rise to even more expensive levels. Because we seek a margin of safety in all assets we add to our portfolios, we avoid expensive assets that may lead to the permanent impairment of capital.

Today, we are allocating to the opportunities we believe can generate positive returns while simultaneously monitoring the overall risk of our portfolios. Cash is a residual asset when there are not enough cheap stocks, bonds, or other assets to build a diversified portfolio. Long-horizon value investing requires patience, discipline, and a willingness at times to avoid the herd and "do nothing."

Rick Friedman: Mr. Friedman is a member of GMO's Asset Allocation team. Prior to joining GMO in 2013, he was a senior vice president at AllianceBernstein. Previously, he was a partner at Arrowpath Venture Capital and a principal at Technology Crossover Ventures. Mr. Friedman earned his B.S. in Economics from the University of Pennsylvania and his MBA from Harvard Business School.

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