

SITTING ON CASH – HOW AND WHEN DO YOU GET BACK IN?

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ABSTRACT

In 2007 the author, a practicing financial planner, decided to adopt a new business model for managed money. This change necessitated that existing assets in most client accounts be sold in order to move to the new platform. The stock market reached a top in 2007 and subsequently declined in 2008. The author maintained the cash holdings for his clients throughout 2008 and into 2009. The market continued to decline in 2009, reaching a low on March 9th. There has been a significant rally from this point. The market, as represented by the Standard & Poor's 500 (S&P 500) is up 11.5% year-to date as of August 10th. Nonetheless, this index has a negative 7.5% three year annual return as of this date [11]. While the author was fortunate to sit on the sidelines during much of the market downturn, decisions must be made regarding when to get back into the market and how to do so. This paper explores alternative strategies for re-entering the market during a period of substantial uncertainty. The efficacy of modern portfolio theory and asset allocation will be challenged.

INTRODUCTION

The author is a Registered Representative of an independent broker-dealer firm. He has practiced as a financial planner since 1983. More recently, his practice has focused on investment advisory services. His client base largely consists of families who are approaching retirement or are in retirement. Most clients seek a moderate growth portfolio. They are willing to under-perform when the market rises substantially. However, they expect to outperform when the market declines. Client portfolios have been designed with this objective in mind.

An institutional approach to managing money was implemented in which the basic tenets of modern portfolio theory were followed. Each client completed a questionnaire that documented investment objectives and assessed risk tolerance. A specific asset allocation was then developed for the client using asset allocation software and/or professional judgment. Either way, the goal was to minimize the level of risk for a given level of expected return. This was implemented by designing a portfolio that consisted of asset classes that had varying correlations to the market as a whole and to each other. Accordingly, allocations were typically made to:

- Domestic equities
- International equities
- Bonds
- Cash
- Real Estate

Further, equity investments were categorized based on market capitalization and style (i.e. value or growth).

Mutual funds are the investment vehicle of choice. Mutual funds offer professional management and diversification. They can be readily researched and selected for inclusion in a portfolio. Morningstar is used extensively for mutual fund research. Morningstar categorizes equity mutual funds according to “nine style boxes” [14].

FIGURE 1 – MORNINGSTAR EQUITY STYLE BOXES

	Value	Blend	Growth
Large Cap			
Mid Cap			
Small Cap			

It was not uncommon to select funds in most, if not all, of the equity style boxes for each portfolio. The value and growth styles of investing tend to go in and out of favor. Similarly, there are periods when large cap stocks outperform. In other periods, small or mid cap stocks outperform. Accordingly, investments were made in most of the style boxes as a hedge. This approach worked reasonably well until the end of 2007 and all of 2008.

A NEW APPROACH

Prior to 2007 the author utilized C share mutual funds for client portfolios. C shares were viewed favorably because the client did not incur a front-end sales charge. There is typically a contingent deferred sales charge of 1%. However, this charge disappears if the client holds the fund for at least one year after purchase. The broker receives a smaller upfront commission when C shares are purchased. However, a continuing income stream is created as long as the client continues to hold the fund(s).

In more recent years, regulators have placed increased scrutiny on the use of C shares. The concern is that clients may incur higher expenses if C shares are held for long periods of time. This may occur because the expense ratio of a C share is higher than that of the corresponding A share of the same fund. While a client incurs an upfront commission when A shares are purchased, the client may pay less total fees if the fund is held for several years. Some broker-dealer firms have placed limits on the dollar amount of C shares that can be sold to a given client. There has been some discussion about prohibiting the sale of C shares.

Accordingly, the author decided to adopt a different platform in 2007. Clients were given the option to move to the Preferred Asset Management (PAM) Account. In this new model, clients agree to pay a fixed fee based on the value of assets under management. The use of no-load mutual funds, exchange-traded funds and individual securities is available. This model provides greater transparency of annual fees and expenses, more investment options and detailed quarterly reporting of investment performance.

All clients presented with the option to move to a PAM account elected to do so. There was one major catch. C share mutual funds are not allowed in PAM accounts. Accordingly, we were required to sell all

C share mutual funds in existing client accounts. The proceeds from sale were subsequently transferred to the new PAM accounts established. It was permissible to transfer A share mutual funds to the new PAM accounts if the client had held the A shares for at least two years prior to transfer. In many cases, clients ended up with a PAM account consisting entirely of cash.

Most clients realized gains when we sold C shares in 2007. Further, substantial losses were avoided because we remained in cash throughout 2008. In fact, a positive return was generated for the year because interest income received on the uninvested cash exceeded the expenses incurred. It must be noted that the move to cash was not part of some profound ability to time the market. The author did not forecast a substantial decline in the market. The sell-off of client assets was indeed fortuitous.

Nonetheless, we remained in cash throughout 2008. Doing so ran the risk that the market would take off and leave us behind. Fortunately, this did not occur. History has shown that being out of the market when the market moves up sharply over a few days can result in significant underperformance for the full year. Thus, those holding large cash balances must decide how and when to get back into the market.

Is It Time To Get Back In?

The stock market has rallied 45% from its lows in March, yet Jack Albin, Chief Investment Officer of Harris Private Bank, suggests that stocks will head higher in the next 12 to 18 months [1]. He bases this assessment on five indicators: valuation, the economic backdrop, liquidity, psychology and momentum. A growing number of prognosticators believe that the recession is over. Stocks have posted positive returns for the six month and twelve month periods following post-World War II recessions in 9 of the 10 occurrences [9]. In a poll conducted by Barron's, nearly 60% of the money managers polled described themselves as very bullish or bullish, 28% were neutral and 13% were bearish. There is a consensus that a sweet recovery is brewing for 2010 [13]. Alternatively, A. Gary Schilling, a well-respected economist, suggests that the demise of the bear market is greatly exaggerated [10]. A large number of money managers and economists believe that the economy remains deep in the woods and requires a surge in consumer spending, business investment and home buying for sustained growth [4].

The stock market may be roaring. However, net inflows to stock funds have been anemic. Flows to stock funds remain well below their 10-year average of \$7.8 billion a month [12]. Investors are waiting on the sidelines. They wonder whether the recent run up in stock prices will last [6].

Against this backdrop of divided opinion among money managers, academicians and economists, the author has decided that the risk of being entirely out of the market is one not worth taking. Accordingly, a portion of the uninvested cash in each PAM account has been put to work.

A Challenging Time For Advisors

Many advisors are saddled with guilt regarding the decimation of client portfolios during the historic decline on Wall Street. Others are frozen into inaction due to the fear of making further missteps. There is a crisis of confidence afflicting advisers [7]. Some advisers have suggested that diversification didn't work and that modern portfolio theory (MPT) is dead. Brad McMillan believes that MPT worked well. The problem was many advisers became enamored with stocks and minimized the allocation to fixed investments. Some advisers felt that they had a diversified portfolio because they made allocations to domestic and international large, mid and small-cap stocks and real estate investment trusts [8].

Brent Bodeski, a financial adviser in Rockford, IL, recommends that investors who got out of the market should start stepping back in to get back to their target asset allocations. His firm's model portfolio for a taxable account consists of the following allocations [2].

- U.S. Stocks 46%
- Foreign Stocks 19.5%
- Bonds 27%
- Other 7.5%

His model portfolio includes twenty-five mutual funds. The largest allocation (15%) is to the Vanguard Total Stock Market Index.

Larry Carroll, a financial adviser in Charlotte, NC, recommends preferred shares for investors seeking income. Mr. Carroll invests client money in mutual funds, but he also invests a portion in individual securities. His model portfolio for income-oriented clients consists of the following allocations [3].

- U. S. Stocks, Preferred Shares & Asset Allocation Funds 45%
- Bonds 40%
- Cash 3%
- Foreign Stocks 7%
- Commodities 5%

CONCLUSION

No one knows the shape that this recovery will take. Will it be a V shape or will there be another significant decline and then a new leg up, a so-called W shape? Given the uncertainty, it makes sense to maintain some level of exposure to the market. However, it may be advisable to structure and manage portfolios differently than we have in the past. Market volatility will likely continue. Accordingly, advisers may need to take a more active approach to portfolio management. The concept of buy and hold appears less attractive. Similarly, it may be advisable for advisers to move away from fixed asset allocations for a more flexible approach. It should be noted that a client's risk tolerance changes over time and in response to economic events. Similarly, the risk in most investments is dynamic and relative. Going forward, advisers will need to be good listeners, educators and communicators in order to structure portfolios consist with client objectives [5].

The author has decided to gradually move back into the market by designing a custom asset allocation for each PAM account. Allocations may vary from one account to another based on the unique objectives, prior experiences, financial position and perceived risk tolerance of each investor. This approach recognizes that one size does not fit all – even when investors have similarities in age, income, etc.

Mutual funds have been categorized as follows:

- Core Equity
- Core Bond
- Growth
- Income & Growth
- Asset Allocation
- International
- Defensive

The percent of a client's assets allocated to each bucket will vary over time. However, the goal is to play offense and defense at the same time. The defensive category includes funds designed to provide protection against down markets (e.g. cash) and inflation (e.g. real estate, commodities and inflation-protected securities). Initial positions have been established in each category. Additions will be made via systematic investment (i.e. automatically adding to each fund on a monthly basis). This approach should prove reasonably successful if we experience gains in the market in 2010.

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