Cash as an Asset

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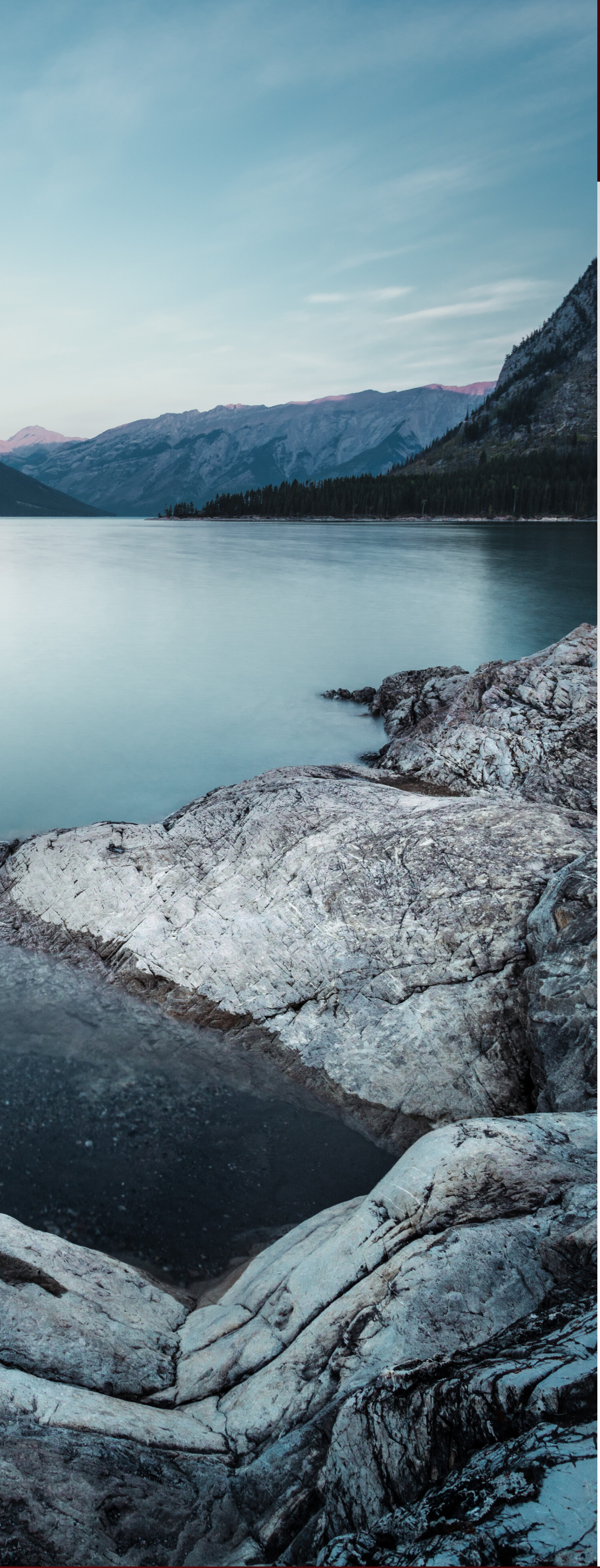

Introduction

As the market continues its upward rise, we believe the emphasis we place on our managers holding cash makes more sense than ever. With most Mutual Funds lagging the S&P 500 Index for 10 years, we feel it is important to go against the crowd. For example only 3% of the 7,500 U.S. equity funds tracked by S&P Capital IQ recently had cash positions of 10% or higher, while 97% were almost fully invested.

If the average fund holds no cash, then it signals that most funds are fully invested and thus could lead to an overvaluation of the market. This in turn could be a signal to hold more cash as there are fewer bargain opportunities when the market is fully invested in. That gives ammo to money managers who say "cash is trash." A federal funds rate stuck near zero means cash will continue to deliver negative real returns for some time.

Who in their right mind, the standard Wall Street taunt goes, who would own cash when it's a guaranteed losing proposition?

Some standout value fund managers, that's who. Warren Buffett of Berkshire Hathaway, Prem Watsa of Fairfax Financial Holdings, and Bruce Flatt of Brookfield Asset Management have all recently increased their cash positions with the prospect that there is a lack of quality buying options. As Warren Buffett puts it, "There will be some incident, it could be tomorrow. At that time, you need cash. Cash at that time is like oxygen. When you don't need it, you don't notice it. When you do need it, it's the only thing you need. We operate from a level of liquidity that no one else does".

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Berkshire Hathaway

Berkshire Hathaway has perhaps the largest cash position of these holding. With over $64.56 billion in cash and equivalents and another $46.54 billion in short-term investments (which can essentially be considered cash for liquidity purposes) reported at the end of the second quarter of 2018, Berkshire Hathaway has a total of $111.1 billion at its disposal (3). This represents nearly one-fifth of the company's market cap! Despite a $2.4 billion increase in cash from last quarter as a result of the acquisition of Monsanto by Bayer, it appears that all excess cash generated by Berkshire's operating business was reinvested, which is a slightly encouraging sign that Buffett finds some investment options attractive (3).

Regardless, such a large cash position is still a clear signal that Warren Buffett believes the market is full and that he would rather wait for bargains than invest at high prices. This is not a new strategy for investors like Warren Buffett as he has been known to increase his typical $20 billion cash position in times when he feels like there are no options, which has contributed to his 19.1% average annualized return on book value since he took over Berkshire Hathaway (4).

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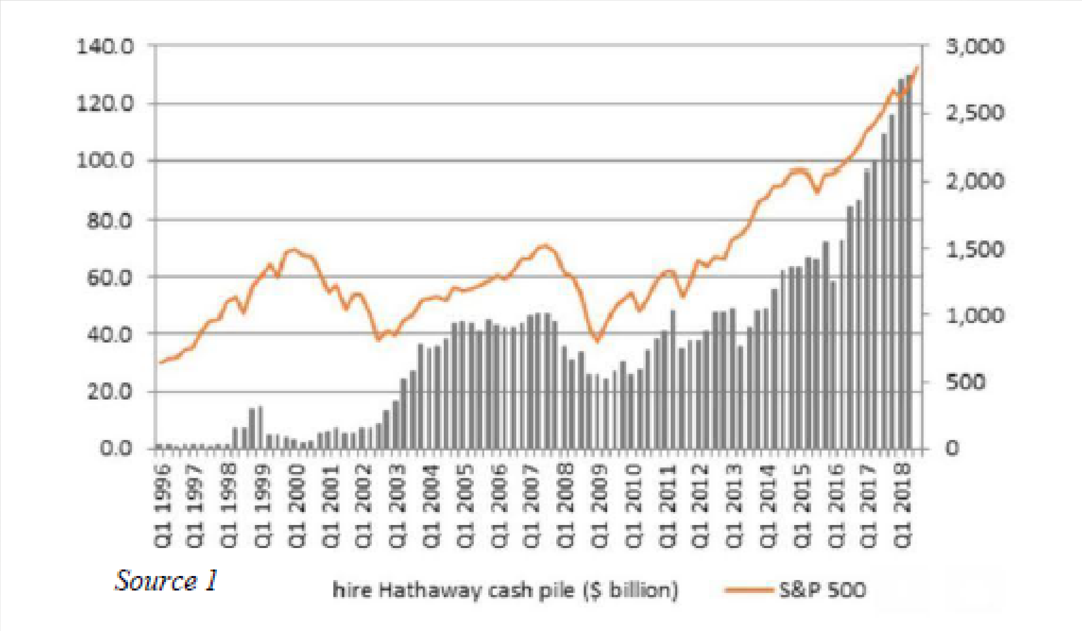
Berkshire Hathaway



From the graph above, it's evident that Berkshire Hathaway's cash balance has been an effective proxy at determining the level of the market. In both the recent market crashes, 1999 and 2007, Buffett increased Berkshire's cash position in the preceding periods. Now as Berkshire's cash position has risen to record high levels, this is a definite sign that Buffett views the market as overvalued. In a recent statement, Buffett stated the lack of attractive pricing "proved a barrier to virtually all deals we reviewed in 2017" (1).

He would rather wait and take short term losses equivalent to inflation rather than expose himself to unnecessary risk. More notable is that the cash position has continued to increase, which should make investors very nervous that an already inflated market is getting more and more overvalued. You can bet that when the market does eventually fall, Buffett will utilize Berkshire's massive available funds to capitalize on the lower, more valuable prices. Buffett could also look into acquiring an entire business if a company were to be found trading at an attractive valuation. Buffett's aptitude for purchasing entire companies is no secret and hasn't happened since 2015, so following a decline in the market this could be a realistic possibility. As a final option, Buffett could use the cash to buy back stock. Recently, Berkshire's board of directors amended the repurchase plan, getting rid of a stipulation that the shares must be trading at less than 120% of book value (3). This will be something interesting to watch going forward as share repurchases will give a key indication to how Buffett views his company is valued is relative to the market.

Fairfax Financial Holdings

Prem Watsa, CEO of Fairfax Financial, is another value manager, who has compound annualized returns on book value of 19.5% from 1985 through 2017. The stock price for Fairfax has appreciated at a compounded annualized rate of 18.1%, keeping almost in line with the book value growth (2). Recently, he has significantly increased his cash position due to perceived uncertainty and high prices. Fairfax Financial Holdings sold 90% of its holdings in long term treasuries to bring its cash position up to one-third of the total portfolio, that is up 19% from June 2016 with total cash and equivalents position of $10 billion. In a quarterly conference call, Prem Watsa explained his views on the importance of holding cash and how it has helped them historically:

"As far as the 30% cash, remember, that can change. So in 2008, and we had this position in 2007, in 2006. 2008, things turned the financial markets. Stock markets dropped... about 50%... And Tom, the only people who could benefit from that were the people who had cash or government bonds. And so we are conscious of that in our history. Cash gives you options, gives you the ability to take advantage of opportunity but you have to be long-term. We have built our company with a long-term view. Our long-term results are excellent. For example, in 2007, '08, and '09, the 3 years, 2007, 2008, 2009, we made $2.8 billion after tax, our book value went up by 150%. Since that time, we haven't done a lot. But we've said to our shareholders that we are long-term focused, our results are lumpy and we never know when it can change. But the cash gives us a huge advantage in terms of taking advantage of opportunity as and when they come. At the moment, we don't think they're many, so we are building cash."

Conclusion

A topic of consideration however is the impact these cash positions have on returns. Take for example a fund with a 33% cash position over the course of a year. The fund returns 12% in net capital appreciation. When you adjust for the large cash position the returns were actually 33% higher for money that was exposed to the market (i.e. invested capital). Therefore, the return for the invested capital within the fund was 16%. Keep this in mind when evaluating fund performance over specific periods and especially when comparing those returns to an index or peer funds.

"If you have cash, you may remain safe in the shelter of the harbour until the storm passes"
Frank Martin

"The hardest thing to do in investing is not the decision to buy or sell but to sit idle even if that means allowing the build-up of some cash"
Christopher Begg

Sources

[1] Ciolli, Joe. "Why Warren Buffett's record-breaking cash stockpile should have investors very worried". Business Insider Nordic. August 7, 2018. <https://nordic.businessinsider.com/warren-buffett-berkshire-hathaway-cash-balance-should-worry-investors-2018-8>

[2] Fairfax. "Fairfax Financial Holdings Limited 2017 Annual Report". Fairfax Financial. <https://s1.q4cdn.com/579586326/files/doc_financials-/2017/annual/WEBSITE_Fairfax-FINANCIAL-FULL-Annual-Report-v3.pdf

[3] Frankel, Matthew. "Here's How Much Cash Berkshire Hathaway Has Now". The Motley Fool. August 7, 2018 <https://www.fool.com/in-vesting/2018/08/07/heres-how-much-cash-berkshire-hathaway-has-now.aspx>

[4] Maxfield, John. "An Interesting Chart About Berkshire Hathaway". The Motley Fool. July 23, 2017. <https://www.fool.com/investing/2017/07-/23/an-interesting-chart-about-berkshire-hathaway.aspx>

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