

# Who Moved My Cash?

CYRUS TARAPOREVALA &amp; ROBERT A. JAEGER

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Cash was supposed to be the low-risk, low-return asset. And then everything changed. During the financial crisis that developed after the Lehman bankruptcy and the AIG rescue, cash became the high-risk, high-return asset. Today's cash is not your grandfather's cash. How did this happen, and what does it tell us about the role of cash in investors' investment portfolios?

Cash offers a very simple tradeoff. Investors get high liquidity and high safety of principal, but have to accept low income, zero potential for capital appreciation, and the risk of losing capital after adjusting for inflation. Investors always hope to get paid for taking risk, so the expected return on cash is lower than the expected return on risky assets. Cash therefore creates "cash drag." Most long-term investors have tilted their portfolios toward equities, hedge funds, illiquid assets, and other investments that will enable them to harvest a broad set of "risk premia." Cash is boring: "the forgotten asset," a drag on performance.

After the Lehman/AIG crisis, cash was anything but boring. There was a global stampede to safety and liquidity: all risky assets crashed in unison as investors scrambled to the safety of cash and government bonds. A massive "flight to safety" replaced the "flight to risk" that had emerged during The Great Moderation. This flight to safety was especially painful for leveraged investors and those non-leveraged investors who were nonetheless flying too close to the sun, with too much exposure to equities, corporate bonds, and/or illiquid assets.

During the flight to safety, cash became a high-return asset. The returns were high simply because they were positive, in contrast to the painful losses generated by all risky assets. The *actual* returns lined up very differently from the *expected* returns: sometimes you get paid for taking risk, sometimes you don't.

"Cash" also turned into a high-risk asset. Some money market funds and other commingled cash pools "broke the buck," sparking anxiety that others would follow, thus triggering a U.S. government guarantee of money market funds. Major sectors of the money market dried up, including the commercial paper market and the market

for auction rate preferred securities. And we all know how SIVs and other structured vehicles fared.

In the recent financial crisis, all types of investors — including pension funds, endowments, foundations, and retail mutual fund investors — have faced liquidity problems. The fundamental question is very simple: how much cash should investors hold in their portfolios, and should that amount be allowed to vary with market conditions?

For many years the central dogma of investing has been: “Stay fully invested at all times, keep cash drag to a minimum, and don’t try to time the markets.” This dogma has operated both at the total portfolio level and at the level of specific mandates managed by external investment managers. The brave new world of investing now unfolding before us requires more flexibility. This flexibility has three dimensions:

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**More strategic liquidity for the overall portfolio.** In order to minimize cash drag, many investors took two steps: they did not have an explicit strategic allocation to cash, and they employed overlay programs to sweep up and equitize any “free floating cash.” In the recent downturn, many investors rue their obsession with minimizing the cash drag. Some investors have faced true liquidity crunches, in which they have been forced to sell assets in order to fund immediate cash-flow needs. These cash-crunched investors have watched forlornly from the sidelines as rare, deep-pocketed investors like Warren Buffett, who have been sitting on huge piles of cash over the past several years (“What, me worry about a cash drag?”), have swooped in and purchased equities at seemingly bargain-basement prices. There’s nothing worse than being a forced seller in a panic-driven market.

Recent market turmoil demonstrates that investors must have a pool of liquidity to cover spending requirements even when asset values are down and cash inflows are down. Reasonable people will disagree on the specifics: some will want to cover three years of spending even in a disaster scenario, others will be content to cover one year of spending in less disastrous scenarios. But the bottom line will be the same: more attention paid to liquidity. The liquidity pool need not consist entirely of true-blue cash. Investors will likely want a tiered structure (a laddered portfolio), with benchmarks and permissible investments varying by tier. However, even the longer-duration tiers need to be focused squarely on safety and liquidity. “Reaching for yield” is strictly forbidden, since it is fatally vulnerable to “black swan risk.”

**More tactical flexibility for the overall portfolio.** Most investors tend to regard market-timing as a cardinal sin. We agree that markets are fundamentally unpredictable: there are no systems for calling tops and bottoms. Nonetheless, intelligent people, relying on a wide variety of clues (not a system), can legitimately suspect that things are getting out of hand. Value judgments are not the same as timing judgments. When Warren Buffett wrote in late 2008 that U.S. stocks looked very cheap, he explicitly acknowledged that they could get cheaper, and he explicitly denied the possibility of calling the bottom. This attitude contrasts sharply with that of Alan Greenspan, who maintained consistently that the Fed is incapable of identifying bubbles while they are in progress. Greenspan identified value judgments with timing judgments; Buffett clearly sees the difference.

We are not suggesting that institutions should commit large parts of their portfolios to “tactical asset allocation,” trying to catch all the twists and turns of the markets. But they should get rid of the dogmas that blinded them to abundant clues that markets had turned unsustainably frothy.

**More flexibility for external investment managers.** Obsessed with cash drag, many investors have insisted that their external investment managers remain fully invested at all times. This was part of a larger effort to make sure that managers stayed in their assigned “style boxes.” Investment managers have often been chastised for holding anything more than token cash: “We’re not paying you active management fees to manage cash.” Indeed, as mentioned above, many institutional investors employed overlay managers to promptly equitize any cash that crept into individual managers’ portfolios.

In the recent downturn, some equity managers outperformed their benchmarks by raising higher levels of cash. Imagine these managers’ surprise when, instead of a congratulatory pat on the back from investors, they are greeted by: “That’s great that you outperformed your benchmark. But I’ve still lost 30% of my money! You told me you were bearish. All your monthly newsletters from the beginning of 2008 said you were bearish. So why on earth didn’t you move more than 5 percent into cash?”

Fortunately, there have been some signs of loosening in recent years. Hedge funds have become increasingly popular, and institutions are increasingly allowing their long-only managers to use some of the tools from the hedge-fund toolkit. Indeed, the recent market turmoil may help demolish an unfortunate double standard that had developed within the investment community. Hedge fund managers were declared to be “skilled investors” who should be allowed maximum freedom, while long-only managers were declared to be “less skilled investors” who needed to be kept on a tight leash. The reality is that many hedge fund managers were less skilled than they were perceived to be, and some long-only managers had skills that were untapped by their clients. The recent market turmoil helps create a more level playing field.

We are not suggesting that investors embark on a general program to undo constraints on all their external managers. But investors should look selectively for opportunities. “Selectively” means that both the investor and the manager need to be comfortable with the greater degree of freedom. And both parties need to remember that the decision to raise cash can be either a top-down “macro” decision, or a bottom-up “micro” decision, or some combination of the two.

Cash, and other forms of liquidity, have to be built into the foundation of a portfolio. If you don’t have enough liquidity then you can’t be an effective long-term investor: you can’t buy during panics and you may even become just another forced seller. Moreover, the cash allocation should be allowed to change with market conditions. This doesn’t mean that we should all turn into market timers. But it does mean that we must reject the familiar dogmas that blind us to valuation and blind us to the unique risks of exceptional circumstances.

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**Cyrus Taraporevala** is the Head of North American Distribution at BNY Mellon Asset Management. He is a member of the Executive Committee of BNY Mellon Asset Management, and of the Operating Committee of The Bank of New York Mellon. Cyrus has leadership responsibility for North American Institutional new business strategy and sales results, as well as client management and marketing. He also oversees Dreyfus' retail distribution efforts. Prior to joining BNY Mellon Asset Management, Cyrus helped oversee Legg Mason's institutional business, and also served as head of business strategy for Citigroup's Global Investment Management sector. Before Citigroup, he was a partner at McKinsey & Co., serving asset managers and life insurance clients throughout North America, Europe, Asia and South Africa. Cyrus received his MBA from the Johnson Graduate School of Management at Cornell University, and his bachelor's degree from Sydenham College, University of Bombay.



**Robert A. Jaeger, Ph.D.** is Senior Market Strategist for BNY Mellon Asset Management, working with large institutional clients on issues related to investment policy and asset allocation. Prior to assuming his current responsibilities Bob was Vice Chairman and Chief Investment Officer of EACM Advisors LLC, a BNY Mellon subsidiary that acts as a "manager of managers" for institutional clients in the U.S. and around the world. EACM has responsibility for both long-only portfolios and hedge fund portfolios. Bob was affiliated with EACM and its predecessors from 1983 to 2007. From 1970 to 1982 Bob was a member of the faculty of Yale University. In 1982-83 he was a member of the faculty of the University of Massachusetts at Amherst. He is the author of *All About Hedge Funds* (McGraw Hill, 2002). He holds a B.A. from Princeton, a B.Phil. from Oxford, and a Ph.D. from Cornell.



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