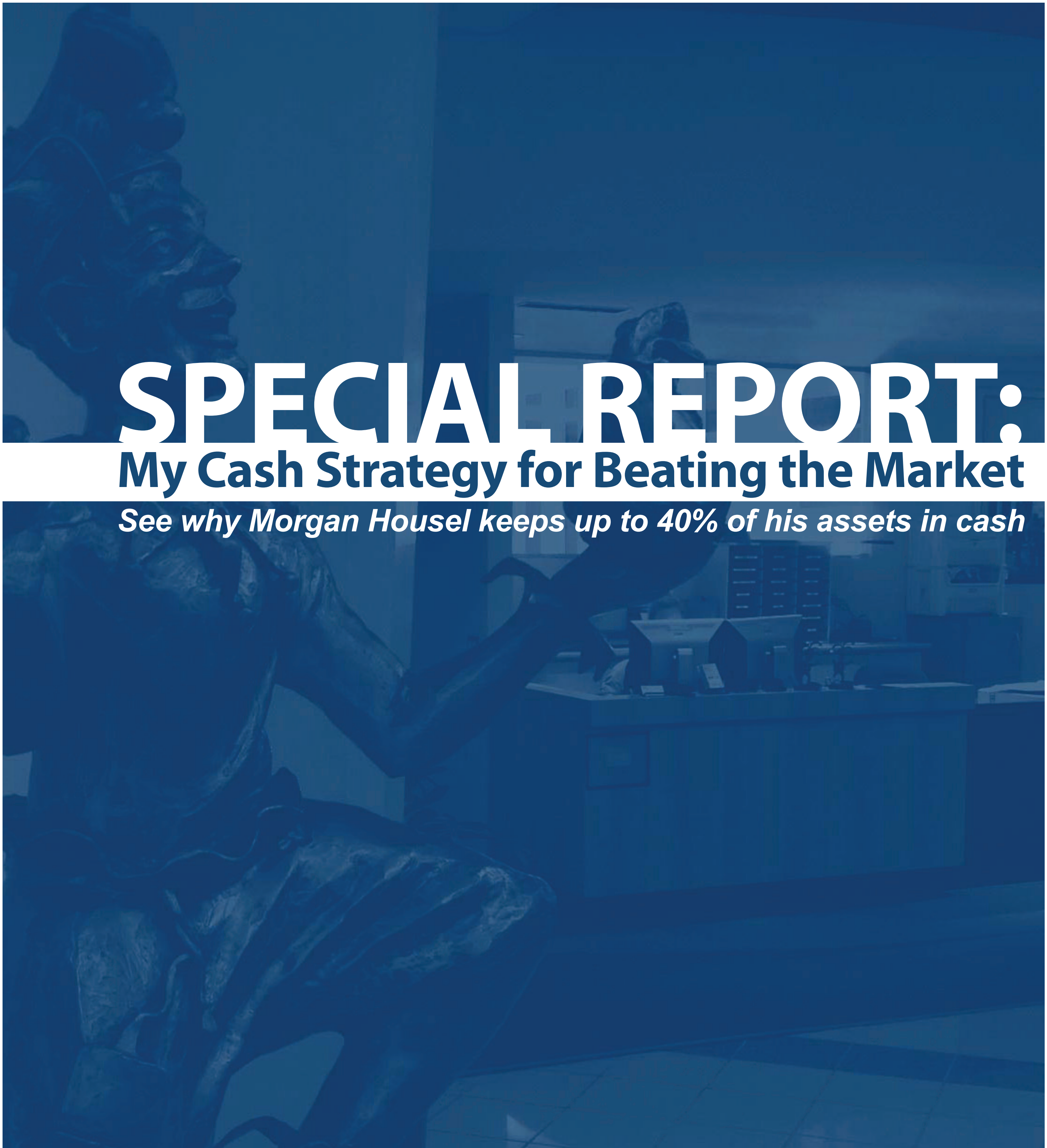


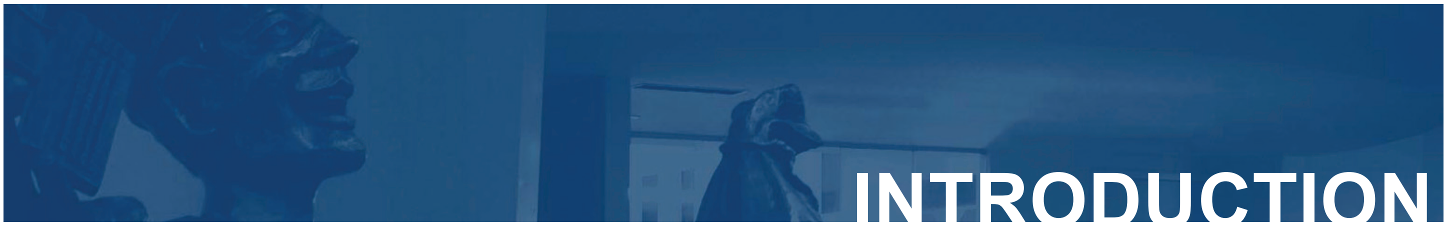
SPECIAL REPORT:

My Cash Strategy for Beating the Market

See why Morgan Housel keeps up to 40% of his assets in cash

by Morgan Housel

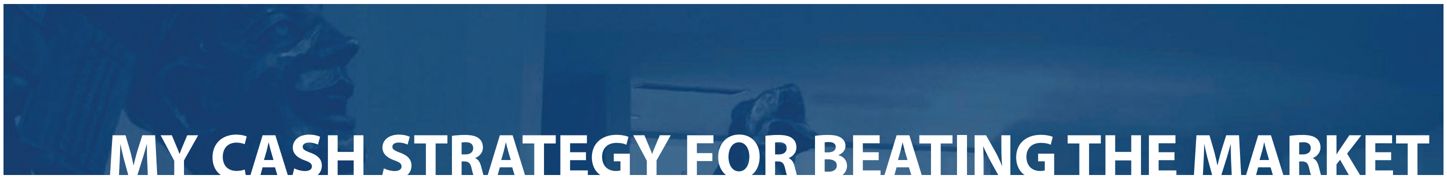
Motley Fool™ One



INTRODUCTION

About Morgan Housel

Morgan Housel is a longtime Motley Fool columnist with more than 3,000 articles under his belt, focusing on big-picture issues in the economy and how they affect people's lives. He previously worked in investment banking and private equity, but fell in love with the Fool's culture of helping the world invest better. He's a two-time winner of the Best in Business Award from the Society of American Business Editors and Writers, graduated from the University of Southern California, and enjoys running, reading, and napping (not always in that order).



MY CASH STRATEGY FOR BEATING THE MARKET

See why Morgan Housel keeps up to 40% of his assets in cash

Do you hold cash in your portfolio? Many Foolish investors dismiss cash strategies as market-timing, short-sighted, or worse. But Morgan Housel disagrees. Find out why he believes the "optionality" value of cash is one of the biggest hidden opportunities for investors looking to build lasting wealth. Your cash isn't sitting … it's waiting.

You may have never heard of Arnold Van Den Berg, but he's among the greatest investors of our time.

Van Den Berg was born in Holland in 1939 and survived Nazi occupation when he and his brother were smuggled into an orphanage. He moved to America after the war, finding a job as a mutual fund salesman after high school. In 1974, he set out on his own, opening an investment management company called Century Management, aiming to invest based on the value principles of Benjamin Graham.

The rest is history. Since 1974, Van Den Berg's fund has returned 14.5% a year, versus 11.9% a year for the S&P 500. That 40-year track record puts him in the upper echelon of investors. $1,000 invested in his fund in 1974 would be worth $196,000 today, versus $80,000 for the S&P.

But what's fascinating about Van Den Berg isn't his returns. It's how he achieved them.

During the 40 years he's been managing money, cash has made up more than 20% of his assets, on average. The typical mutual fund holds closer to 5% cash over time.

To me, that is remarkable. As investors, we constantly hear about how much a drag cash can be. That's been especially true over the past five years, as interest rates have hovered close to zero percent, or negative after inflation.

"Cash is trash," one recent headline read.

"Money market funds are the stupid investment of the week," another warns.

It's enough to make you mad. How do we reconcile the idea that "cash is trash" when one of the world's most successful investors held more than one-fifth of his assets in cash for four decades?

The answer is more complicated than it seems.

The 3 Main Strategies for Your Cash

Most investors, especially the young and working, are constantly saving, with new cash ready to invest each month or year.

But that poses a dilemma. Maybe it's a dilemma you face, too: How, and when, should investors invest their extra cash back into the market?

Index giant Vanguard did a study last year asking a simple question: If you inherit some money today, should you invest it all at once, or spread it out in even amounts over time, known as dollar cost averaging?

Cash gives you options. It lets you take advantage of some situations and protects you from others.

Most financial advisors I know would recommend dollar-cost averaging, investing evenly over, say, a one-year period.

But Vanguard's data doesn't support that idea. The firm looked at market data going back to 1926, and what it found was clear as day: The majority of the time, you are better off investing all of your cash at once, in a lump sum.

The reason is simple. Stocks tend to go up over time. Holding cash means you'll possibly — even probably — miss out on the market's returns. And since no one can know when stocks might slip into another bear market, it makes sense for long-term investors to remain fully invested rather than tip-toeing in over time. Over 10-year periods, the investor who invested her cash in a lump sum outperformed the investor who practiced dollar-cost averaging by an average of 2.3% per year. The results were pretty much the same when Vanguard looked at U.K. and Australian markets. "It's logical," Vanguard wrote, "to implement a strategic asset allocation as soon as possible because it should offer a higher long-run expected return than cash."

But there's another side to this story. And it's where Van Den Berg comes back in.

Vanguard's report assumes there are only two ways to deploy cash: in a lump sum, or an even dollar-cost average.

But there's obviously a third way: investing strategically, deploying cash only when you think the market offers the best opportunities.

Know Your Optionality

When most investors think about the return they're getting on cash, they take the yield in their savings account, maybe strip out inflation, and come to some abysmally low number.

But if you're a strategic investor, cash earns another type of return that often goes overlooked. It's called optionality.

I've been thinking a lot about optionality since having breakfast with a seasoned financial advisor earlier this year. I asked him, what the biggest mistake investors make is. "Not having enough cash, ever," was his answer.

"What do you mean?" I asked.

"Interest rates have been low for 10 years. So no one wanted to hold cash," he said. "But think about 2008. There were two types of people: those with secure jobs and those without. Then the economy crashed. Those with secure jobs didn't have enough cash to take advantage of once-in-a-lifetime investing opportunities. Those without secure jobs didn't have enough cash to keep their heads above water."

It's being forced to sell stocks before you're ready that will clobber your long-term wealth — not earning a low interest rate on your cash.

This reminded me of something Nassim Taleb, author of the popular book *The Black Swan*, once wrote: "Optionality is the property of asymmetric upside (preferably unlimited) with correspondingly limited downside (preferably tiny)."

That's what cash is.

Cash gives you options other assets don't. It lets you take advantage of some situations and protects you from others. For investors, the optionality value of cash comes from the fact that it possibly lets you buy stocks at cheaper prices in the future.

And here's what's important: The value of that optionality can more than offset the abysmal interest rate you're earning on your cash.

Van Den Berg was once asked why his fund holds so much cash. "Think of it this way," he said. "If we sit in cash and wait for a $15 stock to get down to our $10 buy point, then when it eventually goes back up to $15, we get a 50% return on our investment. We think this more than makes up for the few months or quarters we might have to wait in cash, even if cash paid no yield at all."

When you think of it this way, cash in the bank yields a lot more than the advertised fraction of 1% most people earn these days. The "real" yield is the pitifully low interest rate plus the value of the optionality.

Take two hypothetical investors. Each has saved $100 per month, every month, since 1929 (bless them).

The first practices dollar-cost averaging. He invests his $100 every month into the S&P 500 come rain or shine.

The second puts her $100-a-month savings in cash when stocks are rising and deploys the entire amount only after stocks have declined 20%.

How have these two investors fared since 1929?

The investor who's hoarded her monthly savings, and only deployed it when the market crashed, has nearly 14% more money today than her friend who practiced dollar-cost averaging.

That extra return, which can add up to a lot of money over a lifetime of savings, is the optionality value of the cash she held in the bank all those years, waiting for the market to fall. It's a very real return she earned on top of her savings account's interest rate. For years, her friends chided her for earning a puny 1% or 2% yield on her savings account, when in reality she was earning substantially more once the value of the cash's optionality is factored in. Now she's richer than her snickering friends.

This kind of thinking is why smart investors like Van Den Berg outperform the market over time despite holding a lot of cash. Their cash hoards aren't anchors earning low returns; they are opportunities awaiting a large return. "Cash combined with courage in a crisis is priceless," Warren Buffet once said.

All this is fine, you're probably saying, but everything I've discussed is backward-looking theory. How can you implement an actual cash strategy in your portfolio *today*?

My "Crazy" Cash Strategy

I can't provide individual advice — investors of different ages, incomes, and risk tolerances have different priorities. But I can tell you how I think about cash with my personal money.

Bill Gates was once asked why Microsoft kept so much cash on its balance sheet. "I wanted to have enough money in the bank to pay a year's worth of payroll even if we didn't get any payments coming in," he said.

That may seem extreme, but Gates understood something most Americans overlook: Things change fast. You can go from on top of the world one day to fighting for scraps the next. The best way to protect yourself from life's vicissitudes is to ensure you aren't forced to sacrifice long-term gains to deal with short-term pain. If Gates hadn't kept so much cash in the bank, he might have had to sell strategic assets, or even the entire company, if Microsoft had a bad quarter. I will even suggest that a main reason Microsoft has been so successful for 30 years is because it's kept enough cash in the bank to remain flexible and focused on the long run while its competitors have had to sell out to remain solvent in the short run.

I take a similar approach with my own money. I keep as much as 40% of my assets in cash, which is inordinately high for my age.

Most financial advisors will tell me this is crazy. But I disagree. I want to make sure I never have to sell my holdings to generate cash to cover a short-term problem, such as illness or unemployment. It's being forced to sell stocks before you're ready that will clobber your long-term wealth — not earning a low interest rate on your cash. That's especially true when you think about the fact that you're more likely to need emergency cash when the economy is in poor shape, triggering layoffs and friends and family in need. And that's exactly when stocks are likely to be cheap.

For most of you, how long you *stay* invested is the single biggest determinate for how well you'll do at investing. And the best way to remain invested for the long run is to keep enough cash around to ensure you're never forced to sell out.

I want to stress that everyone's finances are different, and this is not personal advice. But some people think they are maximizing long-run potential by remaining fully invested in the market, when in reality they are putting themselves at the mercy of short-term wobbles. As Buffett put it, "When forced to choose, I will not trade even a night's sleep for the chance of extra profits."

A Simple Plan for Taking Advantage

The other reason I keep a large chunk of cash around is the same reason Van Den Berg does: I want to be ready and able to invest when the market presents opportunities to buy cheap stocks.

But that's easier said than done. How do you know when to deploy your cash? And how much of it should you invest when the market tanks?

I have a simple method that provides what I think is a good framework for cash management.

Throughout history, the harder the market drops, the more opportunity there's been for bold investors to make their moves. The problem, of course, is that the deepest market drops — where stocks fall 30% or more — occur less often than shallower drops of, say, 10%. I needed to figure out how to deploy enough cash to take advantage of *decent* opportunities while still keeping enough cash on hand for *big* opportunities.

So I looked back at 140 years of market data and came up with a plan.

Say I have $1,000 cash set aside to invest (in addition to an emergency fund so I sleep well at night). It's opportunistic investment money. Here's my roadmap for deploying it:

Market falls by this much	I invest this much	Historical frequency
10%	$100	Every 11 months
15%	$220	Every 24 months
20%	$300	Every four years
30%	$130	Every decade
40%	$125	Every few decades
50%	$125	2-3 times per century

I deploy the most cash when the market falls by 20% because that's both a big decline and one that, historically, occurs pretty frequently. A 50% or greater crash represents the biggest opportunity, but it occurs rarely enough that I don't want to set aside too much cash waiting for it to happen.

As for which companies I'll invest in when the market crashes ... I'm comfortable not knowing that beforehand. Every crash affects different industries in different ways, creating opportunities that simply can't be predicted in advance. How much I'm comfortable investing can also fluctuate alongside valuations. I might not buy stocks after a 10% drop if we're coming off a bubble, such as tech stocks in 2000.

What my roadmap does help with is thinking about how much value my cash has when the market drops. Investors have a natural tendency to freeze and panic when stocks fall. Being armed with a plan to deploy my cash based on historical evidence is the best way I know of to combat the emotions that prevent most investors from taking advantage of market opportunities. It's how I prepare to actually realize the optionality value of my cash.

As Van Den Berg once put it, "That cash you're holding today is the raw material of tomorrow's superior returns." Wise words to consider as investors fret over miniscule returns earned in their savings accounts.

The Motley Fool owns shares of Microsoft.