QV UPDATE
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Mark Dyki, CFA I Joe Jugovic, CFA

Cash, the Boring Friend

In the investing world, cash is like the boring friend in a high school group that always thinks they are driving too fast and skipping too many classes. While his concern is often sound, it is a real downer on a fun-filled Friday afternoon. Heeding Mr. Boring's advice can be likened to the portfolio performance equivalent of cash drag. Cash drag is the opportunity cost of holding cash in a portfolio versus other asset classes which have greater upside or downside performance potential.

In 2016, cash drag represented over two percent of missed gains in the QV Canadian Small Cap Strategy. That is a significant amount of return, especially if it is compounded over a few years! The strategy returned 27.6% (gross of fees) over the year, but if the average cash weight of 7.2% was entirely invested across the board, the return would have been about 29.7%. This is a theoretical figure that we will use for illustrative purposes, because it is not practical to be 100% invested for any significant period of time. Let's explore the drivers behind our cash allocation.

Although we typically strive to invest in companies for the long term, there are instances when we must move quickly and require cash to take advantage of opportunities as they arise. At any given time we are monitoring dozens of price levels at which we would contemplate investment in various companies. In the QV Canadian Small Cap Strategy, it is especially important to have some cash on hand due to greater liquidity constraints. Raising the funds required for a potential purchase could take longer than the window of opportunity remains open.

When market valuations are broadly depressed, we find many quality companies trading at attractive valuations and have no difficulty deploying most of the cash that is available to us. Conversely, in times when valuations are broadly higher, the opposite takes place. We discover only occasional pockets of value in which to deploy cash, while more of our investments require trimming to manage the enhanced valuation risk. Cash accumulates as a result. Assuming valuations revert to the mean, this by-product of bottom-up value investing works to our benefit. Following a period of ample buying opportunities, there should be reduced cash drag as valuations increase from low levels. After taking profits from more expensive companies, a larger cash buffer usually exists and preserves capital as valuations fall from elevated levels.

The result of this bottom-up cash management phenomenon is evident when we compare the QV Canadian Small Cap Strategy's cash levels as we emerged from the financial crisis to last year. The estimated price to earnings ratio, an indicator of the valuation level for the strategy, was over 50% higher at the beginning of 2016 than it was at the beginning of 2009. Our 7.2% cash position in 2016 was roughly in-line with the strategy's historic level, but the average cash weight in 2009, when equity markets were on sale, was closer to a fully invested level of 4.8%.

As a point of note, the bulk of what we refer to as "cash" is typically a "cash equivalent" investment in the form of short term treasury bills (T-bills). In recent years, these investments have had little impact on performance given they yield less than 0.5% per year. This was not always the case. In 2007 a three month Canadian T-bill attracted a yield of 4.4% and almost 20% in the early '80's. With a few exceptions, Canadian three month T-bill yields have historically outpaced the rate of inflation. Unfortunately we have been in an exceptional period of negative real returns since 2008.

It is our belief that maintaining a healthy cash position provides enough practical and operational benefit to outweigh its lack of return. While holding excess cash deteriorates upside returns in strong markets, it provides valuable capital preservation in recessionary periods and enables us to act quickly when needs arise. Sometimes heeding the boring friend's pleas from the back seat will keep you out of detention and safely on the investment highway.