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Don’t let cash earnings cloud your sense of risk

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In the seven weeks following its high on September 2, the ASX 200 index retreated almost 500 points, or just under 9 per cent, to 5155 points.

In August, Montgomery analysis revealed the market was a little expensive — about 10 per cent expensive — and our experience was few opportunities existed to purchase quality on the cheap.

Thus we were selling holdings that had run above our estimate of their value but could find few alternatives to reinvest the proceeds. Holding a significant 30-40 per cent of cash across our funds certainly served its purpose — to protect investors’ funds when the market was expensive and good value was absent. The correction, since slightly recovered, has not come as a surprise — what is always surprising is the magnitude and the frequency.

In a bull market everyone is an expert — much as most people believe they are an above-average driver.

Sell-offs, however, have a tendency to reveal who was swimming naked. The seven week sell-off knocked the wind out of the sails of many investors, thanks to the level of mystery that has accompanied it.

The weakness cannot be attributed to one particular catalyst but has coincided with uncertainty about the pace of the US recovery, the financial system inquiry, the 40 per cent decline in the iron ore price this year, “tapering” from the US Federal Reserve and the substantial decline in German exports in August.

The absence of any clear cause makes reinvesting all the more uncertain because there are no defined clearing-of-the-skies signals. We can propose a solution, however, and it requires a rethink about the value of cash. Let me make one thing clear: at Montgomery, we aren’t enamoured with earning 3.5 per cent on our cash holdings. But we don’t let that burning feeling in our pockets corrupt our sense of risk — and neither should you.

When interest rates are low and relative yields between different securities compressed, one can easily jump from the frying pan into the fire. A yield of 5 per cent on a share, or 4.5 per cent gross on a commercial property, can look enticing compared with returns from cash, but the relative risk associated with those other assets require a much bigger margin of safety to warrant their inclusion in a portfolio.

It is far better, despite the apparent inferiority of the yield, to remain in the safety of cash.

Paying prices for shares well above our estimate of their value, even if they have a yield above cash in the bank, is not sensible investing. The sharemarket is a risky place — so is residential and commercial property — so expected total returns must justify the risk.

Prices are still lower than they were just a few short weeks ago — just ask the loquacious broker who suggested, at the top of the market recently, that investors buy a basket of “laggards” in a strategy akin to betting on a donkey in a thoroughbred race because it hasn’t had a turn at winning yet.

Rather than the absurd “strategy” of buying something simply because it hasn’t gone up as much as others, consider researching high-quality businesses and buy them like you would groceries — when they’re cheap.

Some examples to start your research with might include Challenger, Sirtex (for the more risk-inclined), CSL and Infomedia. Be sure to seek advice first and get comfortable with cash when great alternatives are hard to find.

Roger Montgomery is the founder of Montgomery Asset Management.