Don't be afraid of cash

by Roger Montgomery

Each time I have written for you, I have discussed a company whose business and prospects are both attractive and whose share price even more so. But with aggregate earnings revisions declining precipitously, and price to earnings multiples at meaningful historic highs, it's worth counselling investors about the merits of having some cash for a rainy day.

Asset prices generally are described by some as "horrific" and they have of course been buoyed by low interest rates that make the fully franked dividend yields offered by large caps attractive.

But while many investors would be happy with the 5.49% on offer today (Telstra's dividends are unlikely to decline any time soon), I wonder whether you'd appreciate generating a yield of 6.85% or 8.00%. To receive those yields, you need Telstra's shares to decline 20% and 31% respectively.

Can't happen? If you are a net buyer of stocks, you should be hoping so.

The share price has indeed fallen by that quantum five or six times in its listed life, indeed it fell by 21% just recently from its high of $6.61 in February 2015. Of course, relative yields may have something to do with that but the fact the company's earnings haven't grown (they are extremely stable however), means that the share price could be vulnerable to a change in general market sentiment that inevitably occurs from time to time.

Is right now a great time to be investing or, if you have some spare cash, should you be waiting?

Back in 1981, the US risk free rate of return as represented by 5-year US Treasuries, was 15%. Real rates were close to 5%, debt was about half of what it is now and companies were restructuring, getting back to 'core operations' and taking a very disciplined approach to investing shareholder capital – thanks to that 15% hurdle rate!

Thanks to management getting their companies in order, thanks to the credit boom that followed and thanks to low asset prices, what followed was one of the greatest stock market booms in history.

The aggregate peak in US company operating cash flow was five years ago in 2010 and it has turned negative year over year since then and even as net debt continues to grow at an incredibly fast pace. Think about that for a minute. Typically debt is used to grow earnings. If you give me more money, you would expect me to put it to work and earn more next year or the year after than I earned this year. That has not happened. Why?

The reason is that the use of that debt in this cycle has changed. It has not been put to productive use. It has been used for financial engineering, for share buybacks and mergers and acquisitions. And remembering the aggregate decline in earnings I mentioned a moment ago, it seems the mergers and acquisitions must have destroyed value.

Despite no increase in interest rates, while growing borrowings by US$1.7 trillion, the profit share of the corporate sector peaked in 2012.

In 1982, the market sold for seven times earnings, those earnings were depressed and there were dozens of rate cuts as well as productivity improvements ahead.

Today, with rates at zero, debt to the gills, declining margins, rising wages, a questionable allocation of capital and earnings arguably inflated, we're at a price to earnings ratio of 18 times.

I think there is nothing wrong with wanting to generate a higher yield than what is available on cash. Obviously, putting all your money in cash is not the solution because you are, over the longer run, guaranteed to earn a return that will see you lose purchasing power.

Putting some of your cash aside however at 2.5% is sensible because it gives you an option; an option to buy the wonderful companies we have spoken about, here in the past, at even more attractive prices.

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