In Volatile Markets, Cash is King

Every investor must allocate a part of his portfolio towards cash and cash equivalents such as investments in short-term fixed deposits and money market mutual funds. This is true even though holding cash usually costs money. For example, investments in short-term fixed deposits are currently yielding a return of around 8 percent per annum. Taxation will take away a third of that return and whatever remains will be expropriated by inflation.

Why then hold cash if it is unlikely to earn a positive, real, post-tax return? The answer: to exploit opportunities offered by a volatile equity market. In fact, the more volatile a market, the higher should be allocation of cash in a portfolio.

Take the case of HPCL. Recently, the stock of this company was recommended for purchase at Rs 190. No doubt, at that price, the stock was extremely cheap relative to its normal expected future earning power, assets, as well as other stocks. However, in the stockmarket there is no guarantee that what is cheap today will not become even more cheap tomorrow. The stock promptly plunged to Rs 140. Those who bought at Rs 190 should have bought a lot more at Rs 140. But only those who had cash available with them at that point of time could do so. And those who did, were rewarded very soon as the stock then soared to Rs 300.

My point is that even though holding cash costs money, this cost is more than offset by the extra returns earned through intelligent action taken at a time when the market is behaving stupidly. And the more volatile a market, the more the chances of earnings those extra returns.

In the recent past, there have been several occasions when the availability of cash enabled some of my clients to take advantage of irrational market behaviour. One was on the day the government lost the vote of confidence. Stocks were dumped on that day as if there was no tomorrow. For this particular client, I bought 30,003 shares of State Bank of India at an average cost of Rs 171. Exactly one month later, when sanity had returned on Dalal Street, these shares were converted into cash at an average price of Rs 211. (That immediately after I sold these shares, the stock went on to Rs 272 is another story.) The total pre-tax return came to Rs 12 lakhs. A return of Rs 12 lakhs on a Rs 51.3 lakh investment translates into 23% over a holding period of one month. But this return would not have materialised if my client was not holding cash on that fateful day when the government fell.

For this client, then, holding cash for opportunistic reasons made a lot of sense. Opportunities such as the one described above are common in India. They occur several times a year when the stockmarket irrationally plunges because of some political, economic, or corporate event and recovers soon afterwards. Holding cash then amounts to earning only 8% per annum but with very good prospects of earning 23% in a month at least once a year. Put in these words, it should be clear why cash is king in a volatile market.

Currently I am again converting short-term cash holdings into equities. This time I am betting that this war scare with Pakistan will wear off. Stock prices have tumbled over the last few days because the market is worried about a war. I do not think that there is going to be a war. In fact, in my opinion, the headlines on the Kargil story will disappear from the front pages of newspapers within the next month. If, as I expect, the war scare wears off, the stockmarket will recover, at which time I will convert the equities being purchased now, back into cash.

This method suggests that investors should have a target allocation for cash in their portfolios. More importantly, they should stick to that target, which is not very easy, given the psychological pressures involved.

Let us suppose that my target allocation for cash for a given client is 30% of the total market value of the portfolio. Now suppose, that the market declines suddenly for reasons which I believe to be irrational. At that time, I will utilise some of that cash, perhaps half of it, to buy stocks, which have been hammered down the most. When the market recovers, a few weeks hence, I would force myself to move towards my target cash allocation of 30%. To do so, I will have to sell the stocks which I had bought earlier and invest the proceeds in money market securities. I will do so, even though I believe that there is still some upside left in the stocks I had bought earlier.

Having this discipline is crucial because otherwise it would mean that the investor frequently finds himself 100% in stocks at a time when the availability of cash would have been more profitable. The idea is not to make the most money from cash invested for opportunistic reasons. Rather, the idea is to have cash ready at the right time, when it is needed the most, to take advantage of irrational market behaviour which is likely to be corrected, sooner rather than later.

My experience in the Indian stockmarket has taught me that holding a bit of cash and then waiting patiently for the right opportunity is a good investment policy. I am reminded of a quote from Warren Buffett who, incidentally, is currently holding $15 billion in cash and cash equivalents: "When you want to shoot, rare, fast-moving elephants, you should always carry a loaded gun."

In a volatile market, cash truly is king.

Note

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