CASH, PROFITS AND MISPLACED PRIORITIES

"We're not paying you to be in cash."

It's a not-so-veiled threat that is all too familiar to most investment fund managers. But why is it that so many investors seem to fear cash more than losses?

On a superficial level investor impatience with uninvested cash seems logical; why tolerate an investment manager apparently opposed to investing? One wouldn't abide a chef who refused to cook. But the analogy begs a simple question: What *exactly* is the fund manager being paid to produce – full investment or attractive returns?

Allocators select passive investments – such as ETFs that mirror indices – because they seek the return characteristics the underlying asset has historically exhibited. In terms of thought process, the investment decision is the selection of the asset, from which the return derives. But active investment management is about the *return itself*. Actively-managed funds receive higher fees than the passive alternatives because the manager's discretion, however exercised, is expected to justify the expense.

It follows that if the return is the overriding priority, provided returns are sufficiently attractive relative to the risk taken, the level of investment should largely be irrelevant. To the extent that it is immune from losses, any excess cash should arguably be somewhat reassuring.

The logic isn't complicated: If the primary reason for hiring an active manager is attractive returns, and the key to superior returns is avoiding losses, then

Loss avoidance should be more important than cash avoidance.

And yet, by insisting that all cash be deployed, the fund investor forces the manager to prioritize full investment over returns.

Imagine a fund with 25 holdings, 5 of which lost money. The return is decent, but would be much higher if those 5 losses could somehow be erased. If offered the opportunity to retroactively replace those losing positions with cash, none of the fund's investors would hesitate to do so. That being the case, why prevent the fund manager from doing so before the fact? If optimal returns are the goal, why discourage him from pre-empting his own mistakes by compelling the manager to lower his investment standards?

Returns derive from net gains, not level of investment.

Needless to say, there's nothing intrinsically unsound about full investment. But the freedom to avoid losses by not investing is the most important dimension of investment discretion. Discouraging it compromises both the manager's risk discipline and, as a result, the investor's own best interests. After all, cash isn't the enemy – losses are.

Steven R. Grey (2013)

