CASH – THE SECRET WEAPON

"Cash is trash" was an oft-repeated mantra throughout the 1980's and 1990's. Stock and bond portfolios alike produced double-digit returns for two decades. Although risk free treasury bills averaged about 7% per year over that twenty-year span, investors scoffed at such meager returns when so much more was available to those willing to accept the risk of longer-term investments.

Stocks obviously hit a monumental speed bump as the new century began, forfeiting more than half their peak values. Bonds held up longer, but even they experienced negative total returns over a year or more through May 2004. In such an environment one would expect risk free securities to regain popularity, but yields near 1% provoked a collective yawn from investors. Memories of the strong returns of the 1980's and '90's have conditioned today's investors to expect far more, and most view twenty-first century declines, particularly to stocks, merely as annoying and patience-testing interruptions to the inexorable march to higher prices.

Understandably, very few of today's investors have personal experience with extended periods in which stocks or bonds underperform risk free securities. The reality, however, is that roughly half of the twentieth century was characterized by extended periods in which risk free securities outperformed stocks or bonds. Significant evidence points to the prospect that we may face an extended period ahead in which risk free securities could play an integral and productive role in a well structured investment portfolio. In fact, we believe that there is a reasonable probability that over the next decade or so cash returns may exceed those of stocks, bonds, or both. Let me make the case.

Much of that case is based on repetitive patterns that stretch back two centuries or more. Any such analysis, when applied to the current environment, typically elicits skepticism on the basis that "It's different this time because …. " While specific conditions are always different from one era to another, fear and greed, which tend to be investors' prime motivators, remain remarkably consistent factors over time. Without question, many believers in "new era" rationales dismiss historic precedent on the basis of honest, though often limited, research. But in assessing motivation, it helps to recognize that the well-oiled marketing machine that is Wall Street functions far more profitably when investors believe the bullish case. Investor fear that stocks and bonds might perform poorly for any sustained period of time would put a significant dent in the profits of Wall Street firms.

Exhibit 1
Long-term U.S. Stock Market Cycles
Inflation Adjusted Total Returns

WEAK CYCLES		
Time Period	**Real Annual Total Return**	**Duration**
1802 – 15	+2.7%	13 years
1835 – 43	-0.6%	8 years
1853 – 61	-3.0%	8 years
1881 – 97	+3.9%	16 years
1902 – 21	+0.0%	19 years
1929 – 49	+0.8%	20 years
1966 – 82	-1.4%	16 years
STRONG CYCLES		
Time Period	**Real Annual Total Return**	**Duration**
1815 – 35	+10.0%	20 years
1843 – 53	+13.7%	10 years
1861 – 81	+12.0%	20 years
1897 – 02	+15.2%	5 years
1921 – 29	+25.2%	8 years
1949 – 66	+14.0 %	17 years
1982 – 99	+14.9%	17 years

Source: Robert Powers

Exhibit 1 shows a remarkably consistent two-century old pattern of stocks moving from long periods of strength to long periods of weakness. That poor stock performance ultimately follows strong performance certainly surprises almost no one. What is largely unrecognized, even in the Wall Street community, however, is how long the unproductive periods have lasted. Most investors and investment professionals alike believe that periods of market strength cover far longer stretches of time than do periods of market weakness. As Exhibit 1 demonstrates, when shorter-term variations from the primary trend are smoothed, both the weak and strong periods of the past two centuries lasted almost a decade and a half on average.

The real, after inflation, return in the two composites is starkly different. The long weak cycles saw real annual returns registering a few slight positives and a few slight negatives, netting just a small fraction of one percent per year above the rate of inflation. By contrast, each long strong cycle provided a double-digit return even after subtracting out inflation.

Without question, we entered a new weak cycle in early 2000 as stocks peaked and fell in their steepest decline since the Great Depression of the 1930's. A remaining question is whether this cycle will prove to be shorter than its predecessors in the nineteenth and twentieth centuries. In the nineteenth, two of the four weak cycles lasted just eight years each. In the more recent century, the shortest of the three weak cycles went on for sixteen years. Virtually no one today is talking about equity returns approximating the rate of inflation into the middle of the next decade. Yet similar market behavior has recurred cyclically with remarkable regularity for the past 200 years. Is it even conceivable that the markets are in the early stages of a similar length weak cycle? In fact, we believe it is probable.

Most investment managers and analysts have grudgingly toned down expectations for the next decade to something in line with or even a bit below the long-term historic average. Most of these men and women began their investment careers in the booming decades of the 1980's or 1990's and see the decline from 2000 to 2002 as merely a steep but brief aberration in stocks' inevitable move higher. They point to increased productivity, greater globalization, growing profits, a strong economy and low interest rates and see these pointing logically to increasingly higher equity prices. Despite Wall Street's efforts to imply causal relationships, analysis of a half-century or more of data shows that, logic notwithstanding, none of these has a clear positive correlation with multi-year equity performance.

On the other hand, any of a number of long-term studies demonstrate that today's equity valuation levels are completely consistent with the continuation of a weak cycle for another decade. In fact, returning to average equity performance in the upcoming decade would break the two-century long pattern and would certainly be outside the typical equity performance range following periods of extremely high valuations.

Exhibit 2

Long Weak Cycles in the Twentieth Century	Annualized		
	Common Stocks	Inflation	Cash Equivalents
Jan. 1903 - Dec. 1920	3.02%	4.65%	4.05%
Sept. 1929 – May 1949	1.47%	1.63%	0.54%
Feb. 1966 – July 1982	5.05%	7.02%	7.04%
54.25 year averages	3.07%	4.27%	3.68%

Sources: See Endnote[i]

The three long weak cycles of the twentieth century profiled in Exhibit 2 covered 54¼ years, more than half of that highly productive and profitable century. Over the cumulative span of those weak cycles, nominal common stock returns came to 3.07% per year and were measurably below the 4.27% rate of inflation. Common stocks have been widely accepted for decades as excellent hedges against inflation. Unfortunately, for more than half of the twentieth century, they did not offset inflation's effects.

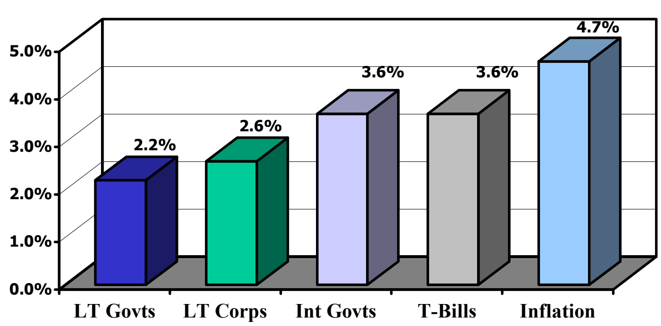
Perhaps even more surprising to most, owning risk-free cash equivalents was a more productive investment strategy than owning equities for more than half of the twentieth century. That's heresy to the legions of investors and investment professionals who learned their craft in the go-go 1980's and 1990's. A careful examination of data, however, yields the shocking truth. Over the 54¼ years of the three full weak cycles, essentially risk-free cash returns came to 3.68% per year. While that "unmanaged" return lagged the 4.27% rate of inflation growth, it was superior to the 3.07% return available from stock ownership. Actively managing the cash equivalents would certainly have increased the advantage over equities.

Exhibit 3
Moody's AAA Bonds

Source: Ned Davis Research

The fixed income markets have not been as consistently cyclical as have the equity markets. Interest rates have, however, shown a very interesting pattern over the past 85 years. Smoothing out relatively brief interest rate changes, there have been only three major interest rate moves since about 1920, as seen in Exhibit 3. For roughly the first two decades of that period interest rates declined. From the early 1940's to the beginning of the 1980's interest rates rose. From the early 1980's to present interest rates fell again. Today opposing worldwide forces of inflation and deflation continue their battle, and the Fed ponders the conundrum of relatively non-responsive long rates. Long-term investors wrestle with the question of whether the quarter-century long rate decline is approaching an end. Exhibit 4 demonstrates that the consequences of a lengthy rise can be severe. For more than four consecutive decades, when rates last rose on a sustained basis, risk-free treasury bills outperformed any broadly diversified portfolio of high-grade bonds.

Exhibit 4
Fixed Income Performance
January, 1941 to December, 1981



Source: Ibbotson Associates, 2005 Yearbook

This is not to suggest that investors should forego stocks and bonds and become committed cash holders. Logic demands, however, that any easy to own and trade security that has outperformed equities and longer fixed income securities over such extended periods of time be entertained as a viable and prudent investment tool. It is ludicrous to read consultant-produced statements of investment objectives and policies that treat cash equivalents as pariahs to be reluctantly admitted to long-term portfolios only to the extent needed for meeting liquidity needs. Virtually all such statements produced in the past decade or so set target allocations for stocks and bonds ranging anywhere from 25% to 70% each, depending upon the circumstances of the investment program. If there is a target, or allowance, for cash equivalents, it is rarely above single digits.

We would not argue for a permanent commitment to cash equivalents beyond liquidity needs. We do believe, however, that it is a great mistake to preclude the use of cash-- even in very large amounts--to protect portfolios against falling stocks or rising interest rates. Clearly that introduces the problem of when and how allocations should be changed. For long-term investors, we advocate an historically-oriented, valuation-based allocation strategy that requires patience. That would necessitate a change of mindset on the part of consultants and plan sponsors alike. We have long argued against the almost blind adherence to the practice of selecting only specialist managers and aligning their respective pigeonholes to construct an appropriately diversified portfolio. That was a strategy destined for success in the one directional stock and bond markets of the 1980's and 1990's. Performance results since the stock market turn in 2000, however, have proved less than stellar for most commonly structured portfolios. If we are, in fact, still in the early stages of an extended weak cycle, that disappointing performance pattern may continue for a decade or more. The problems would be compounded if interest rates begin another extended rise. In such an environment, the judicious use of well-managed cash equivalents could prove, both offensively and defensively, a very valuable tool.

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[i] Most data are from Ibbotson Associates, 2005 yearbook.
Inflation data for 1903-20 came from Professor Robert Shiller's data referenced in his book *Irrational Exuberance*.
Cash Equivalents for 1903-20 are derived from Commercial Paper Rates, New York City, adjusted down by 1.0% per year, to approximate the return of treasury bills, which were first authorized by Congress in 1929. Data are from the National Bureau of Economic Research.