The Mutual Fund Cash Dilemma

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After any major stock market rally, investors should examine each of their mutual funds to assess whether the manager must remain fully invested or has the ability to raise cash in the absence of acceptable opportunities.

History shows that stocks can remain at high valuations for a long time before suffering a bear market, and there are always those who argue that a bull market has further to run. However, before a bear market ensues and inflicts major damage, investors should know exactly how their funds are positioned in terms of their ability to raise cash and act accordingly.

This raises an interesting question: Should fund managers let cash build in the absence of opportunities, or should they remain fully invested at all times? The big 2009–2013 rally in U.S. stocks has a downside for fund managers whose job it is to hunt for bargains. Bargains are fewer and many managers, especially those with a value bent, are hard-pressed to come up with ideas that are both compelling and reasonably priced. As a consequence, some managers with the flexibility to do so are letting cash accumulate rather than investing in merchandise that doesn't meet their valuation standards.

As one well-known value investor explained, "As long-term investors who attempt to deliver absolute returns to our clients, we will continue waiting patiently for opportunities to buy securities that we view as undervalued rather than compete on a relative basis over the short term by buying securities today that we think are fully valued and risk permanent impairment of capital." In the same shareholder letter, the fund manager further elaborated, "We would rather hold a portfolio […] with some dry powder on hand […] than compete on a relative basis by owning a fully invested portfolio when equity investments are high, interest rates are low and corporate profit margins are at peak levels."

As Benjamin Graham wrote in his book "**The Intelligent Investor**" (revised edition, HarperCollins, 2009), "The intelligent investor recognizes that stocks become more risky, not less, as their prices rise and less risky, not more, as their prices fall. By refusing to pay too much for an investment, you minimize the chances that your wealth will ever disappear or suddenly be destroyed."

The Case for Being Fully Invested

Except for cash required to meet redemptions, most fund managers have a mandate to remain fully invested at all times. They view their job as picking stocks and leave the asset allocation decision to the fund shareholder or a financial intermediary/adviser.

The shareholder or adviser will decide which asset classes are undervalued and select funds that provide optimal exposure to that class. They don't mind paying a management fee as long as the fund is fully invested.

This is understandable, but remember, astute asset allocation is never easy. You don't want to own a fund that is 100% invested in a declining asset class. Also, the sale of fund shares may incur a transaction fee and may be a taxable event if the shares are held in a taxable account.

An Alternative Approach

Instead of making the asset allocation decision and then buying or selling the appropriate fully invested funds, many individuals and advisers use a different tactic. They say they aren't clever enough to decide which asset classes are going up or down and how long they will remain that way. Instead of focusing on asset allocation, they focus on finding "best of breed" managers that do well throughout the cycle of a specific asset class. Such managers tend to take profits when valuations are robust and then redeploy the cash when valuations are lower. Valuations drive their decision-making, and such managers are not forced to bend their valuation standards in order to remain fully invested.

Investors and advisers interested in the above types of managers will often "adjust" fund performance to arrive at a cash-adjusted rate of return to assess stock-picking results. An individual investor can do this by tracking what percentage of the portfolio is invested over the course of a year and then applying that result to the absolute return generated as follows:

% Invested = (Investments – Cash Equivalents) ÷ Net Assets

Fund investments, cash equivalents and net assets can all be found in a fund's annual and semiannual reports as well as the two Form NQs filed with the SEC for the "off" quarters. It may also be found on the fund's website or factsheet. For example, let's say a fund averages 58% invested over the course of a year, which equates to an average cash allocation of 42%. Perhaps that fund's absolute return was 16.6% for the year. However, to obtain a better idea of the manager's stock-picking ability, one must adjust the returns for the cash held as follows:

Cash-Adjusted Rate of Return = Absolute Return ÷ Percentage Invested

In our example,

$0.166 \div 0.58 = 0.286$, or 28.6%

Adjusting the absolute return for the cash held shows the stocks held actually did quite well, returning 28.6%. This is similar to the Morningstar Risk Adjusted Return (MRAR) used to assign fund star ratings. Since fund shares are held indefinitely throughout the asset class cycle with cash fluctuating as required, taxes and transaction costs are minimized. The downside, of course, is the risk of being underinvested in a rapidly rising market, as occurred in 2013.

How can an investor determine if a fund's managers have the ability to raise cash or whether they must remain fully invested? The answer is most commonly found in the fund prospectus. Under Principal Investment Strategy, look for language that says something like "Normally, the fund will invest 80% of its net assets in the equity securities of small-cap companies" (if it is a small-cap fund). If you see that type of disclosure, you know the fund has a mandate to remain at least 80% invested. In the absence of such disclosure, it's probably a safe to assume the manager has the flexibility to let cash build, although you may want to call the fund to confirm.

There will always be disagreement on whether it is better for a fund to remain fully invested and absorb the market's volatility or to build cash reserves when investing opportunities are scarce.

Investors should know where their managers stand on the issue and which approach works best for them. Knowing what managers must do with cash will help an investor know what to expect and ideally use their funds more effectively.

After several years of bull markets now is not the time to become complacent. Shareholders would be wise to assess now how their funds will behave if the market or a particular asset class goes down instead of up.

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