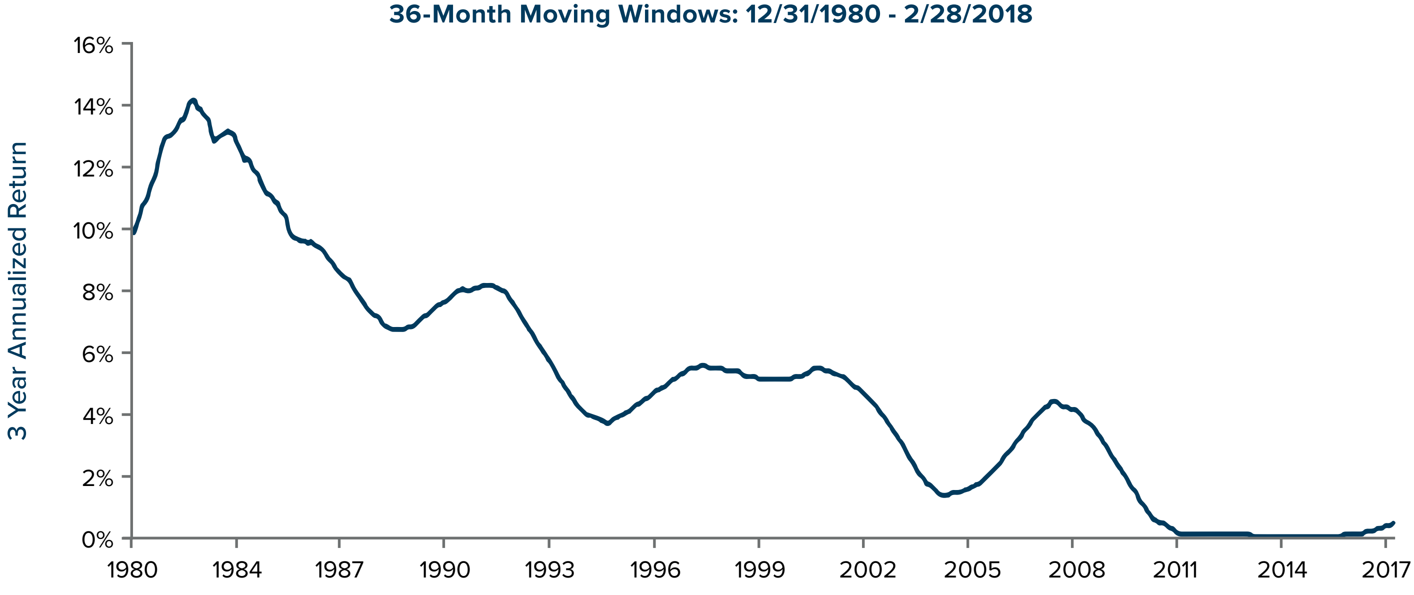
In a Highly Valued Market with Rising Rates What Role Does Cash Play?

The holy grail in investing in our opinion is providing competitive returns over a market cycle and protecting client assets in a down market. It is easier said than done. We have built our reputation over the last 35 years on a disciplined value investment approach that is keenly attentive to generating returns and protecting capital. Warren Buffett commented in his 2017 annual letter, "What investors then need is an ability to disregard mob fears or enthusiasms and to focus on a few simple fundamentals." We believe cash is as fundamental as it gets and as a value investor cash is part of the equation in managing portfolios and preserving capital.

> **"You can't predict, but you can prepare."**
>
> **- HOWARD MARKS**

Over the last ten years, the interest rate on cash (or money-market funds, in this case) has dropped from over 5% in 2006 to essentially zero post the Great Financial Crisis (GFC) in 2008 and 2009.[1]

ICE BofAML US 3-Month Treasury Bill [1]
36-Month Moving Windows: 12/31/1980 - 2/28/2018



While yields on money market funds have begun to inch higher, their real return (which subtracts the inflation rate) has remained near zero at best, and it is especially unattractive during periods of rising inflation. However, that does not make cash totally undesirable to us. Instead of investing for the sake of putting money to work, we at Anchor wait until we find stocks at attractive valuations with a margin of safety. Cash can provide the option to buy something at a better value in the future, which is a tactical advantage.

Admittedly, an elevated level of cash is a drag on portfolio performance during a rising stock market. We often hear some investors have a mantra to stay fully invested, but at Anchor, our mantra is to stay fully prepared.

How Pricey Markets Can Drive Up Cash Positions

For value investors like Anchor, a fully valued stock market creates different scenarios. First, the equity markets typically experience a higher level of mergers and acquisitions (M&A) towards the end of a business cycle[2] when valuations are typically higher than average, leaving portfolios with more cash in hand. Second, and more importantly, our disciplined process compels us to sell a stock when we believe it to be fully valued. These days, when stocks meet our criteria for sale, but fewer meet our criteria for purchase, again, cash levels may be elevated.

Cash is typically a fall out of our investment process and not an attempt to time the equity markets. Investment processes can fail when there is too much emphasis on the short-term.

Ten years have passed since the global financial crisis, and the economy is now heading into a later phase of the business cycle that began when the Great Recession ended. We cannot pretend to know exactly when that cycle will end. However, the fact remains that a number of equity valuations are now high compared to historical levels[3], resulting in Anchor selling fully valued positions.

How Cash Positions Can Change

Our cash balances are a product of our stock selection and implementation. All things being equal, our cash levels will tend to rise as our estimates on future returns decline. Our cash levels also tend to rise as we collect dividends from our holdings, and as takeover activity occurs.

It is important to understand that our cash position/investment view is dynamic and will change as the market warrants. In fact, cash may be deployed under the right circumstances, i.e. when we find something we want to buy. At times client portfolios may have higher cash levels than in other time periods. We believe cash can provide a buffer in down markets.

Reasons to Believe: It pays to be patient and opportunistic

We think that the increasing cash levels are appropriate given that we are heading into a later stage in the business cycle and valuations overall are approaching higher than historical levels. Having cash available in portfolios helps prepare and protect for a downturn in the market and it also helps us prepare for when true values emerge and we are ready to invest.

Cash adds stability to a portfolio, and provides our clients with a level of safety and liquidity that might discourage rash decisions of whether to be “in or out” of the market.

When markets decline for an extended period, cash can offer downside protection. When stock prices are high, cash enables us to be ready when new opportunities appear. We passionately believe that this patient approach can serve as a complement to “all-in” growth- and momentum-driven strategies, helping investors to achieve success over the long term.

1 Zephyr Style Advisor

2 JP Morgan Guide to the Markets, 2Q18, Chart of Corporate M&A and Cash levels

3 FactSet financial data and analytics

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