STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

THE ROLE OF CASH IN AN INVESTMENT PORTFOLIO

From a business perspective, how much better to be actively deploying capital, even if the investments are mediocre, than to be stalled in neutral; the employees keep busy, while the clients confuse decisions with diligence, activity with insight, and a fully invested posture with a worthwhile portfolio.

-Seth Klarman

The Current Market Environment

The markets have been throwing hard curve balls to those of us in the money management business the last few years. Because of the near financial collapse and the ensuing slowdown of the global economy, revenue growth rates of U. S. companies have dipped substantially, adding risk to the selection of equities. The economy's sluggishness has led to a decline in interest rates, which slid even lower following the Fed's expansive monetary easing. Although boosting the prices of bonds, the Fed's response kindled fears of inflation and heightened the risk of a dramatic future price reversal in this asset class, keeping most money managers on the bond market sidelines during the run-up. The unprecedented low rates, moreover, made finding a safe, meaningful return on cash investments impossible. In short, building a balanced portfolio for our clients has not been an easy task recently.

Your Portfolio as a Three-Legged Stool

At Sterling Capital, we view an investment portfolio as a three-legged stool that supports the client's long-term financial objectives and, absent specific instructions from the client to do otherwise, invest his or her assets accordingly. Individually, each leg of the stool serves a particular purpose in the portfolio's overall strategy; together, they keep the stool upright and growing sturdier. Cash and short-term investments like money market funds and Treasury bills make up one leg of the stool. These investments offer a safe, though small, return on principal and provide liquidity. The fixed income leg of the stool includes longer-term but still high-quality debt like US Treasury bonds and high-grade municipal and corporate bonds. The equity leg of the stool offers greater growth potential but also more risk. Although we attempt to find stocks that have limited downside, market sell-offs often drive good stocks lower as we witnessed in 2008 through early 2009. Cash and safe fixed income securities are designed to steady the stool when the equity leg is damaged. And cash serves another important purpose—it provides a source of funds, allowing us to take advantage of opportunities afforded by low equity prices when other investors are desperately selling their equities at fire sale prices to avoid even greater losses.

Low Interest Rates and Risk

The unprecedented low level of interest rates the past few years, however, has severely limited the return potential of the cash and fixed income legs of the stool. As millions of Baby Boomers each year join the existing pool of retired Americans looking for a safe income to support their lifestyles, the interest payable on traditional vehicles such as money market funds, certificates of deposit, Treasuries, and high-quality municipal and corporate bonds remains extremely low. This rate environment has caused many to "reach for yield" by purchasing riskier instruments like junk bonds or by extending the maturities of higher-rated debt. Our concern is that these investors, much like those who chased stocks during the internet bubble over a decade ago and those who purchased highly leveraged lower-grade mortgage-backed securities before the recent subprime mortgage bust, do not appreciate the riskiness of their behavior. As those who own mutual funds that hold bonds issued by Puerto Rico or Detroit have discovered, default is more than a theoretical concept. And even those investors not incurring greater credit risk may suffer losses of principal by lengthening the maturity of their bond portfolio. When interest rates rise sharply, longer-term bonds lose value quickly.

Our Response to the Low-Rate Environment

As a result, we prefer not to reach for yield but to preserve your cash while we await better opportunities. At any given time, we usually have a list of five to ten stocks on which we have done in-depth research. The decision to purchase has been made with respect to some of these candidates, and we are waiting for the proper price at which to initiate a position. On others, the decision is pending additional research and analysis. At the same time that we are analyzing these new ideas, we are establishing price levels that will trigger additional purchases of stocks already in our clients' portfolios when these stocks fall without justification.

To take advantage of all these situations, we need to have cash readily available. *Thus, we don't view cash as merely an extremely low yielding instrument, but as a position that will enable us to take advantage of opportunities.* As mutual fund manager Zeke Ashton once remarked, "Our view is that the best way to exploit the occasional bouts of market fear is to have an inventory of ideas that one is ready to buy at the right price, and the cash available to carry out that buying. One without the other is useless."

There are only two ways to ensure the availability of cash in the portfolio. One is to accumulate a designated amount of cash by selling the portfolio's securities when they reach our target prices. The other way is to ask clients for additional cash after the stock market has dropped significantly. The second option is clearly less attractive. When the market has suffered large losses, most clients are reluctant to commit more cash to stocks, and in fact, if nearly fully invested, will likely prefer selling rather than buying.

Put another way, maintaining a cash position allows us to guard against the common flaw in human nature that often impels investors to buy high and sell low. The pertinent question is not whether earning very little in cash is less preferable than possibly earning more in stocks or bonds; instead, it is how much this cash can earn if it is available for deployment when stocks are cheap versus how much it can earn when invested at far less opportune times.

As stewards of your money, we expect the management of the companies in your portfolio to allocate assets efficiently, and we would be quick to express our displeasure if management bought a new factory or gave its executives raises just because it had the cash available to do so. "Why, then," as Seth Klarman (quoted at the beginning of this paper) has stated, "should any investor (hedge fund, mutual fund or individual) always deploy 100% of their capital into marketable securities, applying none of the analytical rigor or intellectual honesty they would demand of the underlying corporate managements? As we said last year, why should the immediate opportunity set be the only one considered, when tomorrow's may well be considerably more fertile than today's."

Recent Examples of Taking Profits in a Long-Term Portfolio

As you know, we typically hold our stocks for a number of years as we try to buy good businesses, not just stocks. But being long-term investors does not mean we completely disregard the movements in stock prices. As you may have noticed, we have recently made some trades in two of our long-term holdings, Landec (LNDC) and Shenandoah Telecom (SHEN). We believe these two companies are great businesses whose best days lie ahead, but we recently took the opportunity to sell some of our positions in the stocks after strong moves in their prices this year. We sold a portion of our Landec holdings as the stock got above $15 per share in July. We firmly believe Landec will move steadily above this $15 mark in the future but concluded that the stock was pricing in most of the current positive expectations and was likely to correct. We were able to buy back the shares we sold at around $12 when investors overreacted to a small earnings miss because of an accounting-related timing issue that affected their recent quarterly earnings.

We also recently sold some of our Shenandoah Telecom shares as the stock rose nearly 30% in September on no significant developments. We regard SHEN highly—it is a well-run company that has invested heavily in its business by making cable acquisitions and technology upgrades. Moreover, management's substantial outlays to move their wireless network to 4G are ending, which will free up cash for dividend increases and additional investments in the company's business. In fact, within the last week, the company announced a 9% bump in its dividend, and we believe further increases are likely. Despite this positive longer-term outlook, we concluded that the stock had appreciated too quickly over the short term and took profits on part of the position. Also contributing to our decision were filings by some members of management disclosing that they had sold shares during the recent run-up. As of this writing, the stock has continued to appreciate. We believe the stock will come down soon and give us an opportunity to buy back the shares we sold as we did with Landec.

But if not, we will continue to enjoy the appreciation in the shares we still own, and this cash, along with other cash in our clients' portfolios, will be available to acquire stocks with even more favorable risk-reward characteristics. In our opinion, holding cash for this purpose makes more sense than deploying it in a riskier segment of the interest rate market.