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THE BLAST: Why 60% Cash is a Good Idea Right Now
By Dan Ferris

"Price determines your return, not how fully invested you are."

The fellow who made that statement ought to know what he's talking about. The firm his father founded in 1974 has rewarded its clients with an average annual return of 15.83%.

Every $100,000 invested in 1974 is worth $8.4 million today. In 30 years, the firm has only had two years of negative return, 1990 (-9%) and 2002 (-0.5%).

The speaker was Scott Van Den Berg. His father, Arnold Van Den Berg, founded Century Management in 1974.

I sat listening to Scott, then Arnold, speaking to a few hundred of their clients in a large conference room at the Austin Convention Center in Austin, Texas last Saturday.

I was listening to Scott explaining to clients why the firm had, on average, over 60% of their money in cash throughout 2004.

Scott Van Den Berg's comments reminded me of similar ones made by Warren Buffett, quoted in this column several weeks ago. Buffett said, "the idea that you say, 'I've got 60% in stocks and 40% in bonds,' and then have a big announcement that 'now we're moving our allocation to 65/35' as some strategists, or whatever you call 'em on Wall Street, do – that's pure nonsense. I mean, 60/40, 65/35 – it just doesn't make any sense.

"What you ought to do… Your default position should always be short-term instruments. And whenever you see anything intelligent to do you should do it."

Holding cash, Van Den Berg and Buffett might say, won't hurt you when stocks are too expensive to produce big returns.

Over the past 30 years, Arnold Van Den Berg's cash position has averaged just over 21%. Compare that with Peter Lynch, who says he's always fully invested, at the top and at the bottom, or Bill Miller, whose Legg Mason Value Trust is about 99% invested in stocks, and actually reports a negative cash position (he owes cash; he doesn't own it).

Last week in Austin, the Van Den Bergs showed me some research that made it clear why they were holding so much cash.

First of all, there's the number of stocks that are within 10% of their low prices, as measured by the price-to-sales ratio.

Van Den Berg favors the price to sales ratio instead of the price to earnings ratio because earnings are more complicated to calculate, and easier for accountants to manipulate and "manage."

In 2000, when the market was held up by a few big tech stocks, there were 2,394 stocks within 10% of their low price-to-sales ratio. That number fell to a low of only 293 stocks in early 2003. Today it's still low at 524. The universe of potential bargain stocks is very small today.

Another number mentioned in Austin was the price-to-sales ratio of the S&P 500. When Van Den Berg is doing a lot of buying, the S&P 500 is usually trading at around 0.4 times sales.

Today the S&P 500 trades at three times that level, around 1.25 times sales. The S&P 500's long-term average price-to-sales ratio is 0.88. So it could easily fall 30% and it would only be getting back to its average level.

Then Van Den Berg showed us just why he's so skeptical of the price-to-earnings ratio. He showed us how options accounting, pension funds, record low corporate taxes, managed earnings and record low interest rates have combined to raise the S&P 500 earnings as much as 33% above where reality suggests it ought to be right now. Simply eliminating widespread accounting tricks could result in a 19% drop in the S&P 500...just to keep it at today's price-to-earnings ratio.

When a man who has made investors 84 times their money over the last 30 years says stocks are overvalued, you ought to believe him.

If you're holding cash because you can't find enough stock bargains, you should not waiver.

Remember what Scott Van Den Berg said: Your returns are a function of the price you pay, not how fully invested you are at any given moment. That cash you're holding is the raw material of tomorrow's superior returns.

Finally, Van Den Berg reminded us that, just when you're wondering if you ought to jump in and join the rally, the stock market falls, producing a buying opportunity for anyone who's got the cash. Such buying opportunities happened seven times when the market went sideways for 17 years, from 1965 to 1982.

During that horrendous period, there were seven times when stocks went into Van Den Berg's "value zone," at 0.4 times sales. With good quality earnings, a .4 price to sales ratio corresponds to a price-to-earnings ratio of 8, if the profit margin is 5%.

Sixty percent below sales is super cheap. So is eight times earnings.

For stocks to get back to those levels, the S&P 500 will have to fall between 65% and 75% from its present levels. Ouch! (Don't say I didn't warn you.)

Sure, earnings and sales could rise to justify current levels, but there's nothing in that deal for anyone who buys today. The odds are squarely against most stock market participants today.

As Damon Runyan might have put it, "When stocks are high, they can go higher, but that ain't the way you lay your dough."

Good Investing,

Dan Ferris

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