What A Drag It's Not Having Cash

The late Gilda Radner created the character Roseanne Roseannadanna who would end a crank about a certain situation with, "you don't know what it is!" Such is the attitude many stock market analysts have toward cash; not that they are averse to getting their hands on a heaping helping thereof. You constantly hear talk of "cash on the sidelines," spoken in the same tone as "flotsam on the beach."

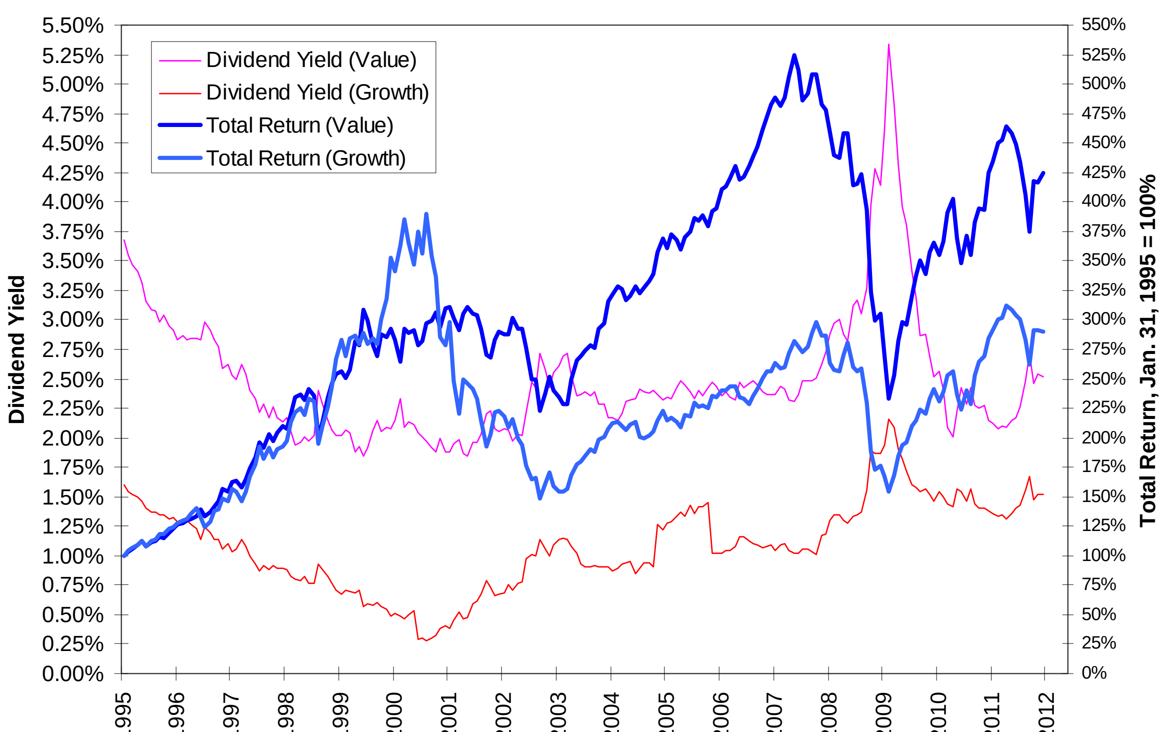
There are some good reasons for this disdain, mind you. A fund manager benchmarked to an index is assured of underperformance in a bull market unless short-term interest rates exceed the realized total return of that benchmark. Corporate managers who pile up cash on their balance sheets are signaling a paucity of attractive investment alternatives. A fund manager can defend low cash levels by saying clients can choose their own personal cash levels but the fund is being paid to manage stocks or other assets, not cash. A corporate manager can justify cash by saying they are lowering the risk of the corporation and can use a highly valued stock as currency for purposes of incentive-based compensation or for mergers and acquisitions. Moreover, if corporations return cash to shareholders in the form of dividends or share buybacks the shareholders in taxable accounts are liable for taxes on the distribution.

Dividend Yield By Style

Much of what passes for wisdom on Wall Street is nothing more than untested urban legend, such as the belief value investors are driven more by dividend yield as part of their total return mix and therefore might favor high dividend payouts and high cash reserves. The exact definition of what constitutes a "value" or a "growth" stock is far more of an, um, value judgment than it may appear. Value stocks have lower price-to-book and lower expected earnings growth than do growth stocks; even so, approximately 30 percent of issues in the Russell Investment Management scheme have proportional membership in both indices.

We can track the behavior of the Russell 3000 Value and Growth indices over time on both a total return basis and on a dividend yield basis. Over time, the dividend yield on the Value index has been consistently higher than that of the Growth index, and by a fairly steady absolute margin. The only real exception to the tracking on this variable occurred during the 2008-2009 financial crisis when plunging share prices and a lag in companies' willingness and ability to cut dividends inflated yields.

Dividends And Returns

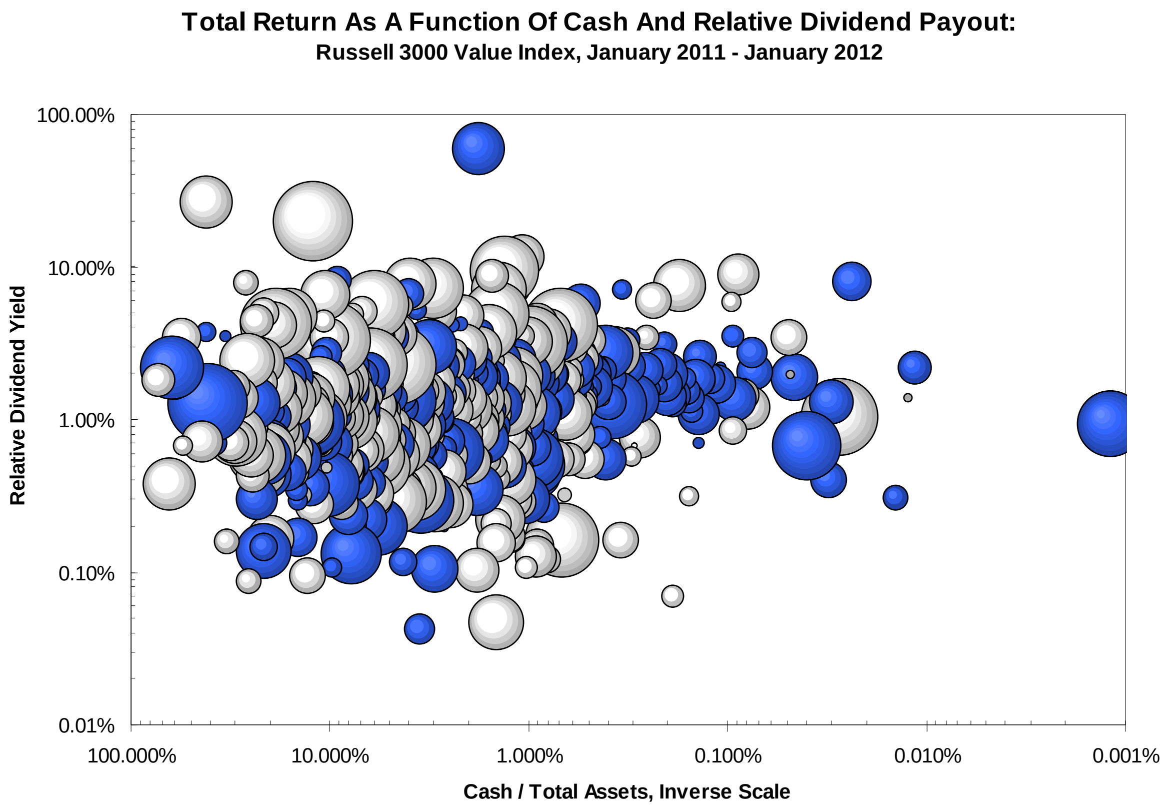


If the two indices' dividend yield relationships have been fairly constant otherwise, the same cannot be said for their total returns. These paralleled each other from 1995 into the final takeoff point of the tech bubble in 1999. Value then outperformed Growth until the onset of the credit crisis in late 2007, after which financial issues were eviscerated. This long-term history should be our first clue relative returns are not a very strong function of relative dividend yields.

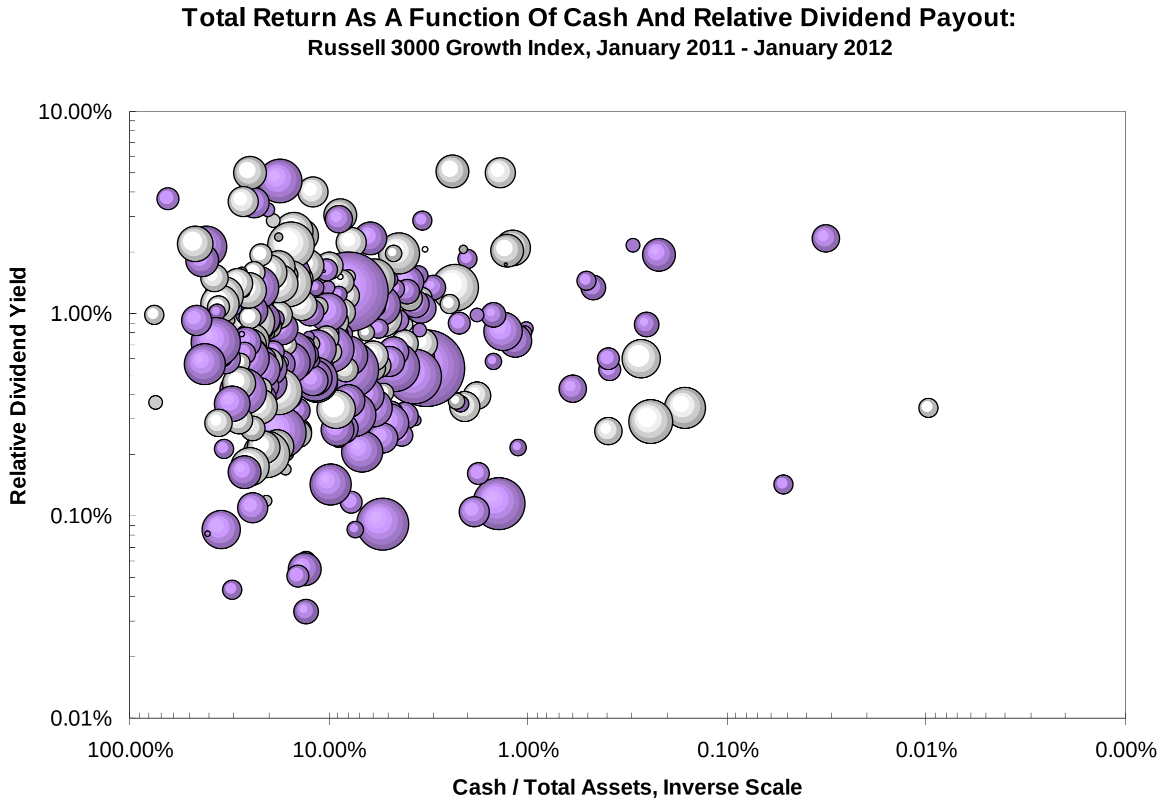
The Cash Stash

Now let's take a look at total return as a function of two variables fore each individual stock in the Russell 3000 by style, the ratio of cash to total assets and the dividend yield relative to the S&P 500. One-year trailing total returns are depicted with bubbles; colored bubbles for positive returns and white bubbles for negative returns with the diameter of the bubble depicting the magnitude of the return. The dividend yields and cash/asset ratios are drawn on logarithmic and inverse-logarithmic axes, respectively. What behavior should we expect to see?

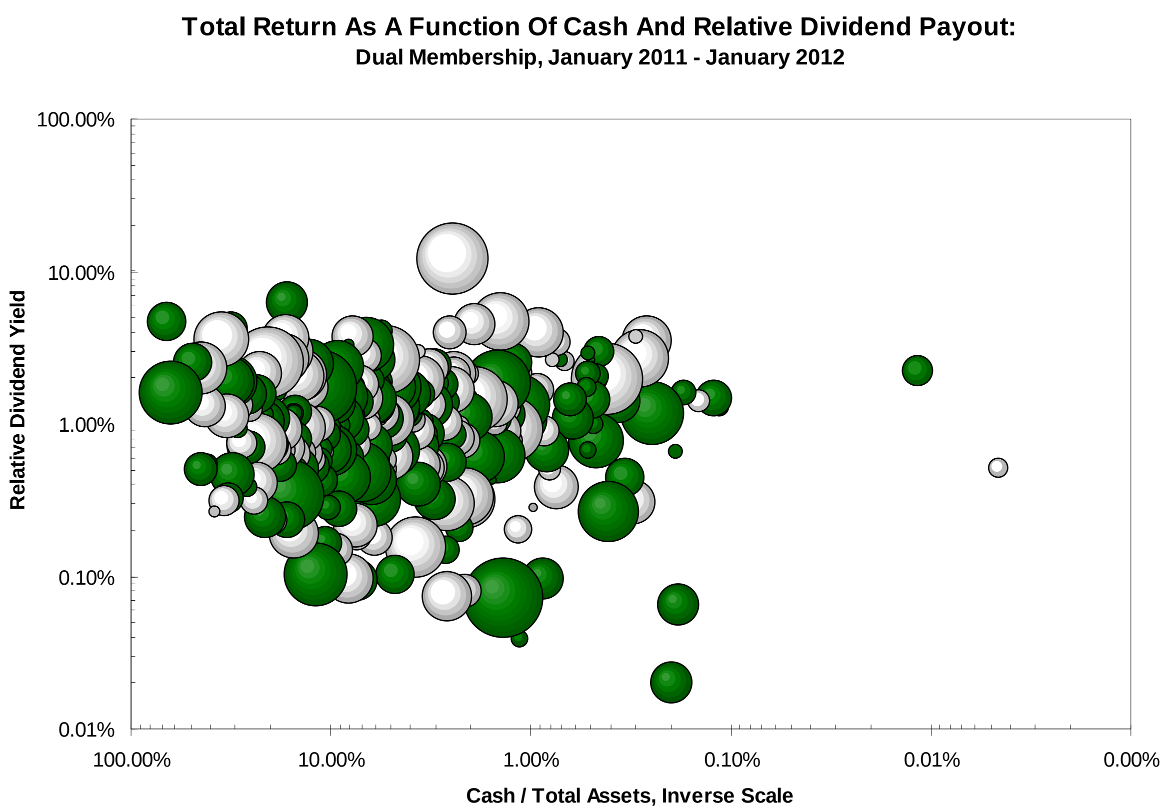
First, if value-oriented investors prefer high dividend payouts and high cash levels, we should see an aggregation of large colored bubbles in the northwest corner of the Value index chart. We do not.



If Growth investors prefer high leverage and are willing to sacrifice dividend yield for capital appreciation, we should see a concentration of large colored bubbles in the southwest corner of the chart; this is not apparent visually and is not demonstrable statistically.



Finally, if we look at issues included in both indices, we another random pattern. Try as we may, we cannot discern a contemporaneous relationship between total return, relative dividend yield and cash levels as a percentage of total assets.



Theory Of The Firm
The author has suggested, only somewhat in jest, all advances in finance are made by the losers: The winners head out for refreshments while the losers stew around the office thinking how to do it better the next time. *C'est la guerre*. However, is there a better explanation for why much of the path-breaking research in corporate finance was done in the 1930s or why the explosion of options theory was done during the difficult decade of the 1970s?

One of these seminal works, *The Modern Corporation and Private Property*, was published by Adolf Berle and Gardiner Means in 1932. It described an eternal tension between managements and shareholders over cash; while managements have an incentive to build empires with the shareholders' cash, the shareholders may wish to take some of their money out for use elsewhere. That bombastic CEO of one of your holdings is actually acting as your agent, as repulsive as that may sound to the high and mighty in the corporate world. You had best hope management is working with your best interests and not its best interests in mind.

The best defense you as a shareholder have in this agency battle is a high dividend and a low level of cash; the dividends are your way of getting returns back at a lower risk and the low cash level is a defense as value-destroying merger and acquisition sprees. If you have to pay the tax on these dividends, and who knows where the dividend tax rate will be in 2013, then pay the tax. It is cheap insurance against someone taking a flyer with your money.