Summer 2005 VOLUME 11:2

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

The Critical Role of Cash

By Che H. Lee
President

To some investors, C-A-S-H can be a "four-letter word," unless we are in the midst of a deep bear market. Over the years, a few clients have asked why cash in their accounts remained uninvested from time to time. While they were too polite to say so explicitly, the unspoken question seemed to be "why are we paying PDV, if you are not investing the cash for us?"

This is a fair question. Here at PDV, maintaining a cash balance from time to time is always a ***deliberate*** decision on our part; it is never out of neglect. It can be caused by one or more of the following reasons:

1) The investments we are interested in have not dropped to the price levels that we are willing to commit your funds to them. In these situations, it is better to wait for the right price with discipline, than get the money invested at too high a price for the sake of getting fully invested. Sometimes, waiting is the ***most difficult, but appropriate and beneficial***, course of action.

2) The cash balance relates to a new account, for which our discipline cautions us against getting all the money invested too quickly. For our new clients' benefit, we prefer to invest cash over a period of time, to average in your prices.

3) Cash is being used as a surrogate for "short-duration" fixed-income assets, on a temporary basis, to deal with a hostile rising-rate environment.

There are times when clients are much better off being partly uninvested than fully invested. We don't think it is in our clients' interest for us to invest in companies unless and until the appropriate prices are available. Clients are not only paying us to do something with available cash, but also to make the disciplined decision to hold off doing something with it, at least temporarily, if that is the appropriate thing to do.

Our valuation discipline dictates how much cash is held in a client's account at any one time. It is a residue of our valuation process for individual securities, not an attempt to time the market. Cash tends to go up during elevated market periods when fewer undervalued investments exist. On the other hand, it tends to go way down during slow or poor market periods, when more investment bargains surface.

Inside This Issue:

- The Critical Role of Cash p.1
- Who's Watching Your 401(k) Account? p.2

Who's Watching Your 401(k) Account?

By Che H. Lee
President

When we meet with prospective clients, they typically bring along financial account statements from multiple sources. Often, there will be a statement for a company 401(k) or similar retirement plan account at work. Nine times out of ten, prospective clients will devote most or all of our meeting to discussing the accounts outside the retirement accounts at work. In our experience, prospective clients have more difficulty seeing the need for professional management of the assets inside these types of retirement accounts at work. This is unfortunate, as assets built up in these accounts over time can make up the bulk of their wealth.

We wrote an article in ***Observations*** several years ago discussing how neglecting your retirement account(s) at work can have long-lasting, adverse consequences. I thought it would be timely to reprint our thoughts below.

****

The explosive popularity of defined contribution plans, such as 401(k) plans, during the 1990's was due to several factors: 1) employers' desire to shift the burden of making investment decisions to employees; 2) employers' desire to reduce their cost in funding retirement plans, giving employees only limited or no matching contributions, and letting employees finance their savings through payroll deductions; 3) employees' ready acceptance of these plans in lieu of the traditional "defined benefit" pension plans, because their contributions enjoy tax advantages and the ability to make investment decisions with respect to their retirement assets gave them a sense of empowerment and control; and 4) the bull market that prevailed during much of the 1990's made most plan participants feel like investment geniuses as losses were few, infrequent and short-lived.

These plans made just about everyone happy, until the tech bubble burst in March 2000, dragging the rest of the market into one of the nastiest bear markets since 1973-74. Slowly, millions of investors with the bulk of their retirement assets tied up in 401(k) plans started seeing their accounts actually lose value, month after month. Then came Enron and its well-publicized woes, a significant part of which related to how its many innocent, hard-working employees stood by helplessly, as their life-savings represented by Enron stock trapped inside their 401(k) accounts were decimated. Suddenly, just about every person with money invested in 401(k) accounts started questioning the wisdom of keeping money in these types of accounts.

As the Enron fiasco unfolded, demands for answers and satisfaction erupted. The politicians went into grand-standing overdrive. The recent legislation aimed at mitigating some of the short-comings with 401(k) plan accounts creates new problems for every one that it solves. People relying on the government to solve all their 401(k) plan account related problems will be sorely disappointed.

When we take a step back and analyze the wisdom and value of defined contribution plans, it becomes apparent that the model only works ***if both employer and employee are capable of making good investment decisions***. This is a tall order. Because of cost considerations, most employers elect to offer a limited menu of investment options from which to choose and among which retirement savings can be allocated and re-allocated. How well employers put this pre-screened, limited menu of investment options together essentially caps the return potential of employee savings invested among these options. In other words, if an employer, while well-intentioned but lacking in expertise, were to put nothing but poor options into the plan, every single participant in the plan will be destined for poor returns and/or losses.

Exactly how well do employers perform in this regard? The news on this is not good. Here at PDV, we have analyzed many 401(k) and other defined contribution plans for our clients over the years. Our conclusion is that employers generally do a poor job putting together a menu of appropriate and diversified investment choices for their employees. We think there are a number of reasons for this.

First, many plans are over-weighted in company stock. Employers have many reasons to make matching contributions with their own stock, rather than in cash. The tax advantages are substantial, and the stock ends up in “friendly hands,” which tends to mitigate stock price volatility and help fend off unwanted hostile bids. When employers put time restrictions on how quickly employees can dispose of such stock (which happened with Enron), they become involuntarily subjected to an over-concentration of their retirement assets in their company’s stock. Should employers get into operational or financial trouble, employees risk losing their jobs at the same time that their retirement assets are getting decimated. [*Since the time of the original article, Congress passed some protections in this area for employees*.]

Second, 401(k) plans are often over-loaded with an inadequately diversified group of popular funds. Many employers make decisions on what investment options to include in their 401(k) plans through the rear-view mirror. They like to do what’s popular at the time, and include the mutual fund options that have been “working” in the recent past. Rarely are they in the position or do they have the expertise to evaluate what contributed to the funds’ recent success, and more importantly, whether the strong returns of these mutual fund options are likely to be sustainable through the next full market cycle or over time. Employees undoubtedly exacerbate this problem by lobbying their employers to include popular options which neighbors, friends, relatives and the media have been promoting. When it comes to money, the pressure “to keep up with the Joneses” is intense indeed.

Many employers’ preference for recently popular mutual fund options for their plans also have to do with perceived legal liability. They opt for conventional market wisdom and popular fund options as their defense (as in, “ we did what everyone else was doing at the time, so how can our employees blame us?”) Often, these options are the very ones likely to go into a tailspin after an unsustainable rise. After enduring poor performance and hearing complaints from employees, employers will finally respond by eliminating those options from their plans and switching to what might be “working better” at the time, thereby possibly starting another cycle of rear-view mirror decision-making.

Employers also get comfort from hiring the biggest mutual fund companies to manage the investment options within their 401(k) plans. Unfortunately notwithstanding all the marketing hype, size does not equate to quality when it comes to money management. No single mutual fund company has a monopoly on investment wisdom. Plans that offer investment options from only one single mutual fund company will especially be lacking in some way. Moreover, because companies are constantly courted by the most visible and largest mutual fund companies, taking the path of least resistance by doing the conventional thing and giving them the business is considered the “safe” thing to do from a legal liability point of view.

It is not surprising that most employers don’t offer a menu of best-of-breed mutual funds similar to those which you might be able to access outside of a company retirement account, because the cost and administrative headache to deal with that many mutual fund companies would be prohibitive. But using a single mutual fund company or very few companies to provide mutual fund options means that there may be too many investment options either in the same category or employing the same investment style, and not enough in others. The menu of available investment options, under these circumstances, would end up duplicative in part and inadequately diversified. We have observed this problem with many of the plans that we have analyzed over the years.

Anecdotal evidence suggests that employees have generally not done a particularly good job making investment decisions with respect to their 401(k) plans either. They generally seem to fall short primarily in two areas: asset allocation to arrive at the proper overall risk level and selection of the individual mutual fund options to implement this asset allocation. Even if the initial decisions in these areas are satisfactory, the dynamics of market conditions require that these decisions be adjusted over time, a task that few employees have the time, interest or knowledge to pursue.

There is no reason that an employee's job of making investment decisions inside of a 401(k) plan account should be any easier than those relating to non-retirement assets. In fact, it may be more difficult because the employee's freedom to choose among the best investments is constrained by the employer's initial decisions as to what funds to include on the plan "menu." Sometimes, it is just as important for an employee to decide what to avoid among the pre-selected investment options, as what to invest in. If an employee is uncomfortable making investment decisions outside of a retirement plan without involving an investment advisor, why would an employee feel comfortable making such decisions on his/her own inside a 401(k) account?

The solution to the 401(k) plan situation is to have fully informed and educated employees making appropriate investment decisions. However, employers are traditionally loathed to give too much specific education to their employees, for fear of liability for having unduly influenced their employees' investment decisions. While the Department of Labor responsible for enforcing ERISA has granted some leeway in this regard recently, it is unclear whether a sufficient number of employees will invest the time and effort to take advantage of the extra education.

As is hopefully apparent from the foregoing discussion, the model of the 401(k) plan is commendable in theory, but breaks down in practice because of the less-than optimal decisions made by employers and employees alike. At its extreme, the combination of 1) poor pre-screening of fund options by employers (who are lobbied heavily by large, but often less than stellar, mutual fund companies) and 2) employees being lulled into a false sense of comfort that choosing among a pre-selected menu of investment options offered by their well-intentioned employer is easier than managing their non-retirement assets, can lead to destruction of retirement wealth over time.

Given that the assets building up in your 401(k) account(s) over time will likely form a large part of your retirement assets, it is important that you do something to protect yourselves. If you are not comfortable or have no interest managing your non-retirement assets outside of company retirement plans, you should likewise consider whether to engage an investment advisor to help manage what will likely become a big part of your retirement assets trapped inside 401(k) plans. The fact that there are in most cases only a limited number of investment options does not make your investment decisions any easier, or eliminate the need for making good investment selections or avoiding poor ones, especially in light of how poorly employers generally put together the investment "menus."