Cash allocation in managing portfolio risk

Who is best at managing cash levels within a client's portfolio? Is it an adviser looking after the client's portfolio, or is it the specialist portfolio manager managing a single component or asset class of the client's portfolio?

On one hand it can be argued that the adviser has a holistic view of a client's portfolio and by allocating components to an equities manager and a fixed interest manager etcetera, allows the adviser to control the client's asset allocation and the application of specific strategies within each asset class. Under this structure an adviser would want each selected manager or strategy to remain 'fully invested' to enable some control on asset allocation, particularly when markets are volatile or negative where an adviser has the potential to add value by moving assets strategically to cash.

However, there is also an expectation that the adviser is proactive enough to move assets to cash in a timely fashion and not be governed by the timing of a client's annual or semi-annual review. This may also require a degree of authority to act on the client's behalf within a defined compliance framework.

The alternative view is that an investment professional working at the coal face of markets is better prepared to increase or decrease risk (that is change allocations to cash) in a timely fashion. A skilled investment manager is perhaps best placed to dynamically increase cash levels as return opportunities diminish and risks increase. However long only managers are often limited by a mandate that they remain fully invested or hold a maximum allocation of 20% in cash at any time.

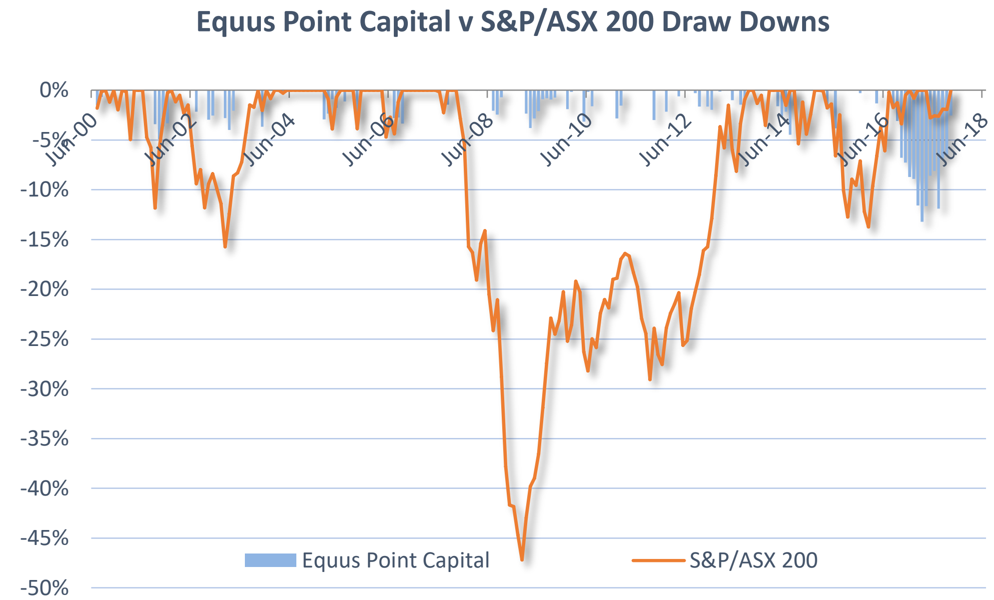
At Equus Point Capital (EPC) we see merit in both arguments. An adviser plays a key role in looking at the totality of a client's portfolio, while a portfolio manager typically is a specialist tasked with looking after a single asset class and does not have that total view of a client's portfolio. But at the same time a portfolio manager is much closer to understanding the risks and opportunities of his/her market and better able to adjust the portfolio accordingly.

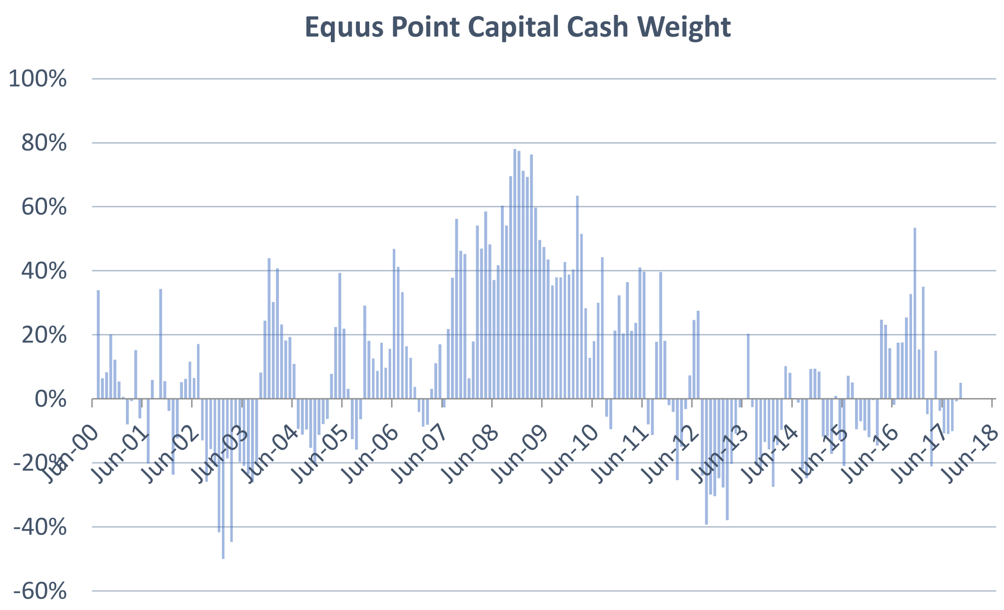
EPC is not restricted in the level of cash it may hold in its portfolio. If perceived alpha generating opportunities are few and risks are elevated, we are prepared to hold cash in lieu of being invested. We believe this better serves the needs of investors in avoiding potential losses and extended draw downs. As a result, our strategy's drawdowns have historically been limited to less than 15%. Compare this with the typical long only strategy where the mandate requires the manager to be 'fully invested' and draws downs reached almost 50% during the GFC.

By being prepared to move assets to cash and not being restricted in the level of cash the portfolio may hold we believe our strategy better preserves capital - a critical element in the achievement of long term investment goals.

It is also worth noting that EPC will sometimes hold a negative cash balance. This can occur because we risk adjust the portfolio holdings and can apply moderate leverage when risk levels are lower. This helps us to generate a more consistent return stream despite changes in the investment environment.

In summary, the decision of what level of cash to hold is made dynamically by EPC in response to changes in both investment opportunities and market risk levels. The portfolio's structure evolves to target a consistent return stream regardless of market conditions.





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