

An Authentic Dilemma: What to Do When Bargains Are Scarce

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As stock prices have risen and bargains have become scarcer, we have been expanding our hunting grounds to countries where we had never invested before. The broadened search has yielded some fine catches, but not enough to keep us from being confronted with a question many other value investors currently face: Should we keep an ever-larger percentage of our portfolio in cash (which at present produces next to nothing) until the bargains return, or should we lower the standards by which we decide what constitutes a bargain?

In favor of hoarding cash, we might reason that having investment standards is what gives us an edge, and that the edge is lost to the extent that the standards are relaxed. Also, there is the argument that, while cash is a drag on performance, it might eventually prove very useful. In Charlie Munger's terse rendering: "It takes character to sit there with all that cash and do nothing. I didn't get to where I am by going after mediocre opportunities."

In favor of lowering our standards is the argument that it can be done to a certain extent while still remaining true to deep value investment principles. Many studies have shown, for instance, that a portfolio invested in the cheapest decile of the market works well over time, which implies, of course, that the average stock in the portfolio is, on an absolute basis, more expensive at some points in time than at others. And many investors have done very well by adjusting to rising markets - my hero Walter Schloss, for instance, seems to have always been at least 90% invested during four and a half decades that included all sorts of market conditions.

Which of the two approaches ends up working better for today's value investors depends of course on how long the bull market has to go. If it still has a long run ahead of it, we'd be better off relaxing our absolute standards and remaining fully invested in the relatively cheapest stocks we can find. If the bull market will soon end, we'd be better off hoarding cash. But, of course, if we were confident in our abilities to predict the ups and downs of the market, why be value investors at all?

At Mercor, we have relaxed our standards a little bit. For example, today we might hold on to a stock whose price has climbed up to the liquidation value of its assets, hoping to "buy on assets and sell on earnings", whereas before we typically would have sold it by that point and used the proceeds to buy another set of cheap assets.

We have chosen, however, to keep most of our standards intact, and so our cash balance has grown significantly. We don't find it too hard to "sit there with all that cash", perhaps because we have the character traits Mr. Munger was referring to, or perhaps because doing so allows us to think of ourselves in flattering terms (bastions of prudence patiently waiting for the next financial bust while the investing masses mindlessly extrapolate recent trends into the future, etc.).

In any case, our choice of hoarding cash over relaxing our standards is not based on our anticipating the imminent end of the bull market. It simply is what we're most comfortable with.

I'm not one of those who think that investors should do what they're comfortable with over what's rational, so as to be able to "stay in the game". In my view, if one is not comfortable doing what's rational (i.e. what the evidence suggest is likely to work best, given the state of one's knowledge and ability), then it is one's job to become comfortable doing it.

However, when choosing between hoarding cash and relaxing our standards we don't have much to go by, as both strategies have worked well in the past, and a decent case can be made for either. So, in this case, why not go with what's more comfortable?