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For Warren Buffett, the cash option is priceless

By BOYD ERMAN

The Oracle of Omaha's company has $41-billion sitting around earning negligible interest. But his method of investing does not make this a waste of funds

If holding cash in your portfolio for little return is driving you crazy, maybe it's time to look at it the way Warren Buffett does.

Mr. Buffett, the world's most successful (and richest) value investor, is sitting on almost $41-billion (U.S.) of cash at his Berkshire Hathaway holding company, the most in a year. Partly, that heap of greenbacks is a safety blanket. But it's something more. As with most matters Buffett, the strategy is more complicated than it looks, Alice Schroeder says.

She should know. The former Wall Street analyst may know more about Mr. Buffett than anyone outside his family and inner circle: She spent more than 2,000 hours with him while writing *The Snowball: Warren Buffett and the Business of Life.*

Ms. Schroeder argues that to Mr. Buffett, cash is not just an asset class that is returning next to nothing. It is a call option that can be priced. When he thinks that option is cheap, relative to the ability of cash to buy assets, he is willing to put up with super-low interest rates, said Ms. Schroeder, who followed Mr. Buffett for years before she became his biographer.

"He thinks of cash differently than conventional investors," Ms. Schroeder says. "This is one of the most important things I learned from him: the optionality of cash. He thinks of cash as a call option with no expiration date, an option on every asset class, with no strike price."

It is a pretty fundamental insight. Because once an investor looks at cash as an option – in essence, the price of being able to scoop up a bargain when it becomes available – it is less tempting to be bothered by the fact that in the short term, it earns almost nothing.

Suddenly, an investor's asset allocation decisions are not simply between earning nothing in cash and earning something in bonds or stocks. The key question becomes: How much can the cash earn if I have it when I need it to buy other assets that are cheap, versus the upfront cost of holding it?

"There's a perception that Buffett just likes cash and lets cash build up, but that optionality is actually pretty mathematically based, even if he does the math in his head, which he almost always does," Ms. Schroeder said last week in Toronto, drawing on knowledge gained during the five years she spent working on *The Snowball*.

Much of that time was spent on the couch in his office in Omaha, Neb., where she said nothing much happens but a lot of reading and thinking. In that time, and the hours spent digging through his files, she said she discovered that while Mr. Buffett likes to speak in folksy aphorisms, in fact, his investing is very complicated.

For someone driven by a quest to find things that are undervalued, as Mr. Buffett is, knowing the price of cash as a call option is the key. The "call premium" on the cash option is essentially the opportunity cost. It is the difference between what he can earn somewhere else and the nil return on holding cash, said Ms. Schroeder, addressing the crowd at the annual Investment Industry Association of Canada conference, after which she sat down for a Canadian exclusive interview.

"There are times when he feels like that option premium is really cheap, compared to the intrinsic value of the option itself," she says.

The option theory of cash is something Mr. Buffett does not tend to get into when he is up on stage at his annual investor meeting, dishing out his homespun take on life and investing. That's probably because Mr. Buffett views himself as a teacher, and he wants to reach a broad audience, she says.

"Generally speaking, he likes to keep concepts simple," Ms. Schroeder says. "He says, 'I like to have all that cash around because you can use it.'"

However, it is a lesson that Ms. Schroeder said she wishes more people would learn. For many investors, there is a sense that holding cash is a cop-out. Investors who see their fund managers holding a lot of cash tend to think that they are not getting their money's worth, which is wrong, she says.

"If investors would realize that what they are paying for is someone to have the expertise to know when to buy a call option called cash, and move in and out of that, then perhaps there might be more value placed on that service."