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The futility of taking Cash Calls

Even if one was to get market timing – selling and re-entry – both legs perfectly right, and that is a big assumption, the net impact on your incremental IRR vs staying invested is marginal.

We enclose calculations below

- Cash call of 20% and a 20% market drawdown —> incremental IRR over 5 years vis a vis staying invested is 1%
- Cash call of 30% and a 30% market drawdown —> incremental IRR over 5 years vis a vis staying invested is 2.3%

Scenario 1: 20% cash call and a 20% market draw down			
Starting Corpus	100		
NAV per unit	10		
Units	10		
Cash call	20%		
Cash generated	20		
Cost of acquisition	15	Assumed 100% return	
Units sold	2		
Units post Cash call	8		
LTCG	11.96%		
Tax	0.6		
Effective Cash	19.4	Units sold less tax	
Market draw down	-20%		
Re entry - NAV	8.0		
Re entry - New Units	2.4	New units at lower NAV	
Total units post re entry	10.4		
Status post 5 years			
No cash call		**With cash call**	
NAV at end	20	NAV at end	20
Units at end	10	Units at end	10.4
Starting Capital	100	Starting Capital	100
End Capital	200	End Capital	209
No cash call - total IRR	14.9%	**With cash call - total IRR**	15.8%
End Capital: NAV at end * Units at end			

Scenario 2: 30% cash call and a 30% market draw down			
Starting Corpus	100		
NAV per unit	10		
Units	10		
Cash call	30%		
Cash generated	30		
Cost of acquisition	15		
Units sold	3		
Units post Cash call	7		
LTCG	11.96%		
Tax	1.8		
Effective Cash	28.2		
Market draw down	-30%		
Re entry - NAV	7.0		
Re entry - New Units	4.0		
Total units post re entry	11.0		
Status post 5 years			
No cash call		**With cash call**	
NAV at end	20	NAV at end	20
Units at end	10	Units at end	11.0
Starting Capital	100	Starting Capital	100
End Capital	200	End Capital	221
No cash call - total IRR	14.9%	**With cash call - total IRR**	17.1%

Why is it that market timing seldom works?

- An over-heated market can rise much further before it corrects. No one rings a bell at the top or at the bottom. Hence, typically one sells too early.
- Re-entry is difficult at the bottom. At moments when re-entry should happen, our minds are seized with fear as the drawdown reflects near term stress in the environment
- The protective instincts of the brains kick in overriding rational judgement (“prices factor in the uncertainty ”) and one looks to protect remaining capital
- And if this seems theoretical, we only need to take a minute to reflect how we behaved last year during March – June.

Then why do people continue to be tempted by cash calls?

- Some people genuinely believe they can over optimize short and long term. Such genius is very rare. But then, over estimating one’s competence is a human trait.
- The mathematics is not intuitive. These lessons have been learned painfully because yours truly engaged in this futile activity for many years

- During times of stress, time horizons compress. We forget the game we are playing. And some of this is biological based on how our brains are wired.
- We take advice from people playing a different game with different incentives. CNBC needs your eyeballs. Your broker needs you to churn.

So how to protect against drawdowns?

- We cannot. The reason historically Equities have been far more rewarding than Bonds is because the "risk premium" is the reward for the pain of enduring market volatility
- One can only minimize drawdowns by not buying junk. The extent of drawdown and pace of recovery is a good benchmark of the quality of the portfolio.
- The only other protection is to hold some Assets in cash equivalents so one has the comfort of a cushion and not over-invest in Equities beyond tolerance for drawdowns
- A deeper question though is if one believes one can compound at 15%, why does it matter if there is a drawdown along the way?

At Solidarity, we firmly believe that trading and investing don't mix as one has to train the brain to think long term during moments of stress and not freeze

- Hence, not only our Investment processes but everything we do is designed to think long term
- Specifically, derivatives trading is banned at our firm so one can still the mind and not confuse oneself at times of maximum opportunity