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Partner Talk®

February 2017

DOW 20,000 – A Non-Event

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The Dow Jones Industrial Average crossed the symbolic threshold of 20,000 on January 25, 2017, just 42 days after reaching 19,000, eliciting an avalanche of articles and commentary, and creating a general feeling of elation. But the milestone also raised a number of questions: (1) does it matter; (2) does it mean stocks are expensive; and (3) is it a validation of President Trump's stated policies? Let's look at each one of these questions in more depth.

Does it Matter?

This is the easiest question to answer: no, it does not matter. We could stop right here and move on but let's explore why. There is simply nothing meaningful about the number 20,000, just as there was nothing magical about the Dow crossing 10,000. These absolute numbers, stripped of context, lack value. When the Dow first crossed 10,000 in 1999, stocks were very expensive. If today the Dow were to suddenly fall 50% to 10,000, stocks would be suddenly very, very cheap: Same number – 10,000 – but a very different meaning. It is like asking if 45 degrees is cold. Well, is it February or August? Are you in Antarctica or Egypt? Are you measuring in Fahrenheit or Celsius?

Another reason this threshold does not matter is that the Dow Jones Industrial Average itself is an index that is in some sense arbitrary. First, it is 30 stocks. To a properly diversified investor, these 30 stocks will represent a tiny proportion of an overall allocation. These stocks - though important, large, and high-profile - do not represent the world or the U.S. market. Excluded from the Dow are small cap stocks, mid-cap stocks, international stocks, all of which can diverge from the Dow in terms of return and volatility. The Dow is also an index in which a stock is given greater weight the higher its share price, regardless of the size and overall market value of the company. For example, General Electric has a market capitalization of 263 billion; Nike's market capitalization is 86 billion. But since Nike's stock price is $52 per share and GE's stock price is $30 per share, Nike contributes a greater weight to the calculation of the Dow than does GE, despite being 70% smaller.

Does it mean stocks are expensive?

This is a more difficult question to answer, although the short answer is also no – it does not mean stocks are expensive. They may be expensive, but this is not merely a function of price. As we alluded to above, context is everything. When we try to answer this question, we cannot just look at price. We must also look at least at price in relation to earnings, or the P/E ratio. But do we look at past earnings or future earnings? Past earnings are in the past and are therefore, some argue, irrelevant. But future earnings are in the future, and therefore impossible to predict with any certainty. We can say that based on the P/E ratio when the Dow crossed 10,000 in 1999 stocks were very expensive (the PE of the Dow was as high as 44), much more expensive than today, when the Dow is at 20,000 (the current PE of the Dow is 20).

In addition, prices reflect market sentiment, a product of the collective feelings of millions of human beings, whose intelligence and judgment are also swayed by feelings that swing from ebullience to despair. Is today's optimism justified? Or, is this a time that proves the advice of Warren Buffett – be fearful when others are greedy, and greedy when others are fearful?

Is it a validation of President Trump's stated policies?

This is probably the most difficult question to answer, because it leads us into the combustible world of politics, but is another question that is probably not relevant. First, only hindsight will indicate if the market was correctly pricing in the effects of tax and regulation reform, but also correctly pricing in the probability that this reform actually happens. And only in hindsight will we be able to say if the market was correctly pricing in the effects of a greater protectionist trade policy, and the probability that this would actually happen.

In the meantime, let's admit it – our opinions on these matters are difficult to disentangle from our feelings about the new President. Those who are aghast at Donald Trump will be more prone to view this post-election upswing as built on illusions and bound to fall.

Those who like the new President will do the opposite. The recent rise in the markets will be evidence of the soundness of his policies, and if markets fall that will be evidence of the markets' irrationality.

So, to sum up, the Dow reaching 20,000 is a non-event, which by itself says nothing about whether stocks are cheap or expensive. And whether it is an affirmation of the economic instincts of the current President, or a sign that we are entering a period of irrational exuberance, depends on where you stand politically, and is best not discussed at family gatherings, neighborhood block parties or any other mixed company event.