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What Our Managers Are Saying

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PMA portfolio managers tend to be “bottoms-up” investors, focused primarily on company financial fundamentals in an attempt to identify those stocks that have real growth potential and staying power. They are not pleased by the current market environment, despite the historic bull market now closing in on its eighth anniversary.

What displeases them most is that central bank actions across the world have used easy money – in the form of “quantitative easing” – and low interest rates to provide stimulus to post-recession economies in the absence of the real fiscal policy changes (tax reform, regulatory reform, infrastructure spending) that legislative bodies have been reluctant to undertake. They see the former as financial engineering, but very much favor the latter as the development of real, lasting policies that could support the economy and the markets for years to come.

Bill Gross, although no longer a PMA manager, has re-emerged at Janus Capital Group (where we work with their Enterprise Mid-Cap Growth Fund) with his trademark monthly commentaries. He is playing his old PIMCO song – suppressed interest rates are punishing savers and distorting the risk return equilibrium by artificially supporting higher asset valuations. He points out that the combined balance sheets of the world’s largest central banks (Federal Reserve, European Central Bank, Bank of Japan, Bank of England) have grown from about $2TT in 2003 to an unprecedented $12TT in 2016. He is skeptical about their ability to eventually unwind their positions in a non-disruptive manner, if ever.

While Gross tends toward the macro, economy-wide view, many of our managers are concerned about how these same issues play out in the market and at the company level.

Fiduciary Management, Inc. which runs PMA's FMI Large Cap Fund thinks today's market is very expensive, has little organic growth, is focused on mergers and acquisitions as a way of artificially achieving growth, and has, overall, just an average balance sheet. They are extremely doubtful that current trends are sustainable, and note in particular:

> Great investors tend to shy away from popular themes as they gather momentum, but most investors do the opposite … One proof of this is the consistent long-term results from the Dalber studies, which show that mutual fund investors achieve only about a half of the market's return [because of bad market timing]. We are highly confident that the rush into index funds in recent years will end with the same result: poor returns … Why investors think that the ultimate trajectory of a passive asset (e.g. the S&P 500) is somehow going to be different than every other asset that has become overvalued since the beginning of time is a curious psychological or behavioral oddity, to say the least.

They recognize that the so-called "Trump Trade" that has fueled a phenomenal post-election stock market rally is essentially enthusiasm for the chance that Trump's agenda for fiscal reform - tax reform, regulatory reform, trade reform, infrastructure spending, health care reform – might come to pass with a sympathetic and supportive Republican congress. However, they are mindful of the potential pitfalls:

> Somehow Mr. Trump is going to spend a trillion dollars on infrastructure without increasing the debt load. Somehow America is going to sell more of its goods overseas even while we bash our trade partners, threaten to erect additional tariffs, and cope with a very strong dollar. Somehow we are going to roll back the regulatory burden and make government agencies more accountable, even though most presidents have been saying that for generations and the government just gets bigger. Somehow we are going to reform the tax code, making it fairer for more people and more attractive for risk-takers and business owners while balancing the budget. Somehow we are going to fix the health care system, eliminate perverse incentives and make it much more cost-effective without diminishing access. We are not mocking these goals. We are simply saying that the proverbial devil is in the details.

Some of our managers saw 2016 as a potential watershed year in terms of company fundamentals coming to the fore. The distinctly bifurcated year – a terrible January and the Brexit surprise followed by the post-election rally – meant that for at least part of the year, the tide wasn't uniformly rising and some of the boats got stuck in the mud. The Sound Shore Fund, a PMA large value fund for many years, noted that "Encouragingly for Sound Shore's bottom-up process, equity performance through the year appeared increasingly driven by company specific fundamentals."

Dodge & Cox, who run both an international stock fund and a large value domestic equity fund in PMA portfolios, were pleased that several of their long term investment ideas came to fruition in 2016. They note that active managers often need considerable time to let their ideas develop, and that the rewards of active management go only to those who are willing to stick with a manager over the long haul:

> Long-term, value-oriented investing is a humbling but hopefully rewarding endeavor. It requires forming independent opinions that may be very different from the consensus view and maintain mental and emotional discipline in the face of inevitable market fluctuations … Those challenges are well worth the potential for superior, long-term investment returns.

Essentially, PMA managers are trying their best to keep their heads above the fray and to tune out the noise of macro-trends and investment fads. Instead, they are focused on the intensive, detailed and rigorous research that helps them understand which companies are likely to grow and thrive and which are not.

These managers do not know the future, but they do attempt to identify companies whose fundamentals are such that they are likely to succeed in most foreseeable market eventualities. Their hard work and thoughtful decision making is what underpins the consistently strong risk-adjusted returns that PMA has sought to provide to its clients for the past thirty-five years.