Partner Talk®

July 2018

A Picture Can Paint a Thousand Words

Fred D. Snitzer

fsnitzer@prudentmanagement.com

Careful readers of the PMA monthly cover letter know that we strongly believe that long-term returns are the returns that truly matter to the investment success of individual and institutional investors. Nevertheless, sometimes looking at short-term returns can be an illuminating exercise, and as we finish up the first half of 2018 we thought it was worth reviewing the first 6 month of this year as a way of reinforcing some timeless investment ideas.

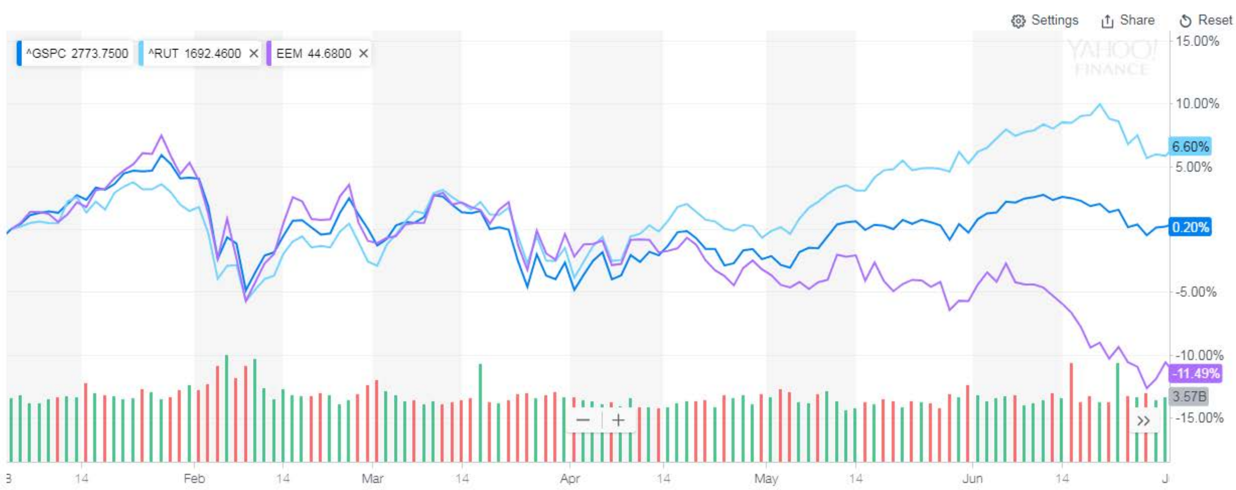
Plenty has been written about the stock market, but sometimes a picture can convey an idea as powerfully and concisely as words. This is a chart of the S&P 500, from January 2nd, 2018 through June 29, 2018, the first six months of 2018:

What does this chart tell us? We think it conveys what we said to clients back in December, 2016: *"Cutting corporate tax rates and easing regulatory burdens while threatening CEOs and interfering in their capital and labor decisions is like putting air in your tires while locking the steering wheel."*

After a steep rise in January, reflecting the market's optimism about the economy and effects of the tax cuts, the market responded to the threat of a trade war with a sharp decline, rebounded when it appeared that trade tensions were more bluster than reality, fell again when it re-evaluated that conclusion, and has basically drifted sideways since, as it tries to figure out how all of this international tit-for-tat will play out.

On a more general level, this chart illustrates the idea that the market is a powerful and efficient processor of information, the result of millions of investors every day evaluating data, buying and selling securities, setting prices in real-time. With every threat of trade wars and tariffs, the market went down. With every hint of a thaw, the market recovered. With the continued uncertainty, it has moved sideways, ending up the first 6 months of the year with a return of .2% (2.6% with the reinvestment of dividends). The chart also illustrates another important idea: government policy matters.

What happens when we add other segments of the equity market to this chart? Remember that the S&P 500 represents 500 of the largest U.S. stocks, the ones most likely to be affected by international trade tensions. What happens when we add the Russell 2000 Index, which measures the performance of smaller-cap U.S. stocks, and the ishares Emerging Markets ETF, which tracks the performance of the MSCI Emerging Markets Index (companies in countries such as Brazil, China, Thailand, and India)?



With these additions, the chart now illustrates several more ideas: the benefits of diversification, as the smaller cap stocks, represented by the top light-blue line, end up the first six months of the year with a 6.6% return (7.7% with dividends); the greater risk of emerging markets, represented by the bottom purple line (down almost 12%); and the volatile nature of short-run returns (notice the way in which these three indices sharply diverge after April, after moving closely together during the first four months of the year). This makes intuitive sense: of the three areas of the global stock market represented in this chart, the segment least affected by international trade tensions (U.S. small-cap stocks) has had the best run since January, whereas the segment most affected (emerging markets) has had the worst run since January.

The three lines of this chart represent three very different and distinct areas of the global stock market. Rather than trying to time which segment is going to do best over a short period of time, a fool’s errand in our opinion, it is PMA’s job to find what we think are the best managers in each segment of the market, from large-cap value to mid-cap blend to small-cap growth, in both U.S. and international markets, and then to carefully decide what weight to give to each segment of the market. In this way, we try to limit the overall risk of our clients’ portfolios without sacrificing returns. We cannot predict things like the direction of interest rates, the outcome of trade tensions, or the daily moods of our political leaders, but we can try to structure our clients’ portfolios to provide the best ratio of return to risk.

A picture can paint a thousand words. These simple charts illustrate the ideas that the market is a powerful tool for digesting data, both economic and political; that the market does not like even the threat of trade wars; that the “market” is really a simplistic generalization that is made up of many sub-markets, all or which can sharply diverge from each other, especially over short periods of time; and that diversification remains the best way for investors to buffer the volatility of these different markets.