PMA

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A Long Term Perspective

Fred D. Snitzer

fsnitzer@prudentmanagement.com

This letter is being written on Tuesday, December 4, 2018. It's 4pm and the Dow Jones Industrial Average has just closed, down 799 points, at 25,027, a 3.1% decline.

And yet, if I had written this letter on Friday, November 30, I could have reported that the Dow Jones had climbed 200 points, its best weekly rally since November 2016, while the S&P 500 and Nasdaq advanced almost 1%, capping off their best week since December 2011.

The truth is that we see neither of these market events as terribly significant, because both are based on the shortest possible view of market results.

Perspective is everything. Just as in life setbacks are inevitable and, some would say, essential, so too it is healthy to be reminded that markets do not only go up in a straight line. And it is also healthy to remind ourselves how short our memories are. For example, for the 9 years from 2009 through 2017 the S&P 500 has delivered, on average, a return of 15.3%, far outpacing its historical average of 10.2%. But what happened in 2015, a mere 3 years ago? The Dow Jones was up 1.4% for the year. What happened in 2011? The Dow Jones was up 2.1%. Overall, the last nine years have been exceptionally good years, and this period has included two years of mediocre returns.

And as we've stressed before in our letters to clients, there is nothing sacred about the time frame of a year. For example, from the vantage point of November 23rd, when the market closed at 24,286, the Dow is up 3.1%. And from the perspective of March 23rd, when the market closed at 23,533, the market is up 6.4%. And from the perspective of December 30, 2016, almost two years ago, when the market closed at 19,763, the market is up 26.6%.

But what about from the perspective of January 1st, which for arbitrary reasons is the only date that some investors really care about? Well, the Dow Jones began the year at 24,719. Through Tuesday December 4, at 4pm, the market is, amazingly, still up 308 points, or 1.2%.

And while 9 years may seem like a long time, for our purposes a 9 year period is still looking at the short-term. What does taking a longer term perspective tell us?

During the 146 year stretch from 1847 through 2017, there were 41 years in which the market delivered a negative return. Therefore, if the history is any guide, we can expect to experience a down market approximately once every 3. 5 years. The average decline for these 41 years: -10.2%.

Of these 41 down years, here are the four worst:

1931: -43.3%
1937: -37.0%
2008: -37.0%
1973: -26.5%

In 1931 and 1937 the U.S. economy was struggling through the Depression. In 1973, there was rampant inflation, price controls, and the OPEC crisis. And in 2008, we had the popping of the real estate bubble and the panicked run on the banks. Today, none of these risk factors are present. Nothing like these risk factors appear to be on the horizon.

Furthermore, over a reasonable period of time, the stock market follows corporate earnings. Corporate earnings are still strong, although less strong than before. Forecasted GDP is up 2 to 3% next year, which is a respectable if not exciting growth rate. Importantly, stock valuations are not that high, which is no guarantee of positive returns in the near future, but it’s a much better indicator than if valuations were stretched.

There is always risk in the market. Right now, the market is trying to factor in how the trade tensions with China will be resolved, and whether or not the strong economy is slowing down to the point where it will enter a recession. These are real risks and we will continue to monitor them carefully. Although the PMA Investment Committee normally meets four times a year, we just held a special meeting, in light of the recent market volatility, to review all of these issues discussed in this letter. Given the uncertainty of trade talks with China, and given our long-term perspective and current risk assessments we have decided to maintain our existing allocations.