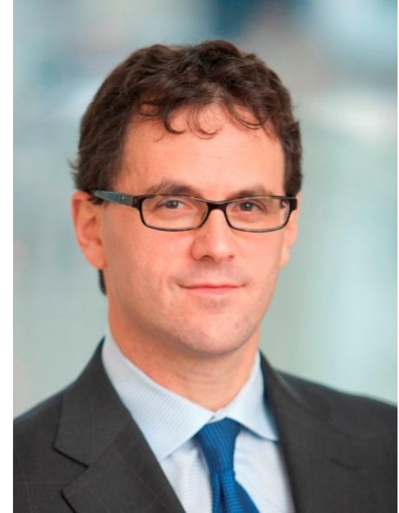
PMA
PRUDENT
MANAGEMENT
ASSOCIATES

Partner Talk®



February 2019

A Scholar's Metaphor for Equity Returns

Fred D. Snitzer

fsnitzer@prudentmanagement.com

In early February 2016, after the market began the year with its worst opening week ever and ended the month of January down -5%, we wrote that "this decline has zero predictive power as to the future returns in the stock market." Fortunately for investors everywhere, this turned out to be correct, as the S&P 500 was up 12% during the year 2016 and 30.4% for the period 2016-2018.

Skip forward to this year, and after a brutal December 2018, in which the S&P 500 fell -9%, the market rebounded in January with a return of +8%. Does January 2019 have any more predictive power than January 2016? You know the answer as well as we do: of course not.

As our recently departed and dear colleague Marshall Blume used to say, delivered in his inimitable, grinning style - the stock market is like a dog on a long, retractable leash, and its master is corporate earnings. Sometimes the dog strays far from its master, testing the length of the leash as it unravels from the spool, but eventually it always returns. If corporate earnings are strong, so eventually will be stock returns, regardless of what happens in any one month.

However, as the past twelve months have demonstrated, and particularly the past two months, companies can deliver strong corporate earnings while markets simultaneously take us on a roller-coaster of volatility. What caused this volatility? No one knows for sure. Maybe it was unresolved trade tensions, political instability in the form of government shutdowns, Brexit problems, Syria problems, interest rate increases of the Federal Reserve. Or maybe it was tax-loss selling at the end of the month. Or maybe it was just the market repricing assets because it concluded that earnings were not going to be quite as good as was expected. And then there is always the X factor – the fact that markets are, at least in the short-term, driven by emotion ridden human beings, with all of our fears, hopes, illusions, delusions, weaknesses, and strengths. This is just another way of rephrasing Benjamin Graham's famous saying that in the short-run the market is like a voting

machine - driven by emotion, hasty decisions, and superficial judgements - but in the long-run the market is like a weighing machine, in which it carefully assesses the true value of a company.

Whatever the reason, the events of December and January illustrate again that markets are inherently volatile and extremely difficult to time or predict.

Nevertheless, the conclusion of the PMA investment committee after our meeting on January 15 was to keep our allocations as is, and not to react to the recent volatility by reducing the equity allocations in our clients' portfolios. Consistent with what the Federal Reserve is saying, we agree that risk has subsided and that the probability of a recession may have increased slightly but is still not high. In fact, as we said in an e-mail blast to clients back in October: "The economy is good; unemployment is down; consumer confidence is high. The trade issues have to be resolved one way or the other. Interest rates will rise and the market will adjust. Volatility will always be present. And in the long-run the economy will continue to grow and the nation will continue to prosper."

We mourn the passing of Marshall Blume. He was a great colleague and a brilliant scholar. His ideas about diversification and controlling risk served as the blueprint for PMA. We honor his memory by carrying on with these ideas, and with the work of the firm he co-founded 36 years ago.