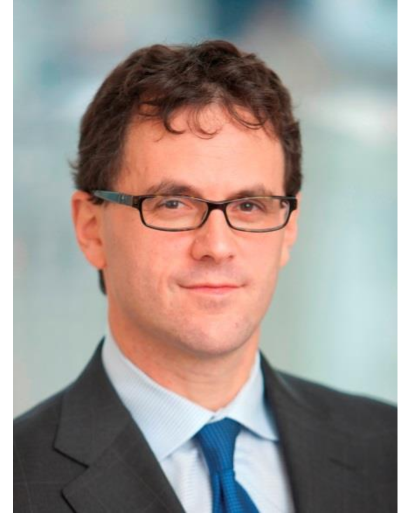
PMA

PRUDENT

MANAGEMENT

ASSOCIATES

Partner Talk®



March 2019

The Nature of Investment Risk

Fred D. Snitzer

fsnitzer@prudentmanagement.com

"Investment success accrues not so much to the brilliant as to the disciplined." – William Bernstein

The S&P 500 ended 2018 in a brutal fashion. In fact, it recorded its worst December performance since 1931. But as of the close of this February the S&P 500 is up 11%, closing at 2,784 year-to-date. Though certainly a welcome turn of events after December of 2018, we need to remind ourselves that one year ago, on February 26, 2018, the S&P 500 closed at 2,779, which means that over the past year the market has gone just about nowhere.

A basic idea of finance is that investors should get paid for the risk they take. Investors who lock their money up in U.S. treasuries should not expect to earn as much as investors who put that same money to work in U.S. equities, because U.S. equities have much greater risk. Generally, this idea does hold, especially over longer periods of time.

But during the past 12 to 14 months investors in U.S. equities (and international equities) have experienced a lot of volatility without a lot to show for it. They have not been paid for the risk they took during this time.

This is the nature of investment risk. If there were no risk, we would all load up on small cap stocks and sit back and watch while our money doubled every few years. That's not

how the world works, of course. And in the world of investing, 12 to 14 months is a blip of time.

And sometimes the period of time over which markets provide meager equity returns is hardly a blip. What was the return of the U.S. stock market from 2000 through 2009, often referred to as “the lost decade”? Basically, it was zero, but this was a nominal return. The real after inflation return was even worse.

Similarly, over the 16-year period from 1966 through 1982, the S&P 500 returned 6.8% per year before inflation. But after inflation, it returned zero (inflation during that period was 6.8% per year).

That is why diversification is a key strategy. Diversification can help assuage the pain during these types of trying times for investors. During 2000 through 2009, the S&P 500 may have returned nothing, but an investment in small-cap value stocks yielded a return of 8.3%, and an investment in emerging market securities yielded a return of 9.8%. An investment in broadly diversified bond funds, an entirely different asset class than equities, during this same 2000-2009 period would have returned 6.3%.

Investing can be challenging to the soul. To reap the benefits of investing in risky equities, an investor has to diversify and be patient, even when circumstances become trying and even nerve-racking.

It’s always worthwhile to quote Warren Buffett: "The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd." And: "Successful Investing takes time, discipline and patience. No matter how great the talent or effort, some things just take time.”

What does all of this mean for future returns? We agree with the author of the enclosed article – “What the Historical Data Says About Stock Market Losses” – on the issue of today’s stock market valuations. Stock valuations are much lower compared to the start of the last two bear markets in March of 2000 or October of 2007, which indicates, but of course does not guarantee, that a bear market is not imminent. This is why it is so important to pick an allocation that meets your needs and temperament, diversify, and be patient. This is what PMA is here to help you do.