Partner Talk®

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A Thoughtful Simplicity

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"Life is the sum of all of your choices" – Albert Camus
"Everything should be as simple as it can be, but not simpler" – Albert Einstein

Beginning with quotes from Albert Einstein and Albert Camus may seem like a pretentious way to start this month's cover letter, but the wisdom contained in these phrases truly and concisely sums up what we do at PMA.

Let's start with the quotation from Camus. Investing requires making a lot of decisions. Should you buy individual stocks or mutual funds? If you buy mutual funds, should you buy index funds or actively managed funds? If you buy equities, should you buy international or U.S. equities? If you buy both, what percentage should you buy of each? If you are investing in bonds, should you buy government bonds, corporate bonds, high-yield bonds, or a combination of all?

The sum of all of these decisions will have an enormous effect on the overall risk and return of your portfolio.

One way to deal with all of these questions is to buy a global stock index fund and global bond fund, accepting the idea that the market knows best and it will decide for you. We think this is too simple. Had you taken this approach in 1987, Japan would have represented 47% of your overall equity portfolio. Today, it's closer to 7%, and $100,000 invested in large-cap Japanese stocks in 1990 would have been worth $90,400 by the end of 2015. The point is that even if the market may get things right in the long run, it doesn't always get things right in the short-run, and sometimes the short-run is not that short.

Another way to deal with these questions is to overcomplicate the investment process, buying and selling too frequently, chasing returns, jumping enthusiastically on the latest investment bandwagon, checking returns and balances every day, hiring and then firing brokers or advisors, and falling victim to a high-cost product that charges 2% while producing returns equivalent to a government bond.

At PMA we try to find what we think is the sweet spot between gross simplicity and grotesque complexity, and between excessive attention and irresponsible neglect. We use academic techniques to make all of these decisions for you through a process that is simple, but not too simple.

We believe in the simplicity of the mutual fund but not in the outsourcing of the entire investment process to two or three mutual funds. We believe in the simplicity and cost advantage of indexing but we also believe in the power of combining index funds and carefully chosen actively managed funds. We believe in the diversification effects of international equities, but not in the idea of passively accepting the market's weight for international equities. In fact, PMA has always made the decision to deliberately underweight your allocation to international equities compared to international market weights.

Our last investment committee meeting on July 17th exemplified these ideas of decision-making and simplicity. We agreed to reduce, slightly, our allocation to high-yield bond funds within the fixed income portion of our bond portfolio, as protection against a possible weakening in the economy. We will continue to monitor this allocation. Our allocation to international remained the same at 25% of the equity portfolio (still considerably less than the market weight of about 45%). We agreed to keep as is the target allocation between stocks and bonds (75/25 for a substantial risk portfolio, 55/45 for a moderate risk portfolio, and 20/80 for a small risk portfolio). And we agreed to begin a search for a large-cap value fund as a potential replacement for one of our existing large-cap value funds.

Finally, a word about the recent market volatility. Back in early December of 2018, right after the market had declined 800 points, we wrote "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 9.8%. But what happened in 2015, a mere 3 years ago? The S&P 500 was up 1.4% for the year. What happened in 2011? The S&P 500 was up 2.1%. Overall, the last nine years have been exceptionally good years, and this period has included two years of mediocre returns…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."

We think these words still apply today. We do not know, nor does anyone else, how or when or even if the trade tensions with China will be resolved. We assume the President wants to get re-elected and has noticed the effect on the markets of his tweets. We assume the leaders of China want to strengthen their economy. Perhaps these assumptions are unwarranted. Nevertheless, we are not going to make any changes to the allocation of your portfolio in an attempt to anticipate the outcome of this unprecedented situation. That is not what we do; that is not controlling risk; that is a guessing game about the future. The evidence remains overwhelming that the majority of investors who try to time these kinds of decisions look back on them with regret.