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September 2019

When to be Fearful and when to be Greedy

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Professor and author Robert S. McElvaine, in his June 2009 Introduction to the 25th edition of his seminal work *The Great Depression*, strikes a triumphalist pose. He is a historian and "not an economist", he tells us, and he was "not among" the experts who failed to see that the country was "riding an unsustainable credit bubble" or that conditions in 2008 were "very similar to those of the 1920s." Indeed, "in the summer of 2007, I completed an analysis of the similarities" between these two time periods, "predicting a collapse." And what a prediction it was, given that the S&P 500 would lose more than 50% of its value from October 2007 to March 2009, a 17 month bear market. Moreover, in addressing the question "is it happening again?" McElvaine reminds us of Mark Twain's aphorism that "History doesn't repeat itself, but it rhymes" and states that this saying "seems particularly appropriate when discussing the Great Depression in the period after the Fall of 2008." For example, the "end of the twenties economy made a terrible crashing sound and the falling economy of 2008 made very similar noises." Finally, he warns that "as I complete this new introduction in 2009, fears that the new economic collapse may prove to be of monumental proportions are even greater than they were" during the deep recession of the early 1980s. In short, be afraid, be very afraid!!

And, understandably, many if not most people were very afraid during that 17 month period, as they watched brand name businesses like Lehman Brothers and AIG collapse, the federal government rush in to force banks to take hundreds of billions of dollars in loans in an attempt to prevent bank failures, the economy fall into a recession and the unemployment rate double, and the value of the equity markets plummet. How many people can truly say that during that period they heeded Warren Buffett's advice to be "fearful when others are greedy and greedy when others are fearful." Under such a philosophy the correct investment approach in March 2009 was to *buy* equities, not despite the fact that they had declined 50% or more in value, but *because* that decline made equities

undervalued and thus a bargain. The truth is that it took an act of strong will for investors to simply retain their equity holdings during that period. Millions of investors did not have that will, causing equity ownership amongst the general population to fall sharply after 2009, and not yet fully recover.

Of course, investors who fled the equity markets after 2008 have missed the longest bullrun in the history of the country, a ten year period in which the S&P 500 and Dow Jones almost tripled in value, with both indices providing returns that exceeded their historical averages.

Why repeat these facts now? Not to be triumphalist ourselves – although PMA of course never advised its clients to liquidate their equity holdings during the 2008 meltdown – but to remind ourselves of the fact, easily forgotten as we almost complete this 11th year of the post-crisis bull market, that equity markets do not only go up. Indeed, PMA firmly believes that at some point in the future a recession will occur and that investors in equity markets will again be required to show fortitude in the face of unsettling market conditions.

But even so, reminding ourselves of these facts somehow rings hollow, as when times are good it is just too easy to convince ourselves that "stocks for the long run" is obvious advice, simple to follow. Financial writer and venture capitalist Morgan Housel most persuasively summarized the psychological and sociological factors that explain how investors during the good times cannot always imagine how they will react during the bad:

> [P]eople underestimate how much their views and goals can change when markets fall apart. The reason you may embrace ideas and goals you once thought unthinkable during a downturn is because more changes happen during downturns than just asset prices. If I, today, imagine how I'd respond to stocks falling 30%, I picture a world where everything is like it is in 2019 except stock valuations, which are 30% cheaper. But that's not how the world works. Downturns don't happen in isolation. The reason stocks might fall 30% is because big groups of people, companies, and politicians screwed something up, and their screw ups might sap my confidence in our ability to recover.

And when those downturns happen, such as in 2007 and 2008, there is no shortage of people screaming on TV shows and in the press to be afraid, be very afraid!!

All of the above raises several related questions – first, why doesn't PMA sell equities before the pain points hit, and then buy them back when it passes? The reason is that PMA cannot, alas, predict the future, and does not know precisely when, or in what form, the pain point will occur (nor, in our opinion, can anyone else so see into the future despite what is written daily in the finance pages). Moreover, numerous studies show that attempting to "time the market" in this manner is much more likely to be counterproductive than productive. These studies show, for example, that a large percentage of market gains are obtained in a very few trading days over a long period of time, and being out of the market for even a very few of these trading days can have a substantial adverse effect on returns. Thus, a recent Morningstar study demonstrates that over the 20 year period from 1997-2017, there were 5,217 trading days which generated an average return of 7.2% in a large company index. However, an investor who missed the 10 best of these 5217 days (i.e. 0.2% of all trading days) would have seen their return cut in more than half, to 3.5%, while an investor who

missed the 30 best days would have lost money, with a -0.9% return. To get the benefit of the best market days, an investor must have the fortitude to remain invested during the worst.

Second, if an investor has no choice but to live through and accept unpleasant market downturns, how long must an investor wait before the market turns around? Although history is not a guarantee of future results, the Morningstar study also examined how long it took a 60-40 stock/bond portfolio to recover after six significant market crises over the last 30 years. The study (see enclosure) found that in five of the six cases the portfolio took three years or less to recover and in the sixth case, five years. Not a short period of time, but not forever either.

PMA certainly does not relish the idea of a market downturn or a recession. Let's hope it is a very long time before the next one. But when it occurs, these are the principles that will guide PMA's response.