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Partner Talk®

June 2020

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Investing in Volatile Times

As I sit down to write this month's *Partner Talk*, I am struck by how different things are compared to the last time I wrote in November of 2019 under the title of "Goldilocks Economy". It really is hard to believe how different things are a mere six months later. 2020 seems so different than 2019. In many ways, it is.

Six months ago, we were enjoying, for the most part, a "Goldilocks Economy" of moderate growth, low unemployment and stable inflation that had continued for several years. While the economy appeared to be slowing relative to 2018, it was still continuing to expand with employers hiring, consumers spending and growth stabilizing.

Six months ago, I was planning for two big life events: my 20th wedding anniversary this June and my 50th birthday this August. We all know what has happened since. Thanks to COVID-19, much of the world's economies were put on hold. The U.S.'s financial markets suffered huge spikes in volatility. Unemployment went from historic lows to historic highs in a matter of months. Our anniversary trip has been canceled (hopefully postponed) and plans for my 50th are on hold. Like so many people, we've been working from home, virtually home-schooling our three kids since March and their spring sports seasons, school events, summer camps and jobs have been canceled as well. This has all been very disappointing, especially given how well things seemed to be going a mere six months ago.

And then, just as it looked as though we were going to continue slowly re-opening in Pennsylvania and the rest of the country, the heartbreaking, senseless death of George Floyd occurred. While we write in our cover letters about investment and not societal issues, we must express the sorrow, hurt and pain that all of us at PMA feel for the family and friends of Mr. Floyd and for all those in this country that have been affected by the sin of racism that has gone on for far too long.

As I stated last November and, as we often state in *Partner Talk* letters, we know that no one is able to accurately predict the future. But, the difference between the state of the economic, financial and political situation we find ourselves in now verses last November really serves to prove this point. Who could have ever predicted, last November, what happened over the ensuing six months and the resulting effects on the financial markets?

This is why, in turbulent times like we experienced during the Global Financial Crisis of 2008-2009 as well as the COVID-19 pandemic of 2020, our advice has always been consistent: stick to the prudent, risk-controlled investment plan that had been developed prior to said crisis, because crises will happen. If you avoid making decisions based on emotions or fear which can end-up destroying value permanently, our belief is that you will weather the storm and your portfolio will eventually recover and begin to grow again as things return to normal.

Our most recent Investment Committee meeting took place on April 15th. However, we met provisionally multiple times during the second half of March to assess what was happening with the markets and to manage the level of risk in our clients' portfolios. Our current thoughts about the economy, the markets and the asset allocation of our portfolios follows below.

The Economy

The economy is expected to experience negative growth this year and enter recession (commonly defined as two consecutive quarters of negative GDP growth). The economy will be especially hard hit in the second quarter. Forecasts of economic growth vary, but declines of 30 to 40 percent, on an annualized basis, are likely as the U.S. has been hit harder than most other nations by COVID-19. Economists' general expectation is that there will be a moderate recovery in the second half of the year as supply and demand gradually starts to recover. It is likely that activity will resume in an uneven fashion, however, with some segments of the economy rebounding more quickly than others. Overall growth, though, is still expected to be negative for the year. Growth forecasts vary widely, reflecting how difficult it is to measure the impact of COVID-19. There is also a chance that a second wave of COVID-19 could flare-up, most likely in the fall. Additionally, the current employment picture is dismal. The official unemployment rate reached 14.7% in the United States in April, the highest rate in the 72-year history of the Bureau of Labor Statistics' jobless gauge. In May, the unemployment rate fell to 13.3%, reflecting a hiring increase as states continue to lift lockdown restrictions. (Sources: Vanguard, Wall Street Journal).

The Markets

In 2019, the S&P 500 returned 31.49%! 2020 has been a very different and very dramatic year so far. Consider the performance of the S&P 500 on a month-by-month basis and on a year-to-date basis:

Month	Return	YTD Return
January	-0.04%	-0.04%
February	-8.23%	-8.27%
March	-12.35%	-19.60%
April	12.82%	-9.29%
May	4.76%	-4.97%

January and February were relatively tame. March featured both the fastest, largest decline into a bear market, as well as the fastest, largest advance out of a bear market, including the best day in 87 years; April gave us record advances for the month; and May was a very good month as well (Source: AJO Partners). Neither we, nor anyone else, can predict what will happen over the coming seven months. We hope that the market recovery will continue alongside an economic rebound in the third quarter and beyond. However, if we get a second wave of COVID-19 in the fall, or some other unexpected negative event occurs, this could change things significantly.

Asset Allocation

Given the steep drop in the equity markets in March, resulting in most clients' portfolios being significantly underweight to equities, we decided to prudently rebalance portfolios. This allowed us to purchase shares of the same mutual funds at significantly reduced prices without materially increasing the portfolios' risk profiles. The S&P 500 is now up over 40% from its March low and most portfolios are now very close to their target allocations again. We believe these rebalancing transactions will position our clients well for overall long-term performance.

At our April 15th meeting, the Investment Committee decided to maintain our current allocation of equities relative to bonds. Within the fixed income portfolio, we had already reduced the weight of the high-yield bond allocation from 25% to 10% at our July and October 2019 meetings and allocated these proceeds to our other intermediate-term bond funds. With this change, the current target allocation of our fixed income portfolio is 50% in short-term funds, 40% in intermediate-term funds and 10% in high-yield funds. Given our previously noted concerns of an economic slowdown, this reduction in the allocation to high-yield also helped our fixed income performance during the March downturn. We will continue to monitor the high-yield allocation very carefully.

Since PMA was founded almost thirty-eight years ago, we have worked to protect our clients' assets in down markets and deliver respectable performance in good markets. This was not by accident. It was by design. Key to this effort, beyond all of the academic theory and research and years of capital markets experience that goes into the asset allocation construction of our portfolios and our mutual fund analysis, is the ability to continue to steer the ship on the same course despite the reasonable fears that come with economic, political, societal and health uncertainty and the resulting market plunges. To not make hasty, emotional, decisions during times of uncertainty and pain is easier said than done. But, that's part of what we've counseled from the beginning. We appreciate your continued trust in our stewardship.