PMA PRUDENT MANAGEMENT ASSOCIATES

Partner Talk®

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A Real Test of Risk Tolerance

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"For man also knows not his time: as the fishes that are taken in an evil net, and as the birds that are caught in the snare; so are the sons of men snared in an evil time, when it falls suddenly upon them." Ecclesiastes

As we come to the half-way point of the year 2020, one of the more grueling and difficult years of recent memory, we naturally look back on the last six months with a mixture of "shock and awe" at what has transpired. The past four months in particular have tested all of us, personally, professionally, financially. Days have felt like weeks, and weeks like years. January seems like eons ago, like another world and another time. Although we should always try to keep things in perspective, and recognize that America is not experiencing anything like the Bubonic Plague or the Spanish Civil War, it's still hard to believe what we are living through. For those of us who adhere to the glass-half-full philosophy, at least we can say this year is half over.

And we can be grateful that, after the truly frightening days of mid-March, the market recovered, helped by the massive stimulus from the federal government and the Federal Reserve, by the small signs of economic recovery, and by the declining rate of infection and death in northeastern states that were hardest hit at the beginning of the crisis. Bouncing back dramatically, the Dow Jones Industrial Average rose 7,000 points, and risk declined, with market volatility falling sharply from its highs in mid-March.

And now risk is back. The United States just recorded its highest single-day total of new Covid-19 cases. In States where cases are rising more dramatically, authorities are starting to reimpose some restrictions, which will likely limit future economic activity. As of June 8th, at the peak of the recovery, the Dow Jones Industrial Average was down only about 5% for the year; now, it is closer to 9% for the year.

What should an investor do in these circumstances? If there is a silver lining to the pandemic of 2020 it is the opportunity to take stock of ourselves. Difficult times force us to zero in on our weaknesses with a candor that we normally avoid. For investors, we may have thought that we could handle market volatility, but not this market volatility. How did you do during this period? How difficult was it for you? How severely were you affected by the historic volatility in the market?

One of the most important decisions we ask clients to make when they become a PMA client is to decide what is the right level of risk for their portfolio, given their stage of life, their unique set of circumstances, and their temperament – their ability to stomach the ups and downs of the market.

Generally, the longer the time horizon an investor has before needing to tap money, the greater the risk the investor can take. Other factors are the stability of income (a government employee v. a salesman at Tesla? working or retired?), liquidity needs (how much cash is needed), and any options available to be exercised (a second home worth $1,000,000 or returning to work part-time). A 35-year-old tenured professor with at least 30 more years of teaching can probably take on more risk than a 75-year-old retiree living only off his assets and his social security. All of these factors can be categorized as an investor’s ability to take risk.

But it is an investor’s attitude towards risk – the ability to handle market volatility, the “sleep at night” factor -- that may be the most critical factor in making the asset allocation decision, and it is the most difficult to get right. Thus a 35-year old with a stable income who can get only four hours of sleep per night because of the markets, probably is taking on too much risk. Unlike the ability to take risk, this factor concerns an investor’s willingness to take risk.

How does an investor measure their risk tolerance? Unfortunately, there is no easy answer. Like with so many other aspects of life, it is hard to know how one will react during times of great stress, whether it be a first job, the first time speaking in public, getting married, becoming a parent, etc. Similarly, one does not truly know how he/she is going to feel about seeing a big percentage of hard-earned money suddenly disappear until actually experiencing it. It’s one thing to tell yourself that you are risk-averse and can handle market drops; it’s another thing to actually see your $3,000,000 in assets suddenly fall 20% or $600,000 and turn, seemingly overnight, into $2,400,000. During this time, for some investors, phrases such as “in it for the long term” and “stay the course” can suddenly lack their previous power.

With regard to this decision, our job is to help you make this decision, not make it for you. Ultimately, that is up to you. Unfortunately, helping you make this decision is not a science or an art. It is not even – to use the worn-out phrase – “part science, part art”. We are not asking you to choose a new car or a painting to adorn your wall. We are asking you to predict how you are going to react to an extreme event that could profoundly affect your overall financial health. It’s an exercise in forecasting and psychology, and it’s an unreliable one. We can show you probability distributions, run simulations, and dissect historical stock market returns, but like a soldier who trains for war, when it comes to a bear market, there is nothing like the real thing. The truth is we just lived through the best risk tolerance test that life can provide. It was a painful test, but a powerful one. It was something that paper risk tolerance tests are not: effective and accurate.

If you had trouble sleeping at night during the period from mid-March to mid-April, if the fluctuations in the value of your portfolio were too much to bear, please consider contacting us to review your asset allocation. Now may be a good time to have that conversation. Despite the last few weeks, the market is still far from its low of March 23rd. We hope the summer will bring a calmer period to the markets, but the coming fall and an election season of almost certain unparalleled ugliness could produce stock market volatility rivaling what we saw in March. We hope this is not the case, but either way, the point is that if the volatility of mid-March was not bearable, now may be a good time to at least discuss making a change to your portfolio.

We hope you all had a good July 4th holiday. Despite its limitations and imperfections, the essential idea of America is one in which we still believe. Like any human enterprise, this country will never be perfect, but it can be better, and we pray and hope that in the not-too-distant future that the country will heal, its divisions eased rather than inflamed, and we return to a nation of moderation, generosity, acceptance of differences, and forgiveness.