PMA

PRUDENT MANAGEMENT ASSOCIATES

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A Note to Clients and Friends About Recent Market Volatility

> *"A rich understanding of human psychology, a reasonable appreciation of financial theory, a deep awareness of history, and a broad exposure to current events all contribute to development of well-informed portfolio strategies." - David Swensen*

We begin this note with a quote from David Swensen, legendary head of the Yale Endowment, and we ask you to focus on two phrases – "a deep awareness of history" and "a rich understanding of human psychology".

When global markets go through the kind of periodic convulsions that we are now witnessing what we need is perspective and calm – the perspective that comes from reviewing stock market history and being able to say "We have seen this before and know that it will pass" and the calm that comes from knowing not only this history but also yourself, and being able to say "I am a long-term investor, I have picked the allocation that best fits my needs and temperament, and I am not going to change that allocation while others panic".

We should view the recent market convulsions as a test of our resolve, perspective, and intelligence. The behavior of financial markets is a mirror of the behavior of human beings, a blend of art and science, a product of financial number crunching and human psychology. At times like these, human fear dominates, and it is in the best interest of investors to resist the urge to panic, and simply do nothing.

Let's remember that the market is a mechanism for evaluating the price of companies. Millions of investors pour over the financials for thousands of companies and try to make a series of judgments: Is this stock cheap or expensive? Are the growth rates implicit in the stock price realistic? Does the company have a sound strategy for growth? Does it have a good management team? For a 1,000 point drop followed by a 500 point gain followed by a 400 point gain followed by a 600 point drop to make sense, the prospects of all the companies in the Dow Jones Industrial would have had to swing dramatically over a two-day period. That, obviously, is not what occurred.

It's a cliché but it's true: markets hate uncertainty. The big uncertainty right now is the true condition of the Chinese economy which, to steal from Churchill, is a riddle wrapped in a mystery inside an enigma. Clearly it's not doing as well as anyone thought, but - whatever its condition – it does not justify a 1,000 point drop in the financial markets of the United States, a country whose underlying economic condition, as measured by consumer and business confidence, remains strong. The International

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Monetary Fund predicts that a 100 basis point (1%) drop in China's GDP will result in a 2.5 basis point (.025%) drop in U.S. GDP. In other words, the effect will be essentially nothing.

Where the Chinese economy may have an outsized effect is in emerging market economies which produce much of the raw materials that China has been consuming in their growth boom. As that boom slows, emerging market economies will slow with it. To assess this risk in PMA portfolios, we did an analysis of our clients' holdings and determined that on an asset-weighted basis, our clients have an allocation to emerging markets of only 2.1% of their equity holdings (about 1.1% of a Moderate Risk portfolio) – a very small number.

In markets like this one, there are three types of investors. The first type panics at the increase in volatility, sells her assets, and locks in losses. The second type remains steady at first, but then gradually loses her nerve, as the volatility does not subside as quickly as she expects. The third type has seen this kind of market before, knows that it will be painful before it gets better, but also knows that it ***will*** get better, and that she will be rewarded for her courage if she can hold on for the long term.

For example, from its' low of 683 on March 6, 2009 until its' high of 2,131 on May 21, 2015, the S&P 500 was up 212%. As of the close of Wednesday, August 26, 2015, it's up 184%. These are the returns that matter – the long-term ones.

Even when the short-term is difficult, the rebounds are often quick and unpredictable, and doing nothing can pay off. In 2009 the S&P 500 was down 26% at its low point in early March, broke even by early May, and ended the year up 26.5%. In 2012 the market reached a high for the year in late April, then fell 9.3%, broke even by early August, and ended the year up 15%. Let's also remember that the market has not seen a correction of 10% or more since 2011. Over its history it has experienced one correction, on average, every 18 months.

Short-term volatility does not drive real investment outcomes unless you react to it. The investors who sell now are locking in real losses; the investors who do nothing suffer nothing more than paper declines over the short-term. Eventually, the declines become gains. The choice is ours. If we can step back, review market history, and steel our nerves, this is not a hard choice to make.

The PMA investment committee held a special meeting on Wednesday, August 26, 2015 to discuss the recent market volatility and what actions, if any, we needed to take. Reviewing the equity allocations of our client portfolios, we found that market movements had brought them somewhat below our targets. For instance, for clients invested in our moderate risk portfolio, the average equity allocation was at 52.5%, down 2.5 percentage points from its target of 55%, not yet in the range that would require us to rebalance. As a consequence, the committee unanimously agreed that no action was required at the present time. We will continue, as always, to carefully monitor the markets, their volatility, and the overall allocation of your assets.

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