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Partner Talk®

February 2016

January Effects

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January 2016 has ended, mercifully, with the S&P 500 Index delivering a return of -5% to investors.

We can say two things about the market's poor performance during the month of January, both of which we have said before. One, in the context of a 7-year bull market which has seen the S&P rise about 180% since its low in March of 2009, a 5% decline, though nothing to scoff at, is not a major setback. Two, this decline has zero predictive power as to the future returns in the stock market.

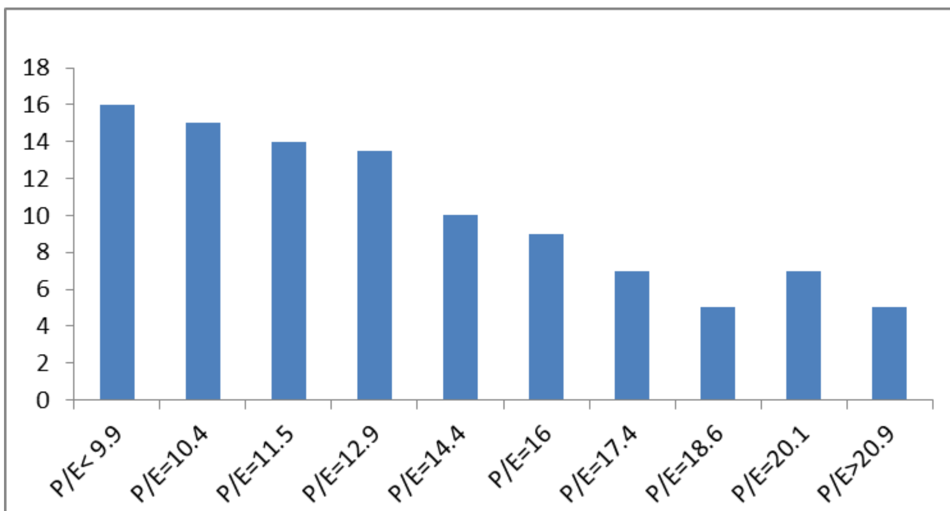
This raises a very natural question: does anything have any predictive power as to future returns in the stock market?

As human beings, we can't help ourselves: we need to know – what is coming next? Is there any statistic, ratio, any piece of data with any power to point to the future? This quest for certainty will never end. Let's look at a few ways in which market participants and scholars attempt to answer this question.

One approach is the "master-of-the-universe" method. Dominant at hedge funds and Wall Street investment banks, this method involves surveying the global economy and delivering confident statements about the direction of interest rates, the value of the U.S. dollar, the future actions of the federal reserve, the likelihood of a recession, the future actions of the Chinese government, the outcome of the presidential election, and – most impressively – how each one of these factors will affect the other. So, if you want to know when and by

how much the Federal Reserve will raise interest rates in 3 months, and how this will affect the value of the dollar, and how the rise in the value of the dollar will affect currencies around the world, and how this will affect the price of oil and the demand for U.S. exports, and how the market will react, this is your method – but it's a method that often reveals its practitioners to be, like the man behind the curtain in the Wizard of Oz, mere mortals at best and charlatans at worst.

Another approach is to ignore the complexity of the global economy and focus solely on current valuation measures, like the P/E ratio, which gives us some sense as to whether the market is cheap or expensive. And, in fact, there does seem to be a relationship between the price of the market and future returns, as the chart below suggests:



But even this metric, according to research by Nobel-prize winning Robert Shiller, explains only 40% of the variance of future stock market returns. So while there is a simple and intuitive appeal to the idea of "buy low, sell high", it's not always clear what is "low" and what is "high", and it may be that what was considered high in the past may no longer be considered high in the future (i.e. the economy is changing because of technology and can support higher P/E ratios going forward, or persistently low interest rates justify higher P/E ratios).

Prudent Management uses the trailing P/E ratio on operating earnings to calculate an expected return, but we respect the uncertainty of this and any method, which is why we say that the expected annual return for a PMA Moderate Risk Portfolio going forward is 5.2%, but that the range of annualized returns over the next five years will be, with a 90% probability, anywhere from -1% to 11%.

The bottom line is that there is no single data point, no theory, that can definitively answer the eternal question – a product of the deep-seated desire of human beings to ease their fears about the future – what's next? Rather than spend precious energy on the futile task of predicting future returns of any market (U.S. stock market, currencies, interest rates, oil, etc), the PMA approach is to focus the client on themselves, on their temperament and

their goals, and on getting the client to answer the important questions of “How much risk are you willing to take” and “How much risk do you really need to take”. Just because you are 25 years and have a 40 year time horizon old does not necessarily mean you should take a lot of risk if you are not suited for it, and just because you are 65 years old does not mean you should invest too conservatively if you want to achieve your spending goals during retirement.

Speaking of January, two well-respected finance academics previously wrote a book that received a lot of attention entitled “The Incredible January Effect.” The authors argued that investors could profit by exploiting the persistent high returns of stocks during the month of January, particularly small-cap stocks. As this year proves, this thesis is anything but dependable. But you can still buy the book on Amazon.com. The range of money you can spend on the book is wide, like the range of returns you can get from investing in the stock market, with the cheapest price being a used version at $1.15 and the most expensive being the collectible edition at $29. Like most theories about predicting stock market returns, this one has proven to be of little value. If you do decide to buy the book, we recommend you get the version for $1.15.