SEVEN SUMMITS CAPITAL

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THE THIN VEIL OF MARKET COMPLACENCY MASKS UNDERLYING INVESTOR RETREAT

One can hardly go through a day listening to the financial media without hearing about investor complacency. On the surface, complacency would seem to be the opposite of fear. However, I believe that there is evidence that, when it comes to investing, complacency often goes hand-in-hand with fear.

Following the financial crisis and Great Recession it seems that many investors have become complacent with risk-averse investment strategies, seemingly ignoring all of the reasons post-crisis to engage in long-term investing. Instead of drawing confidence from markets that have posted strong gains over the last several years, I have witnessed extreme caution and distrust among some investors. This caution, distrust, and, ultimately, complacency in risk adverse strategies is the subject of media stories which are attempting to reconcile the dichotomy that seems to exist between the relatively calm equity markets over the last couple years and the risk adverse actions being taken by many investors. Two recent stories are such attempts to reconcile what seem like counter-intuitive actions: CNN Money's Millenials Invest Like their Grandparents (February 6, 2014) and Reuter's UBS sees no let-up in wealthy investors holding onto cash in 2014 (May 6, 2014).

The dichotomy that exists is between very buoyant markets and ultra-conservative investment strategies among groups of investors who should be thinking long-term when it comes to building and preserving wealth is stark. The United States' equity markets have staged one of the longest consecutive year advances in history, economic growth has been modest, but remarkably consistent, and corporate earnings and profit margins are setting records. This historically significant stock market advance has not been a mirage as it can be directly attributed to corporate earnings growth, record low interest rates, and an absence of the typical imbalances that can lead to the end of an economic cycle. These are fundamental factors that should have compelled investors to become fully invested instead of under-weighting stocks and hoarding cash. These actions, that began during the crisis period of 2008-2009, lead me to the conclusion that excessive cash balances, record low allocations to equities and relatively complacent markets are not a sign of an absence of risk awareness, but a type of paralysis. Fear is still present in today's markets; however it has become more of a normal state. This worrisome behavior is the result of residual risk aversion that dates back to the Great Recession. However, due to the fact that the events of 2008-09 are no longer truly present in today's market, one could state that this risk aversion is due to investors' fear of fear itself.

The fear among investors that has followed the Great Recession likens itself to the fear that President Franklin D. Roosevelt's spoke of during his first Inaugural Address, shortly after the Great Depression, where he stated that "the only thing we have to fear is…fear itself." He claimed that this "nameless, unreasoning, unjustified terror" paralyzed any efforts "to convert retreat into advance." At the time of this address, President Roosevelt knew that our nation must overcome the paralyzing effects of fear in order to successfully overcome the lingering hardships of the Great Depression. For investors, the history of markets has proven time and time again that the natural fear of loss can be overcome. Like President Roosevelt, who faced more fearful challenges than any other U.S. President, such as his bold action with the creation of the New Deal or the Normandy invasion, investors, following a crisis, must first acknowledge and understand the present risks, and then accept those risks and take the appropriate action. Only then can fear give way to a well-conceived plan designed around appropriate and realistic objectives. Investors must follow a similar pattern in order to be successful over time.

This approach to risk management is easier said than done. Often, distractions and noise can obscure real risk and thus, can elicit bad decision making among investors. Over the last few years, I have written about the dangers of noise in this commentary. I have described noise in many different ways depending upon what was distracting investors at the time. For example, noise can come from the market movement (technical analysis), political discourse, and the policies of governments. Noise also can emulate from geopolitical flashpoints or paranoid thoughts about the evils of monetary policy, debt and deficits, and/or predictions of a market correction. Thus, noise is any temporary distraction that can cause investors to lose focus on long-term fundamental factors. The truth is that many large investors, such as hedge fund managers and/or short-term speculators, need the long-term investor to become distracted by noise in order to produce the necessary volatility to make their own investment strategies profitable.

When investing, one cannot afford to become distracted and miss significant advances in the stock market and then expect to recover by side-stepping the next big market correction. Ultimately, noise, complacency, and fear can do more damage to an investor's long-term returns than any one of the many risks that investors attempt to avoid. Two fears that I regularly hear from investors is of their concern regarding the devaluation of the U.S. Dollar and nervousness surrounding the latest geopolitical events that are being sensationalized by the media on a daily basis. In fact, recently, I have received suggestions from several clients that I address these exact concerns.

Regarding dollar devaluation, there is often much misinformation published; I will limit my focus to the two basic concepts that are at the root of devaluation worries: money supply and inflation. Using the following graph that was produced by the St. Louis Federal Reserve Bank, I intend to show that during the last five to six years, in which time the Federal Reserve has expanded its balance to record levels which is not synonymous with money printing, the U.S. Dollar has not lost real value against a basket of other currencies:

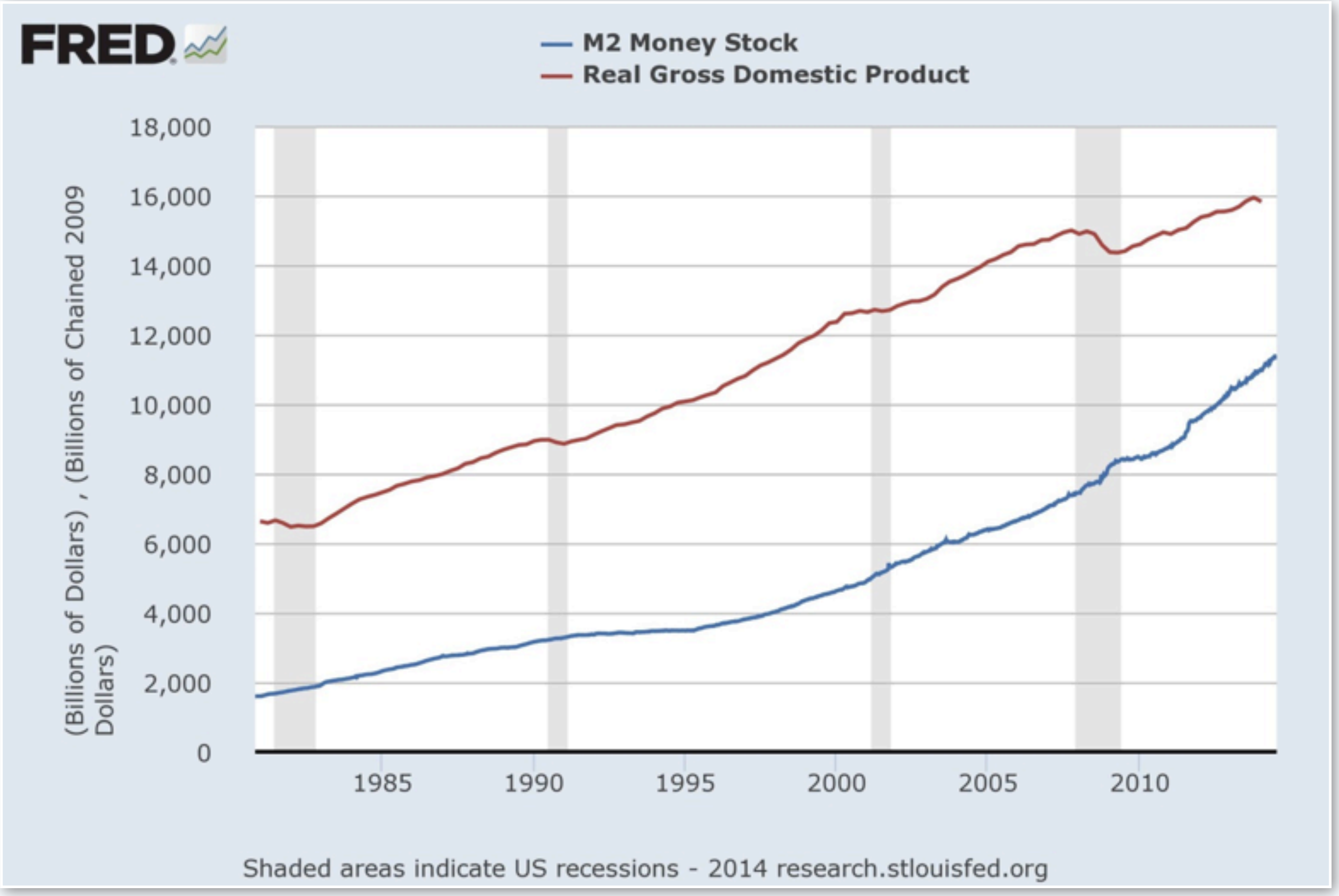
SEE CHART AT TOP OF PAGE 3

Think of the U.S. Dollar as a median of transacting commerce backed by the full faith and credit of the United States. Therefore, the value of a dollar will always be worth a dollar. The question, and the inherent concern of those who utilize the dollar to transact commerce, is what one dollar will be able to buy in the future. If general price levels increase over time, one dollar will purchase less goods and services than in the past, which is the most basic definition of inflation.

Inflation, over the long-term, is a healthy function of supply and demand. For example, finite commodities such as gold, oil, and potable water, will ultimately command even higher prices as demand for each item grows with an expanding world population. Therefore, due to price being a function of demand and scarcity, it should not be surprising that the price of commodities with no sufficient substitute will rise in value as worldwide demand increases. By comparing the purchasing power of a sovereign currency against these finite materials one can see that, over time, there is no inherent devaluation of the currency, but instead, an indication of a natural and healthy inflation in the value of the scarce commodities.

On the other hand, many goods and services do not experience inflation over time because scarcity does not apply to them. For example, due to technological innovation and new types of manufacturing, computer memory chips have seen steady price declines for over the last fifty years. Likewise, labor is subject to many of these same factors. Wages in many American industries and professions have stagnated in real terms over the last few decades due to labor being subject to obsolesce, substitution, and the expansion of supply. Rapid innovation can render some workers' skills to be uncompetitive and events, such as the fall of the Soviet Union and the emergence of China into the developed global economy, have produced an abundance of new low-cost labor. Although all these changes are normal in the evolution of societies and with the advancement of technology, slow adaptation to these changes can be the cause of significant societal strife and social policy miss-steps.

Unfortunately, due to the increased attention and political debate surrounding wage stagnation, commodity inflation, and supposed currency devaluation, these topics can easily become misconstrued. The reality is that the global economy is constantly changing and adapting, thus causing both inflation and deflation to occur simultaneously. Those individuals who are negatively impacted by inflation tend to look at economic data and immediately blame central bank money printing. "Money printing" is a very miused phrase. If money printing is equated to the supply of currency over time, then one must understand that the supply of currency will inherently need to be expanded over time to meet the demand of a growing economy. By being the primary reserve currency to the world, the U.S. dollar is subject to ever growing demand. This demand leads to an expanding monetary base and in turn, this enables the U.S. currency to remain remarkably stable and liquid. Could the U.S., or any large country, devalue its currency by printing too much of it? Yes, currency itself is not immune to supply and demand forces. But, to truly devalue its currency, a country would have to expand its money supply in circulation substantially faster than the growth of the underlying economy. The following chart published by the St. Louis Federal Reserve Bank shows that the U.S. money supply has consistently trailed the growth of the economy over the last 30 years:



As can be seen from the chart above, U.S. domestic money supply has not outpaced the real growth of the U.S. economy and is not close to doing so today. I contend that we have not and do not currently have broad inflation generated by the money supply or the threat of such inflation in the foreseeable future. With that being said, I am concerned for retirees who take a far too conservative approach to retirement investing given the long-term effects of inflation on spending power. This is an especially critical concept for retirees because their inflation is driven by healthcare-related expenditures, energy and food costs, as well as entertainment and travel expenses. Each of these categories of expenses has generally inflated at rates in excess of overall inflation (CPI). Over the course of decades, even a relatively normal three percent inflation can significantly reduce the spending power of an individual's savings. However, since inflation is a natural consequence of a growing economy, I do not believe that investors should view inflation as an investment risk. Instead, they should act like President Roosevelt and accept the existence of the threat, understand its consequences, and plan accordingly.

Unlike inflation, which can reduce the long-term real value of a portfolio, geopolitical concerns can adversely affect the markets and the value of investments over weeks and months. Since geopolitical events are typically unpredictable, but inevitable, the associated volatility must be expected by every long-term investor. All traded financial markets have an inherent volatility (standard deviation) and the measure of standard deviation is a function of historical volatility. This historical volatility captures every geopolitical driven market correction that has occurred and thus, unpredictable future geopolitical market volatility is already incorporated into historical market risk metrics. Therefore, when an investor buys a passive S&P 500 index fund, which has an expected one-year standard deviation of approximately 23%, the investor has already assumed the risk of geopolitical-driven drawdowns in the value of their investments.
However, where many investors get into trouble is when they invest in an investment or portfolio strategy with a given standard deviation and then attempt to reduce the inherent risk of owning that investment by being reactionary. Reactionary behavior can include actions such as stop-loss orders on securities, technical analysis that attempts to predict market direction, as well as sitting on 10% or more in cash awaiting the right "safe" time to invest. Instead of being reactionary, an investor should be opportunistic and approach the volatility associated with geopolitical events as a time to add to existing positions or to use the price weakness to enter into new positions.

The one risk that I am modestly concerned about is the growing global wealth and income disparities that have the potential to ignite social unrest and violent revolts in both developed and developing nations. One such example of this social unrest would be the "Arab Spring" revolution that swept through many Arab and Northern African countries beginning in late 2010. These revolts resulted in regime changes in Egypt, Tunisia, Yemen, and Libya. Likewise, if a similar social rebellion broke out across Europe, then the same violence may spread to other areas of the world, including China and the United States. Thus, this type of "geopolitical" threat would causes me great concern because it would be largely unprecedented, initially likely to be underestimated, and it would not be easily diffused. Unlike the Israeli/Hamas conflict in Gaza, the Syrian civil war, the sectarian fighting in Iraq, and the Russian interference in the Ukraine that are all unrelated, the social revolts as previously described truly could threaten market stability due to their ability to spread to and negatively affect the economies and social fabric of many countries.

It is important to remember that markets adapt to what becomes familiar. Unfortunately, over the last sixty years, regional wars in Korea, Vietnam, Afghanistan, Bosnia, and Iraq have conditioned the markets to look past these non-systemic conflicts. The same can be said for economic crises. Markets have quickly recovered from sharp crashes such as the one in 1987, as well as the crash that occurred a decade later when Russia experienced a currency crisis or when massive losses at a hedge fund called Long Term Capital jolted the markets. Even events as shocking and unexpected as the terrorist attacks of 9/11 did not keep the world markets down for very long because those attacks were not followed by a series of similar events for a sustained period of time. However, the one event that caused markets to not only crash, but to remain down for several years is one that we remember very well and that is the 2008-09 financial crisis and Great Recession. What made this economic crisis different was how global and systematic it was. The U.S. housing bubble bursting caused a chain reaction through both regulated and non-regulated financial markets due to the contraction of leverage (margin loans) across the system.

To summarize how I approach assessing the risk of geopolitical events, I am much less concerned as an investor in isolated events regardless of how long they persist or how terrible they are compared to events which are systematically connected such as the Arab Spring or the Great Recession. Markets adapt to isolated events, even ones as shocking as the terrorist attacks of 9/11 and as long and violent as the 10+ year war in Iraq. Short-term traders think exactly the opposite and are only concerned about what will move the market today and tomorrow, whereas long-term investors should be able look past the vast majority of events which temporarily disrupt the markets.

Thus, unlike many fearful investors who continue to use cautious investment strategies, I believe that now is the time to confidently capitalize upon today's historic market advance. By refusing to submit to the overwhelming investing paralysis and negative noise, I can look past the concerns of U.S. dollar devaluation and isolated geopolitical events. At Seven Summits Capital, our focus is on how to advance and protect our client's financial wealth through well-constructed portfolios and a disciplined execution of short, intermediate and long-term strategies. By being able to properly ignore the constant media noise and distinguish which events are truly threatening to the market, we are able to overcome fear and recall President Roosevelt's advice to "convert retreat into advance.

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