Maintaining Focus in the Face of Ever-Changing Market Narratives

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For most investors, an investment strategy must produce real inflation-adjusted returns over time to be deemed successful. For many investors, those real returns are consciously or subconsciously compared against a market benchmark such as the S&P 500 if they are predominately invested in stocks. The biggest pitfall of measuring success against the market comes down to the "what have you done for me lately" sentiment. The conclusion that I draw from nearly 25 years of managing portfolios is that trying to keep pace with market returns month-to-month, quarter-to-quarter, or even year-to-year is counter-productive to managing risk and long-term returns.

Most investors intellectually know markets are volatile, unpredictable, and many times irrational, however many investors in a secular bull market environment tend to lose sight of managing risk as they chase market returns. Managing risk first requires defining what risk is from an investing standpoint. The risk from a trader's perspective is mostly about timing. From an investor's standpoint, the risk is mostly about understanding the relationship between price and value, which is constantly changing from an investor's viewpoint. This continually evolving dynamic is what many investors get tripped up by. Knowing the difference between the factors which determine the intrinsic value and those which are no more than the market's current fixation separates a rigorous investment process from a reactionary investment process.

At Seven Summits Capital we fully recognize the great distortions that the design of market-cap-weighted indexes have on the headline returns which investors see from the S&P 500, Nasdaq, and DOW every day. Below is an extraordinary description of the broad equity markets in 2021 from the Chief Investment Officer of Syz Group, Charles-Henry Monchau:

A new all-time high for Apple (AAPL). With a market cap above $2.8 Trillion, Apple has added $618 Billion to its capitalization this year, which is greater than the market cap of 492 companies in the S&P 500. It hit $2 Trillion last year and $1 Trillion 3 years ago. Meanwhile, the Technology Sector weighting is now 29.3% of the S&P 500 market cap – a new cycle high. The Nasdaq is up 20% since the start of the year. However, without its 5 biggest stocks, the Nasdaq would be in deep negative territory year-to-date (nearly – 20%).

2020 and 2021 have been textbook examples of how easily the equity markets can adopt narratives and either overshoot from a price perspective or vacillate between competing narratives. In 2020, after the initial pandemic induced Bear Market, the equity markets firmly adopted a single-focused narrative which drove the share prices and valuations of companies that benefited

from the actions taken to combat the virus spread. For example, the stocks of Zoom Video (ZM), Peloton (PTON), Chewy (CHWY), and Teledoc (TDOC) skyrocketed in 2020 only to post significant losses so far in 2021 as follows:

Company	Peak 2-Year Gain	YTD-2021 Return (as of 12/10/21)
-		
Zoom Video (ZM)	650%	-45%
Peloton (PTON)	350%	-75%
Teledoc (TDOC)	250%	-53%
Chewy (CHWY)	251%	-43%

Data from Marketwatch.com

Equity markets are easily susceptible to macro narratives, and when those narratives are continually repeated, stock prices related to such narratives will regularly overshoot commonsense valuation levels. This is precisely what occurred with many of the big winners of 2020. It is because we know, at Seven Summits Capital, that prices can quickly become dislocated from any reasonable determination of forward-looking intrinsic value that our process is not price-focused. We are solely valuation-focused. We admire all four companies listed above and believe each has a promising future. However, we fully recognize that a stock symbol and its associated price translate into a market value for the company. Therefore, the simplified methodology that we use to determine the risk that a particular equity position contributes to a portfolio relates to where its price is relative to the value that we have determined for the underlying operating company. This often means that the lower the price relative to our value assessment, the less risk we assign to that particular equity position. This conversely, the higher the price is comparable to our value assessment, the higher the risk. Our research partner, Valuentum, includes a simple visual in its research reports which graphically illustrates our price-sensitive risk measurement process. An example of this graphic is shown below for Nvidia (NVDA):

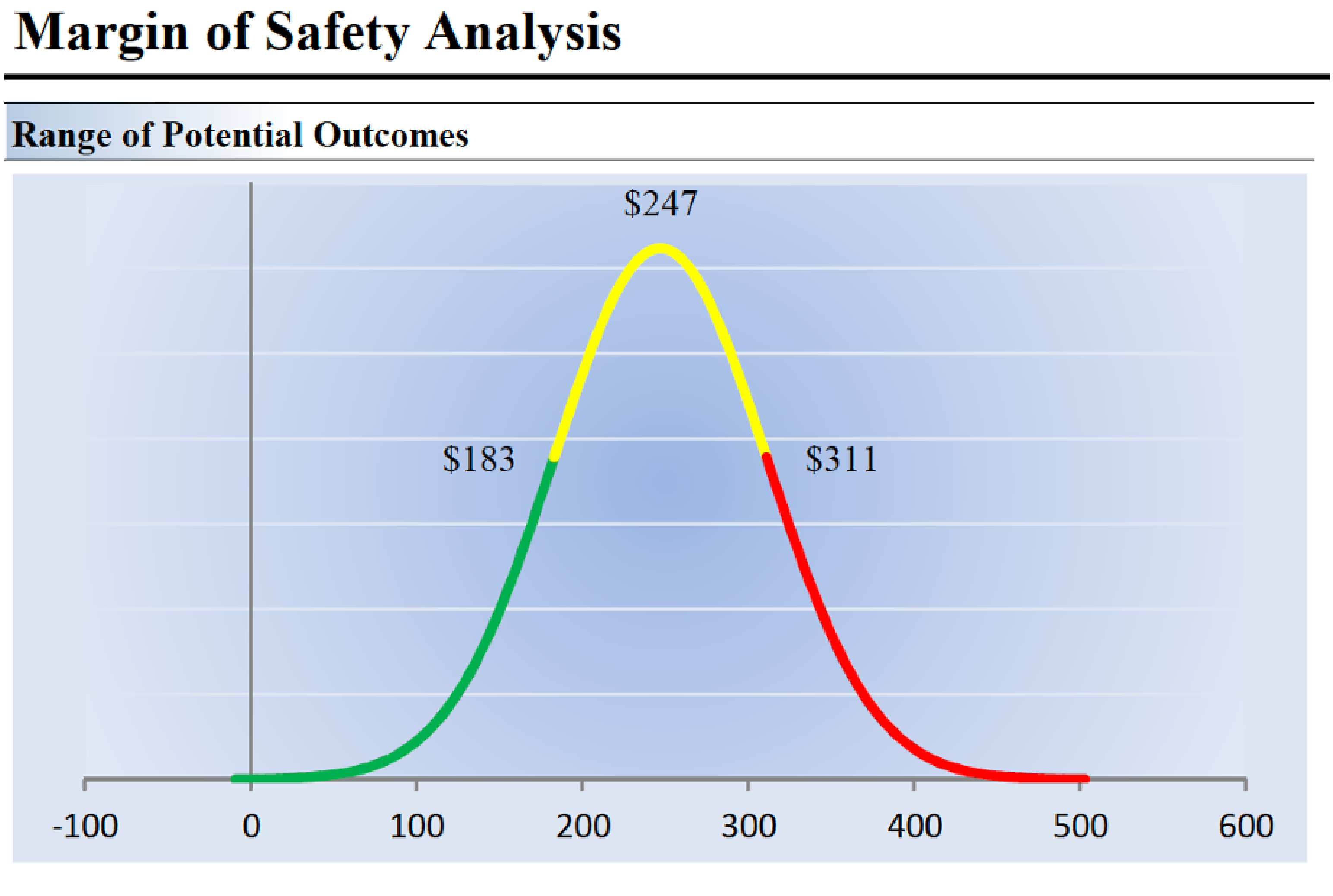

Illustration from November 15, 2021, Valuentum research report on Nvidia (NVDA)

Nvidia stock is currently trading for $319 per share as of 12/7/21. I have been asked about this company's stock numerous times over the last several months. The last time that Seven Summits Capital has purchased Nvidia stock was over two years ago when it was trading around $60 on a split-adjusted basis. Despite our appreciation for this dominant semiconductor company's market dominance in advanced silicon chips for gaming, data centers, and blockchain networks its stock at the current price level presents too much risk. The market narrative, however, conveys the opposite message. The market narrative for Nvidia is that the stock, up nearly 140% year-to-date, is very attractive at the current price, with 22 out of 26 analyst ratings being listed as a Strong Buy.

At Seven Summits Capital, we are not interested in "a narrative," we are instead moored to philosophy and discipline, focused on a fundamentally driven value thesis. For us, stock prices move around continuously, flashing green, yellow, or red depending on how far below or above a stock price is compared to our "fair value" assessment.

When the markets and stock prices go through a period, as many have recently, where volatility is amplified, and the market narrative turns negative for many of our portfolio holdings, we generally see the margin of safety (risk) in our stock holdings go down, not up. A period of negative market returns and higher volatility makes aggregate investors risk-averse. As this risk aversion sets in and we see the price of our stock positions fall, our appetite for these stocks increases because the margin of safety becomes greater. If Nvidia stock fell from $319 per share to $175 per share between now and the end of the year, that selling pressure from the aggregate investor would reflect risk aversion relative to Nvidia stock. However, we would likely become very interested in the shares being sold at those levels.

Much of the current risk aversion in the equity markets is being driven by a knee jerk reaction to the potential of the persistent above-trend inflation causing the Federal Reserve to reduce its program of buying bonds (Quantitative Easing) more quickly than anticipated and embarking on an accelerated series of interest rate increases in 2022. Overlaying these concerns are the worries about the impact on the economy and inflation of the new Omicron COVID-19 variant. At Seven Summits Capital, we make buy and sell decisions based upon individual thesis' focused on a value/price opportunity assessment. We operate in markets where the preponderance of transactions is driven by short-term narratives and the reaction chain among momentum-focused market participants. These momentum-focused market participants dominate daily funds flowing in and out of equities, either directly or indirectly, through trading in market or sector "baskets" such as ETFs. We witness the effects of this type of trading every day, and we rarely derive any actionable knowledge from the ensuing market reaction. Our process puts us on the outside, looking in. We monitor short-term narrative-driven market chaos looking for noteworthy price/value dislocation opportunities.

I wanted to focus this month's commentary on the market's chaotic reaction behavior to ever-changing narratives. This subject allows me to draw attention to the contrast between the messages that markets send investors in the form of volatility and our more long-term fundamental focus. Although we cannot avoid being buffeted by the crosswinds of market volatility, we design our process to help ensure that we do not get blown off of our predetermined course.

We at Seven Summits Capital wish our clients, colleagues, and subscribers to this commentary a joyous holiday season and a healthy and prosperous 2022.

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Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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By Curt R. Stauffer
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