Seven Summits Capital

Kein Sitzfleisch Haben (not to be able to sit too long)

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This commentary is meant to help clients and non-client readers become better versions of themselves from an investment standpoint. (I make some comments about the strong performance we have seen in many of our most widely held stocks during January and early February at the end of this commentary.)

The biggest riddle that I have related to investing has very little to do with trying to understand markets but is instead rooted in attempting tounderstand investor behavior. Much has been written on behavioral finance, but I have yet to find a satisfying answer to why so many investors get tripped up by emotions when security prices move significantly over short periods of time in one direction or another. When prices spike up quickly, many investors want to chase those prices, and when prices fall sharply, investors experience fear of more significant losses and sell. Traders trade price and investors buy, sell, or hold relative to a defined range of fair values.

I read as much as possible and try to understand why this relatively straightforward concept is so hard for many investors to grasp. On the one hand, I am not a behavioral psychologist but a professional seeker of opportunities. Therefore, our process of seeking opportunities benefits from the many investors who react emotionally to point-in-time security prices and allow greed and fear to drive decision-making. This common irrational emotional reaction to markets is the very thing that creates the opportunity for the long-term investor. But as a professional seeker of opportunities accountable to clients, I need others to give in to greed and fear while expecting our clients to be immune from such reactive behavior.

I came across the following The Market NZZ January 31, 2023, interview with Howard Marks, during which he spent much of the interview discussing the very investor behavior that perplexes me. I am making it part of this commentary. You can find the entire interview at: https://themarket.ch/english/howard-marks-most-important-question-is-about-stagflation-ld.8325.

I added my thoughts in italics after each of Mr. Mark's comments.

Accordingly, how should one proceed as a prudent investor?

When you think long-term, volatility doesn't matter. Let's say you come into a bunch of money and you go out and buy Sixt, the car rental company. You are not going to look in the newspaper every morning to see what it's worth. You are going to operate it, rent cars and make money. The fact that stocks are public causes people to be concerned with daily prices. So if you're convinced a company is a good company, you should buy the stock, put it into the drawer and only look every year end at the prices.

What you need is sitzfleisch: The stamina to resist the temptation of responding to these short-term influences. Of course, that's easier said than done, but if you want to do a great job as an investor, you have to do things that are easier said than done. Look at Warren Buffett. He treats shares of a stock not as speculative objects, but as a piece of a corporation that you are going to own for years because you believe in it. If that's true, then why look at the price every morning?

I look at the prices of stocks we hold in client portfolios daily. However, I do so not to gauge how much gain or loss a client has in that particular security, instead, my interest lies in determining where the price sits relative to our 24–36-month valuation range. Where the security price sits relative to our valuation range will dictate if action is required to seize an opportunity to buy additional shares or sell and reduce the number of held shares.

So how should you align your portfolio to today's market environment?

As I mentioned earlier, market psychology is neither euphoric nor depressed today. So you should behave as normal. In contrast, for the last thirteen years you had to do something abnormal which is you had to reduce the ownership of debt in your portfolio because it yielded so little. Now, you can go back to the portfolio you held 25 years ago, before all this craziness, before the tech bubble, the global financial crisis, and the boom of private equity and hedge funds. For everybody who came into this business in the last thirteen years this easy period is all they've ever seen. But that wasn't normal, any period with zero interest rates is not a normal time. Zero interest rates distort all kinds of behavior and distort investment results.

The period between the end of the 2008-09 financial crisis and the Covid 19 Pandemic was indeed abnormal from a portfolio construction standpoint. For the clients whom we worked with through the financial crisis, they know that in their growth-oriented portfolios, we aggressively purchased bonds between 2008 and 2010, at a time when many high-quality bonds were trading as if the underlying issuer was going to go bankrupt because of the forced selling of 2008 during the panic and the post-crisis denial period when many investors were so scared during the crisis that they could not accept that another similar crisis was not hiding around every corner. After several years, the scars of the crisis finally healed, leaving bonds prices such that they presented very little yield and/or total return. This bond environment persisted for nearly ten years until 2022. Beginning in the fall of 2022, we began to see opportunities develop in many areas of the bond market. But we also anticipated that the opportunities would be short-lived as the Federal Reserve ceased raising rates, the economy slowed down, and the fixed-income markets began to price in interest rate easing in the near future.

Is there a specific advice you would give against this background?

Every reader should sit down and think hard about what her or his portfolio should look like in terms of aggressiveness and defensiveness. But most people don't take a methodical approach to investing and especially to setting their risk parameters. They think: «Oh, I heard on TV this stock is going up, I'm going to buy it.» Or: «My friend bought this stock and it doubled, so I'm going to buy it.» Well, it already doubled so maybe you shouldn't buy it.

These comments by Mr. Marks resonate because I routinely have conversations, particularly with relatively new clients, that resemble this type of dialog.

What else is important when it comes to the right calibration of a portfolio?

Today, a traditional portfolio of stocks and bonds of varying types and qualities makes perfect sense. Some risky ones, some safe ones, all depending on your risk tolerance, your aspirations and your intestinal fortitude. You have to decide whether you're okay with volatility or not because the cardinal sin of all is to sell at the bottom. So if you have a weak stomach, no sitzfleisch, you shouldn't subject yourself to big downward fluctuations.

Over the years, I have noticed that we have two different types of clients: those with what Mr. Marks describes as intestinal fortitude and those that do not have such fortitude when it comes to investing in the public markets. Those clients with that intestinal fortitude are attracted to us because they know that we don't fear market volatility and have the time and experience to invest in opportunities they might not have the time or knowledge to identify. The other type of clients is those who know that they do not have the necessary intestinal fortitude and know that if they are going to achieve their desired growth in wealth, they need to work with an investment manager who can bring disciplined and non-emotional management to their investments.

That's all?

Let me add one more thing. When you think about what your risk posture is in terms of aggressiveness vs defensiveness, the next question is: Will you change it from time to time, as the conditions in the market change? Most people probably don't have the ability to change their risk posture appropriately. They will lose money because of trading costs, so they should just strap in and hold on. In my 50 years in this business, I only made about five, six or seven market calls; once or twice a decade, when the market was either ridiculously overpriced or ridiculously underpriced. In these rare moments, you could reach a firm conclusion and you were probably correct. If I had tried to do this 50 times, or 500 times it would have been a disaster. It's just not a good idea to think you can regularly gain success through what's called market timing.

So, *was earlier last year one of those handfuls of times when Mr. Mark's made a "market call?" I went to* Oakmark's *website and searched for Mr. Mark's comments on the overall market from his company's The Round-up: Top Take Away's from Oaktree's Quarterly Letters: 1Q22. Mr. Mark's contribution to this quarterly summary was as follows: "there are very few occasions on which it makes sense to try to time the markets and very few people with the skill to do so profitably; it's far more important to be in the markets over the long run. Second, as bottom-up investors, Oaktree's main emphasis is on selection within our markets, not profitably altering our deployment of capital. Thus, I tell the TV anchors and reporters if one wants to respond to market conditions, the best way is by deviating when appropriate from one's usual ratio of aggressiveness to defensiveness. And where do I stand in that regard today? Right around normal, or perhaps slightly biased toward defense via increased emphasis on selectivity and downside protection. In* *short, I think the considerations are too well balanced – although perhaps not perfectly so – to make getting out (or getting too defensive) the right thing to do."*

Howard Marks is considered one of the world's most accomplished and disciplined professional investors, and he is the investment guru's guru. Warren Buffett has stated about Howard Marks, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something."

If Warren Buffett can learn something from the words of Howard Marks, we all can. I occasionally write commentaries such as this month's because I witness firsthand from clients and non-clients alike who, for some reason, do not believe that they can benefit from the advice and lessons published and provided free of charge from the most successful investors of our time. I stress the best investors, not the best traders. Trading is a mechanical exercise that is increasingly being performed by computers. However, investing is much less of a mechanical exercise; it is predominately an exercise in temperament control, judgment, and patience. There is no quantifiable formula or algorithm which successful investors use that can be copied. But lessons, principles, and emotional discipline can be learned.

The first step to learning not to be your worst enemy as an investor is to admit that your emotions routinely cloud your judgment when investing. From there, if you strive to be a long-term investor, I suggest starting with Howard Marks and Warren Buffett. As important as it is to learn whom to study, it is whom to ignore. From my experience, many of those whom you should ignore are the ones most visible, particularly those routinely seen on the likes of CNBC, Fox Business, etc. The vast majority of the pundits who frequent these business media outlets are either short-term traders of one form or another or hedge fund managers who are "talking their book" and do not provide the individual investor with very little useful advice.

It was not always this hard to learn how to be a better investor. Before the advent of CNBC, there was Wall Street Week with Louis Rukeyser, the acclaimed long-standing program produced by Maryland Public Television (MPT) from 1970-2002. I remember watching Wall Street Week with my grandfather and great-grandfather from a very young age. It was at the same age that I was introduced to the Wall Street Journal, Barron's, which I of course, had an interest in reading so that I could talk about the markets with my grandfather and great-grandfather. It used to be that the discussion of stock investing began and ended with differing opinions about businesses, new technology, and who was buying who. Today, unfortunately, most of what is discussed are dominated by metrics related to the stock itself, not the company. If the company is discussed, it relates to very short-term business cycle-related factors and how they might impact the stock over the next week, month, or quarter.

We had a solid start to 2023 with many companies within our portfolios, particularly those that fell much harder than the broad market during 2022, rallying significantly. This did not surprise us. From our viewpoint, the beginning of such a rally was not a matter of if but when. We also saw on February 1st from the Chairman of the Federal Reserve what we have been looking for and predicting to happen early in 2023, a downward shift in interest rate increases and a softening of central bank rhetoric surrounding inflation and signaling that the end of Federal Funds Rate hikes is near at hand. Following the February Open Market Committee meeting, we got exactly what we were looking for. We have also been very clear that we were not buying into the idea that the Federal Reserve was going to steer our economy into a deep ditch to quell inflationary pressures. We have for many months believed that inflation was rapidly declining on its own and that the Federal Reserve with be able to graciously end its aggressive rate hikes and avoid risking a meaningful recession. Two days after the February Federal Reserve meeting, economists and pundits alike were shocked by the strength of the January BLS Employment Report, which showed job creation exceeding 500,000 when no more than 250,000 was expected by most forecasters. This strength in job creation and an unemployment rate that sits at 3.4%, a low level not seen since 1969, increases the likelihood that if we have a recession, it will be very mild and bolsters the argument that there is an increasing probability that we will avoid a recession altogether.

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Disclosure:

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

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