# How Did the Market Do? Is the Market Attractive? What Will the Market Do in 2022? These Are Not the Important Questions.

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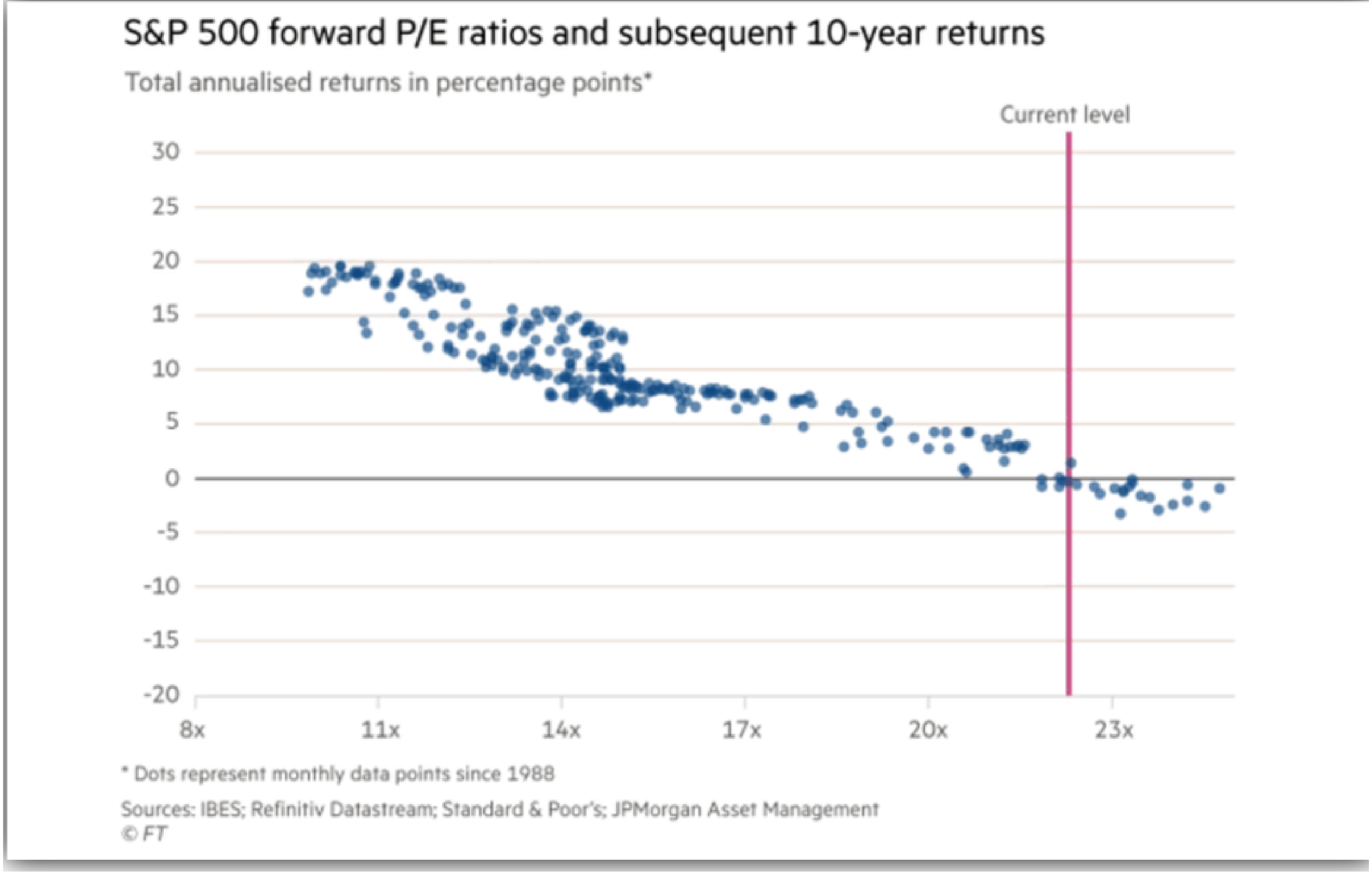
The start of a new year always gives one reason to look ahead with a renewed perspective. As an "expectations investor," as we are at Seven Summits Capital, we wake up every morning as if it is New Year's Day looking to absorb and process new information, which might reinforce or change the outlook that we had the day before. Recent information flow has been concentrated in the following areas:

- Inflation and the expected response of Central Banks, most notably our Federal Reserve.
- COVID-19 variants, current vaccines' effectiveness, and the prospect of upcoming anti-viral medications.
- The legislative prospects of the Biden administration's Build Back Better social, climate, and technology investment plan.

The prospect and outcome of each of these areas of uncertainty will substantially impact how the investment markets, equity, and fixed income, will respond based upon future expectations of real growth, productivity (return on investment), and discount rates. When it comes to equity investing, real growth, productivity, and the discount rate are the most critical inputs to quantifying what an investor is willing to pay for future cash flows and, thus, the multiple that the market assigns to a stock. Today, despite substantially above-trend inflation, real interest rates remain negative (below the inflation rate). Negative real interest rates are stimulative to the economy. Such negative real interest rates support earnings and cash flow multiples for stock prices that are substantially higher than historical averages. 2021 has shown how inflation can rise, interest rates can remain stimulative, and broad equity markets can continue going up.

Conventional wisdom is that higher inflation and large government budget deficits are risks that equity investors have to be very concerned about. The reality is that as long as interest rates remain low and stimulative, higher inflation and growing government indebtedness are not themselves risks to strong equity market performance. In other words, if inflation stabilizes over the next 12-24 months at 2.0 – 2.5% and the ten-year Treasury Note rate remains at or below the rate of inflation, monetary policy will continue to be supportive of higher equity prices. However, looking longer term, should real interest rates become less negative, neutral, or even slightly positive over the next several years, the above trend broad market equity returns that today's investors have become accustomed to should become the exception, not the rule. Currently, our base case is that interest rates will close the negative gap and approach neutral over the next two years. However, we do not assign a high probability that interest rates will move to a level that results in meaningfully real positive interest rates in the foreseeable future.

The substantially negative interest rates that have persisted since the 2008-2009 financial crisis have facilitated higher and higher equity market earnings multiples. History tells investors that the higher the earnings multiples of the broad market, the lower future market returns will be over the next ten years. This relationship is illustrated below in a dot plot published in May 2021 on the ISABELNET website:




***Index performance is provided as a benchmark but is not illustrative of any particular investment. An investment cannot be made in an index.***

It is striking that since 1988, whenever the S&P 500 market multiple has been over 20X, the annualized return of that index over ten years has been below 5%, and whenever the P/E ratio has been at or above where it is currently, the annualized return of the S&P 500 has been negative over the next ten years.

Seven Summits Capital is an active equity manager during a time when more and more investors are being lulled into a false sense of security by perpetually low or negative real interest rates, extraordinary Federal Reserve quantitative easing, and perpetual government deficit spending that are all inflating equity market multiples, stock prices, and portfolio values. Passive investors have done very well over the last eleven years, not because they are skilled investors, but simply because they chose the equivalent of a public transit train that is powered by extraordinary monetary and fiscal stimulus. Conversely, an active investor such as Seven Summits Capital owns a well-maintained automobile that runs on decision-making based upon known fundamentals, deliberative judgments, and conservative forecasts. We take comfort that fundamentals, good judgment, and well-conceived forecasts are fully within our control. We do not envy those who ride the stimulus-powered public transit "index investing" train because we know that monetary and fiscal stimulus are inherently unpredictable and finite.

The opposite of passive investing is what I referred to at the beginning of this commentary, "expectation investing." Expectation investing requires knowledge of what factors contribute to a wealth-creating investment, decision-make skills, and an understanding of risk mitigation. Expectation Investing is also the title of Michael J. Mauboussin and Alfred Rappaport's seminal book on investing, which was revised and updated this year. This book, which Oakmark's Howard Marks calls a "second-level thinking: a graduate-level course on intelligent investing," would be lost on a passive investor. A passive investor does not need to understand or know the essential ideas listed at the end of Chapter 7 in Part II-Implementing the process of the book. Those essential ideas are as follows:

- Whenever the expected value is greater than the stock price, you have an opportunity to earn an excess return.
- The magnitude of the excess return depends on how much of a discount stock trades at relative to its expected value and how long the market takes to revise its expectations.
- As an investor, the three potential reasons to sell are that stock reaches its expected value, a more attractive stock exists, or your expectations have changed.
- Consider the important role of taxes and transaction costs before you decide to sell a stock.
- Beware of behavioral traps when you make buy or sell decisions.

The journey that our clients choose when they chose to work with Seven Summits Capital is the opposite of the one that passive investors blindly embrace. Instead of accepting an unknowable and random path, we navigate risk and opportunity with purpose. The market is not our desired course. Rather, the twists and turns of the market are seen as both risks to manage and often opportunities to exploit.

As we enter 2022, market strategists will try to predict where the market will end the year. This practice is futile, and fortunately, we have no reason to engage in such folly. We will consistently chart our course dictated by informed assessments of both risks and opportunities. Our course may inadvertently resemble the broad markets looking backward or chart a very different path. We make no effort to have our portfolios look like a broad market index, in fact, our process and experience results in the opposite. If you desire to produce superior risk-adjusted returns compared to the market, you cannot build a portfolio that resembles and acts as the market.

As 2022 begins we continue with our never-ending goal to improve our access to information, our ability to assess the veracity of market expectations translated into price versus our expectations, and our ever-evolving decision-making process. Our highly differentiated approach is that we strive to build durable wealth for our clients over time, we have no interest in trading on momentum or playing the markets.

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Disclosure:

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

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