The Cycle of Greed & Fear Scary for Most, Dangerous for Few

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"I like to point out that in the real world, things fluctuate between pretty good and not so hot, but in the markets, they tend to go from flawless to hopeless. The swings are overdone. Whenever human thinking and

psychology are involved, I think A, the pendulum swings, and B, it usually swings to excess." ***Howard Marks – 2022 SIC Investment Conference.***

As I write this over Memorial Day weekend, it appears that the broad equity market, represented by the S&P 500, will eke out a small gain for May. A positive month was salvaged by a strong bounce in the equity markets during the final week of the month. This bounce was broad and included the high-flying small and mid-cap growth stocks that came crashing down to earth beginning last November and the mega-cap tech stocks that had held firm through March but succumbed to the significant selling pressure in early to mid-May.

It is quite possible that mid-May represents the beginning of a bottoming process. The intense sell-off underneath the broad averages should portend a respectable recovery in many oversold stocks through the end of 2022. See the chart below compiled by LPL Research which looks at the prevalence of strong positive follow-throughs coming off a 6%+ week in the S&P 500 since 1950:

Big Weekly Gains Tend To Mark The Start To More Strength

>6.0% Weekly Gains For The S&P 500 Index (1950 - Current)

		S&P 500 Index Returns After Six Week		
Date	**Weekly Gain**	**3 Months**	**6 Months**	**12 Months**
6/7/1974	6.0%	-22.8%	-28.5%	-0.1%
9/20/1974	7.6%	-3.6%	18.9%	22.4%
10/11/1974	14.1%	1.6%	20.3%	24.0%
11/14/1980	6.2%	-6.8%	-3.4%	-11.3%
8/20/1982	8.8%	22.4%	30.5%	44.7%
10/8/1982	7.4%	10.8%	16.6%	29.9%
11/5/1982	6.3%	2.8%	16.8%	15.0%
8/3/1984	7.4%	3.2%	10.0%	17.9%
5/2/1997	6.2%	16.5%	11.2%	38.0%
10/16/1998	7.3%	18.5%	23.6%	18.7%
6/2/2000	7.2%	2.7%	-11.0%	-14.2%
9/28/2001	7.8%	11.5%	9.2%	-21.7%
3/21/2003	7.5%	11.2%	15.7%	22.3%
10/31/2008	10.5%	-13.4%	-6.7%	7.7%
11/28/2008	12.0%	-22.3%	5.4%	22.2%
1/2/2009	6.8%	-9.6%	-3.6%	21.6%
3/13/2009	10.7%	25.1%	37.8%	52.1%
3/27/2009	6.2%	12.6%	28.0%	43.8%
7/17/2009	7.0%	16.6%	20.8%	13.9%
12/2/2011	7.4%	8.0%	3.3%	13.3%
3/27/2020	10.3%	18.4%	30.5%	56.3%
4/9/2020	12.1%	14.2%	22.2%	48.0%
11/6/2020	7.3%	11.4%	19.7%	34.0%
3/18/2022	6.2%	?	?	?
5/27/2022	6.6%	?	?	?
Average		5.6%	12.5%	21.7%
Median		10.8%	16.6%	22.2%
Higher		17	18	19
Count		23	23	23
% Higher		73.9%	78.3%	82.6%

Source: LPL Research, FactSet 05/27/2022
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

As we look back on this period, we will only then be able to see how this recovery compares historically to past rebounds in the broad equity market following 6%+ weekly gains. The market cannot be played/timed; the only truth that we at Seven Summits Capital have confidence in is that stock prices gravitate toward a rational intrinsic value relative to their underlying corporate enterprise during times when extreme greed or fear is not the dominant sentiment. We are confident that the current prices for many of the companies represented in our client portfolios have fallen through that threshold that divides a fair value range from an extreme oversold condition.

Price levels below the bottom threshold of fair value are not an indication of impending doom for the companies or the market. The 2022 Bear Market in stocks is likely to be characterized in retrospect as a "reset" inflection point where the twelve-year "easy money," ultra-low inflation period abruptly transitions to a more "normal" neutral or positive interest rate environment. As Howard Marks mentioned in the quote at the beginning of this commentary, "things fluctuate" and "swings are overdone." Public financial markets are always prone to extremes because the motivation of greed and fear among human participants in the markets is innate. Fortunately for long-term investors, human nature has historically dictated that greed is much more prevalent than fear. Capitalism is built on greed and wanting more. So long as capitalism, with guard rails, remains the bedrock of America, the equity markets will remain one of the most democratized institutions for building wealth that the world has ever known.

We are steadfast in our belief that markets can and do regularly swing from over-exuberant to over-fearful. Still, the intrinsic values of operating companies do not fluctuate significantly over the short-to-intermediate term. Because our view of intrinsic values drives our investment decision-making, we are not motivated to react to or attempt to sidestep periods of heightened market volatility. We size up opportunities with a three to five-year time horizon in mind. Markets will do unexpected things over a three to five-year period, and we incorporate such an expectation into our decision-making process when we enter a new investment. We will not hesitate to act when we get intrinsic value wrong, as we occasionally do. Furthermore, when market volatility gives us opportunities that were not present in the recent past, we will adjust existing portfolios to free up liquidity to quickly seize on those opportunities that materialize during a market sell-off period. Market price volatility only matters to us relative to the opportunity that it offers.

The most challenging aspect of what we do is helping clients get through challenging times during every market cycle. Every bull market period in the stock market experiences corrections, on average, every 12-18 months. Every four to five years, on average, a correction eventually leads to a bear market. Every bear market period experiences heightened volatility, severe down days, and strong rallies before finally kicking off a new bull market. These cycles are what equity investors sign up for in exchange for the unparalleled long-term wealth creation that has historically been provided by equity investing.

Over the last 25 years, equity investors have been severely tested five times when "this has not happened in over X number of years" events roiled markets and caused many equity investors to lose sight of why they were invested in equities in the first place. These events were the bursting of a massive bubble created by the irrational exuberance surrounding the advent of the internet (the most significant financial bubble since the Dutch Tulip Mania of the early 1600s), the fear and panic following 9/11 (the first foreign attack on U.S. soil since the War of 1812), the 2008-09 global financial crisis, and the "Great Recession," which was the closest we have come to a Depression in over 70 years, the COVID-19 Pandemic, the most severe viral pandemic in more than 90 decades, and lastly, the current market decline characterized by the post-pandemic broken global supply chain, “great resignation” and the highest inflation since the 1970s, which was recently exacerbated the first significant invasion of a European country since WWII.

Equity investors have had to endure a lot of scary event-driven market meltdowns over the last quarter century. That being said, the S&P 500, with dividends reinvested, has risen 369.730% since May 31, 1999, equating to a 6.957% average annualized return. That average annualized return equates to roughly doubling invested wealth every ten years. These figures are from near the high of the tech bubble to today’s depressed market levels. If we look at the S&P 500 with dividends reinvested since May 2001, the average annualized return jumps to 7.765% because of the lower starting point, and if we make our ending point in May of 2021, the average jumps to 8.185%.

Over the last twenty-five years, I have been asked many times why I stay invested when times get tough in the equity markets. The simple answer is that I have always invested in stocks not to play their price moves, but to benefit from the growth in value of the underlying company over time. When you own a company, you expect good times and bad, the unexpected, and no matter how well prepared you are, you must always be prepared to manage through difficult times. Managing a portfolio of stocks of companies that you understand enables you to see through challenging periods in markets. Broadly, indexes such as the S&P 500 have proven to perform very well over time while inherently being fully invested every hour of every day in perpetuity. I believe that this inherent buy-and-hold status of a market index is the single most significant reason most investors fail to come close to market returns over time. Many investors are conditioned by the mainstream financial media to think in terms of trading instead of investing. Trading is simply another way to describe market timing.

We trade within our portfolios, but our trading decisions are not driven by an attempt to time price moves in a stock. Our trading is driven by our continual assessment of the variance between market price and intrinsic value assessments. Markets move prices around daily and sometimes in a disorderly manner. Companies’ intrinsic values mostly do not move daily, week-to-week, or even year-to-year. Therein lies the opportunity for an active, fundamentally focused investment manager.

Market periods characterized by significant price drops and the day-to-day flow of fearful news headlines are highly disconcerting to investors. We are very empathic toward our clients who see lower portfolio values monthly. We know our clients’ nerves are being tested as the market decline continues unabated. We are feeling the same pressures. Our business success is directly tied to the value of our client portfolios. Furthermore, in general, our personal retirement and non-retirement investments share many of the same investments as our client accounts. We expect these periods and know that they happen in a very unpredictable manner. However, we are always looking out three to five years in terms of the investments we make and have learned to look through these periods when they occur.

I am getting long-winded at this point. We are highly confident that we will look back at this period a few years from now and realize how the current selling has swung the pendulum of stock prices excessively on the downside. In the meantime, we want to ensure that we capture as much of the eventual price recovery as possible. We cannot possibly pick the bottom of this sell-off, but we can ensure that a timing mistake does not cause us to miss the first ten or twenty percent bounce from the eventual trough levels.

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Disclosure:

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