SEVEN SUMMITS CAPITAL

1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

MAY 2018 INVESTMENT COMMENTARY

BEING CAREFUL, BEING STRATEGIC, AND CREATING LUCK

This month I am going to discuss risk management and the concept of reverse cost averaging at the portfolio level. The idea of cost averaging, from a buying perspective, is to enter into a new position incrementally, thereby using the inherent variability of market prices over a finite period of time to buy into a full position and achieve an average cost for your position. Given that no one knows the future for the price of a security or the level of the broad market over the short term, as measured in days and months, cost averaging into a position is a very prudent and defensible practice.

Stepping back and looking at a portfolio and the observable risks that lie ahead in the near future (six to 24 months), it is tempting to react and abruptly take risk out of a portfolio when the observable risks appear to be mounting. This temptation should be ignored. Such abrupt action is simply market timing disguised as "risk management." Instead, risk management is most effective when it is executed strategically, as opposed to reactively.

For example, several years ago when the bull market in stocks was becoming more mature, valuations for stocks were above historical fair value, and interest rates were setting half-century lows, I began increasing portfolio allocations in non-correlated alternative asset classes. These asset classes included real estate, private equity, and private debt. This strategy was meant to immunize portfolios against the eventual downward price pressure that occurs with market-based fixed-income investments when interest rates rise, without inadvertently over-weighting equities. The other benefit of this strategy was to enhance income generation over the paltry income yields that the market offer with investment grade bonds. For many investors, allocating to non-traditional asset classes in lieu of traditional fixed income, therefore by default, they chose to overweight high dividend paying equities and publicly traded REIT's and MLP's. This action was not a strategy; it was a reaction.

If an investor under-weights traditional fixed income in favor of over-weighting high yielding equities, that investor satisfies a need for higher income at the expense of managing the risks associated with the eventual bottoming of interest rates and the initiation of a rating rising cycle. Just as traditional fixed income prices will suffer in the face of rising interest rates, so will the price multiple that investors are willing to pay for high yielding equities. This would be akin to jumping out of the frying pan into the fire.

For Seven Summits Capital, the strategy of not adding to traditional fixed income, that began in 2013 and continues today, will likely continue until such time that traditional high grade fixed income yields normalize relative to longer-term inflation expectations. Today that would mean a 10-year U.S. Treasury Note yield that would be closer to 4%. This yield level would imply a much more “normal” real risk-free 10-year yield of approximately 2% (10-year Treasury Yield minus the inflation rate). My desire with clients is to not only communicate a strategy, but also discuss the underlying assumptions. As a rule, if someone cannot articulate several examples of what assumptions and rules underpin their stated strategy, they don't have one.

I have been avoiding traditional fixed income and will continue to do so for the foreseeable future. This means that allocations to non-traditional assets classes will remain the same or rise going forward. The next tactic within the context a strategy built upon being aware of equity valuations, as well as market and economic cycles, will be to incrementally reduce equity allocations over the next six to twelve months at the portfolio level (cost average selling). The resulting proceeds for this selling will be redeployed into slightly higher cash holdings, specialized fixed income strategies, market neutral strategies, and non-traditional asset classes.

At this time next year, most Seven Summits Capital accounts will hold five to ten percent less in publicly-traded equities compared to the equity allocation as of the end of March 2018. This risk management shift in asset class allocation will occur as a process and does not rely upon market timing. The objective of this process is two-fold. The primary objective is to reduce publicly traded equity exposure as the market and economic risks get more elevated over the next eighteen to twenty-four months. A secondary objective is to create room in an investor’s allocation to increase equity exposure at a time when valuations and forward-looking risks have reached extremely attractive levels.

For long-time clients, they will remember my March 2009 commentary, written prior to the March, 9th market bottom when market sentiment was verging on doom. I argued in that commentary that long-term opportunities, not seen in generations, in both stocks and bonds, were present and should not be ignored. Seeing those opportunities in early 2009 and my willingness to seize on those opportunities in spite of the prevailing sentiment created the “luck” of being invested at the bottom of the market, which occurred less than one week from publishing that commentary. Experience and skill are what allowed me to recognize and act on opportunities, not my ability to time the bottom of the market, which was unknowable.

Daniel P. Egan, an expert in the area of behavioral finance, wrote an article titled *The Skill of Managing Luck*, published on his website on April 22, 2018. The article discussed the difference between luck and skill and the contrast between human decision-making and algorithmic decision-making. The following two passages are timely and pertinent to the subject matter of this month’s commentary. Below are those two passages:

> *“We humans seem to be attracted to a bad process. To the unexpected, the unusual, the low probability. We’re attracted to luck – the more extreme the luck, the better. We seem to especially relish luck masquerading as skill.”*

> *“Skill is boring. Skill is 10,000 hours of practice. Skills are consistency. Skill is a game of inches. Skill is picking battles to win wars. Skill is incremental.”*

My approach to decision-making within the context portfolio management is centered upon focusing attention upon what can be quantified or heavily reasoned based upon research and experience. In contrast to the prevailing narrative discussed by many market pundits, my decision-making does not rely upon any illusion that I have any special insight into the unknowable, such as the timing of economic cycles or the behavior of markets over the short-term. The greatest unknowable in investing is the ability to time, with any precision, the volatility of the public markets or major turning points within markets and economic cycles. I know first-hand that it is possible to improve the odds of being lucky in terms of timing if you follow a disciplined process built upon what is knowable.

I believe that now is the time to begin to prepare for the end of this current market and economic cycle. There is no way to know WHEN these cycles end, however, we do know that these cycles WILL end at some point. We do know that recessions have historically been caused by Federal Reserve tightening, excess leverage, and financial or geopolitical shocks. Today we see the Federal Reserve on a tightening path to include raising interest rates and ceasing quantitative easing (buying Treasury Bonds and Mortgage Backed Securities in order to keep interest rates down). We see a much higher than previously projected path for public (government) debt and at the same time, measures of private debt levels relative to income and GDP are approaching levels last seen in 2005-06. Lastly, I cannot remember a time when there were so many geopolitical and diplomatic "powder kegs" that have the potential to create significant military and/or economic conflicts. Assessing risk levels at a macro level is a process which is more art than science, and this assessment requires a mosaic approach of being aware of mounting, overlapping, and interconnected situations that require probabilistic reasoning.

This commentary is not meant to alarm anyone; it is intended to communicate a process and discipline designed to manage risk and this is exactly what is being done continuously.

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com