What You See & How You Feel is Entirely Dependent Upon Your Perspective

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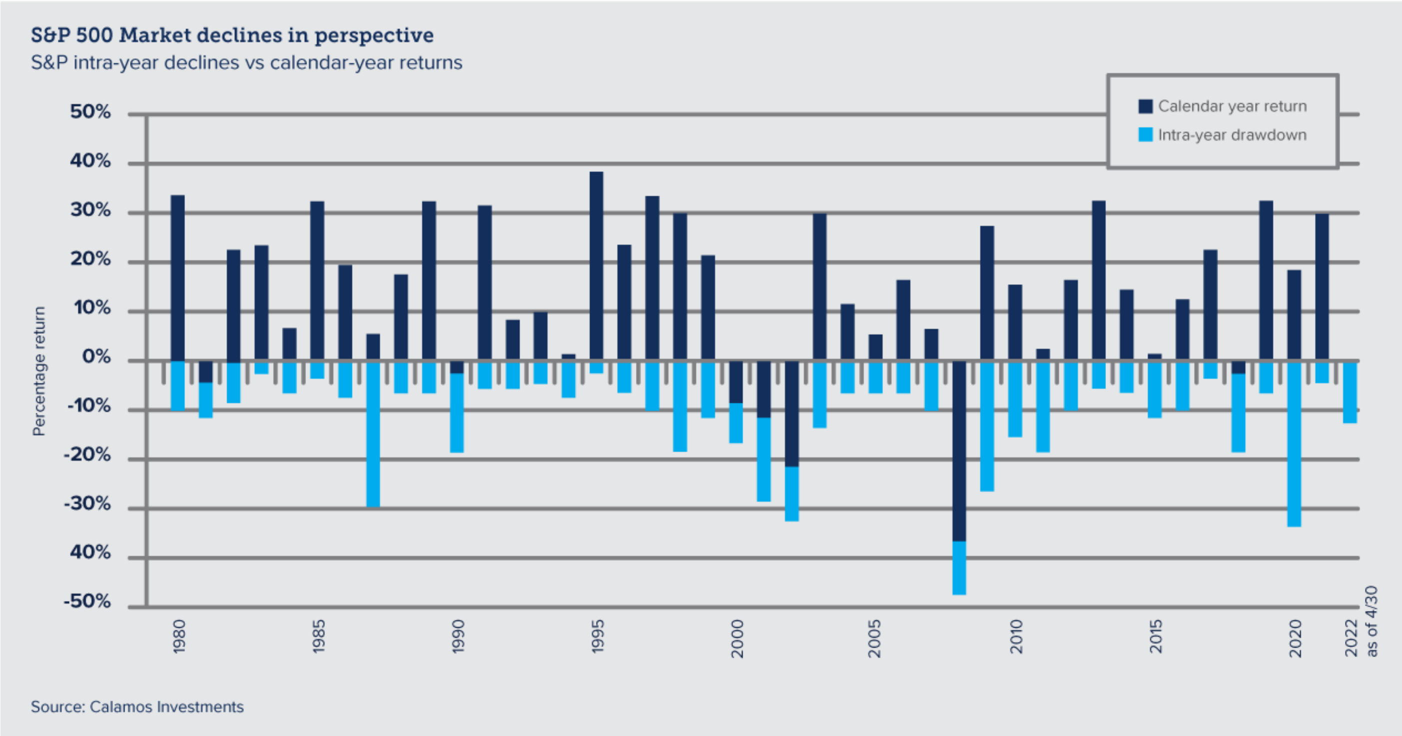
I took a long-delayed vacation during the second half of October, and while away, the U.S. equity markets staged a strong rally that led to only the fourth positive month for the S&P 500 out of the last twelve months. Could there be a relationship between my being on vacation and the rising equity markets? If only it were that simple. This month's cover photo is one that I took while on vacation.

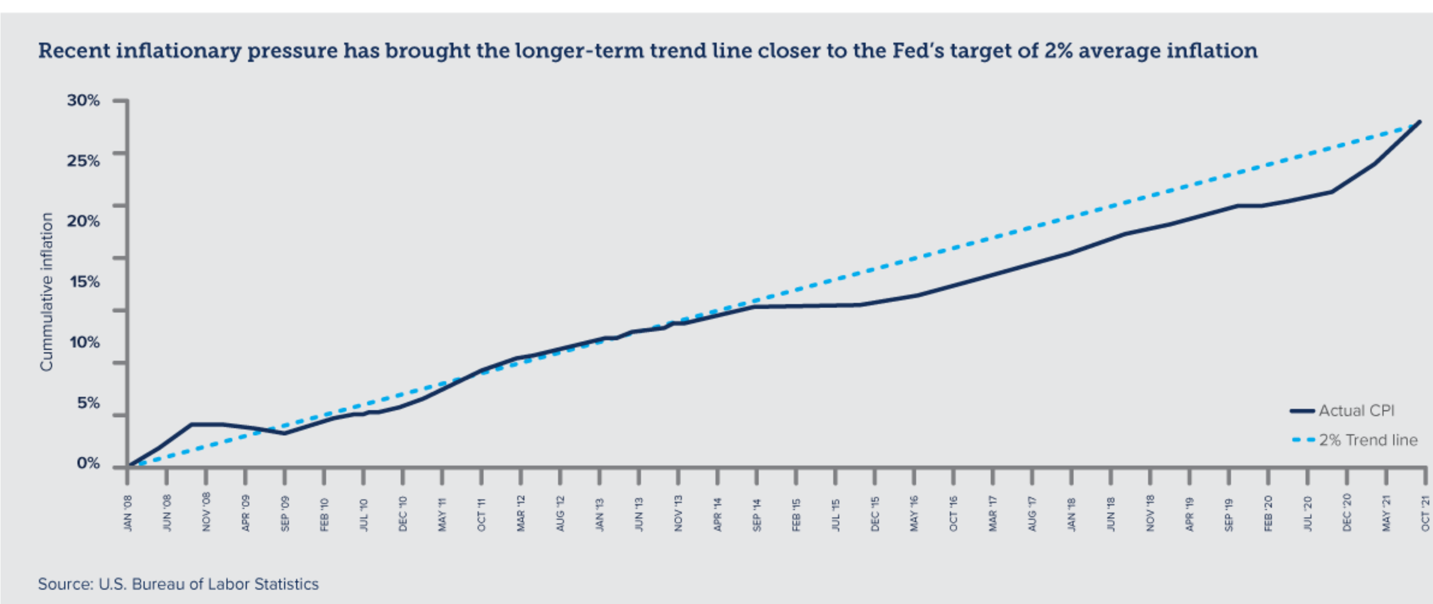
Over the last twelve months, the S&P 500 was flat or down 66.66% of the time measured monthly. Contrast this to the four years preceding this period, and you see that the S&P 500 posted only fourteen down months over that forty-eight-month period, which equates to only 29% down month occurrences. This four-year period was not a "walk in the park" for equity investors because it contained a negative annual return for the S&P 500 in 2018 and a global viral pandemic-induced Bear Market in early 2020. It helps an investor to have a long **PERSPECTIVE** when going through difficult market periods. During 2015 the S&P 500 posted seven flat or down months, with that year ending down less than one percent. That year was characterized by worries about the Federal Reserve beginning to raise interest rates and a sharp drop in oil prices caused by OPEC increasing output to bring prices down in order to hurt U.S. shale oil producers who were quickly expanding production and becoming a competitive threat to OPEC producers.

With equity markets, there are always going to be challenging periods and many factors to worry about, but with the benefit of a long memory, experienced investors can see more clearly than others. Following that challenging 2015 period and a nearly 6% drop in the S&P 500 over the first two months of 2016, the S&P 500 proceeded over the next twenty-four months to post only six down months, of which three were essentially flat months. Everyone wishes that market returns were more linear and down periods more evenly distributed, but that is the stuff of fantasy. Market returns are unpredictable, and the distribution of positive and negative periods is more likely to be very unevenly distributed than evenly distributed.

One concept that holds true more than not with equity markets is that periods characterized by more frequent down-month periods or substantial down-year periods than average are typically followed by a more extended period of months that are characterized by the opposite. We can see this over a many-decade period in the chart below that illustrates intra-year declines and annual returns:



Besides geopolitical concerns, the paramount topic for investors over the last year has been inflation. The common sentiment is that the Federal Reserve should have begun tightening monetary policy in 2021 when inflation pressures first became evident. I personally believe that such a sentiment is a luxury of hindsight. Chairman Powell made it clear over the preceding several years of his tenure that he was willing to let inflation run in excess of their target 2% number if that were to occur because inflation had been undershooting that 2% for a very long time. The chart below tracks CPI versus a 2% trend line of CPI from 2008 to the fourth quarter of 2021. One can gain **PERSPECTIVE** into why the Federal Reserve chose December 2021 as the time to begin changing its rhetoric about inflation and prepare markets for tighter monetary policy. As the chart illustrates, the higher than desired inflation that began in the second quarter of 2021 had elevated price levels to near the long-term 2% trend line that the Federal Reserve had been targeting by late 2021.



The theme of this month's commentary is that it is helpful for investors to have a long memory. It is helpful to add historical context to the prism from which one views current market conditions and prevailing sentiment.

Lastly, about context. It is critically important for long-term equity investors always to remember that traders trade price and investors buy value. We are investors, not traders. We do not like to sell; we like to buy. Only when price equates to an irrationally high value does price induce us to sell. Otherwise, we reluctantly sell to create liquidity in order to buy what we view as a better long-term opportunity created by price weakness. We never forget that we strive to own equity in companies where the equity is accessed via a stock. The value we pay is a derivative of the price of the stock. Therefore, we do not view a stock price relative to where it has been, but instead, where we forecast it will go as the value of the company increases over time.

What does all of this talk about context and long memories have to do with building and preserving wealth to meet financial goals? It has everything to do with it. In the short term, markets and prices should not be expected to track your anticipated financial goals. Precisely, for this reason, is why we always stress that short-term price volatility of financial assets for a long-term investor focused on long-term goals should not be a significant concern. It is critically important for the long-term investor to have the **PERSPECTIVE t**hat short-term price volatility is factored into the average return expectations that we are striving to obtain. There is no free lunch for long-term investors. Inflation destroys the spending power of wealth over time, and low-risk/risk-free investments cannot be expected to provide a sufficient excess return over inflation to enable adequate wealth accumulation for most investors. Higher interest rates are generally thought to be good for savers, and this can be true in the short term. However, over long periods of years, interest rates on relatively low-risk savings vehicles are really just an illusion because the savings rates offered by low-risk savings vehicles such as CDs and Treasury bonds are only designed to compensate the saver for inflation and the time value of money. Any return on investment beyond inflation and the term premium (time value of money) comes from risk. Without risk (or otherwise known as adopting a view about the future), there is very little "real" inflation-adjusted return available to savers and investors. In order to get access to investments that can provide sufficient "real" returns over time, investors have always needed to venture into risk assets, most commonly equities. The greatest misconception that accompanies the concept of risk when it comes to equities is equating price volatility to risk. Price volatility can sometimes be a function of true fundamental risk, but generally, price volatility is simply a function of short-term trading dynamics and is not a very good measure of underlying fundamental risk to long-term capital.

In my opinion, there is no better source for learning how to think about equity investing than Warren Buffett, the most successful equity investor in history. Below are some comments that he made in his 2017 Berkshire Hathaway annual letter to shareholders:

"Stocks surge and swoon, seemingly untethered to any year-to-year buildup in their underlying value. Over time, however, Ben Graham's oft-quoted maxim proves true: 'In the short run, the market is a voting machine; in the long run, however, it becomes a weighing machine.'"

"Investing is an activity in which consumption today is forgone in an attempt to allow greater consumption at a later date. 'Risk' is the possibility that this objective won't be attained … As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates."

"Though markets are generally rational, they occasionally do crazy things. Seizing the opportunities then offered does not require great intelligence, a degree in economics or a familiarity with Wall Street jargon such as alpha and beta. What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period—or even to look foolish—is also essential."

Bear markets and, conversely, market bubbles tend to make long-term fundamentally oriented investors look foolish because markets become driven by the extremes of both greed and fear. Buffett has famously always said and put his money where his mouth is, that to be a successful equity investor over time that one needs to be fearful when others are greedy and greedy when others are fearful.

At Seven Summits Capital, as a fundamentally driven long-term asset manager, we strive to underpin our process with the core elements of the principles espoused by our study of Warren Buffett and other immensely successful fundamental equity investors. I have had my share of periods over the last 25 years when I have had to "look foolish," as described by Buffett. The inherent fundamentally unnecessary price volatility that accompanies public markets is a necessary evil for long-term equity investors to endure. Modern markets have come to function more so to satisfy the trading liquidity needs of non-fundamental participants than to approximate fundamentally derived value. If one could chart fundamentally derived value against daily stock price, the value line would smoothly run through the erratic gyrations illustrated by the price chart. There are many different methodologies for calculating fundamentally derived values or intrinsic values for a company; however, almost any of those methodologies begin with some derivative of cash flow from operation. Thus, below I have charted, using Finbox.com, the trailing twelve-month cash flow from operations for META relative to stock price over the last ten years. This illustration demonstrates how, over the long term, the stock price tracks cash flows but with much greater volatility:

META (Facebook) has not been a stock that carried an extraordinarily high P/E ratio; thus, the ascent of its stock price over the last several years was directly related to the company's ability to grow its cash flow. Since the beginning of 2022, the stock price has declined precipitously, concurrent with this year's Bear Market. However, the company's cash flows held up very well until the recent quarter, when cash flows succumbed to the flattening of advertising revenues and continued heavy investment in long-term strategic initiatives such as the Metaverse. It certainly appears that META's stock price has become wholly disconnected from cash flows.

I show this META illustration to demonstrate that most stocks are driven by cash flow generation over time, and cash flows are usually far more stable than the fickle nature of stock prices. We are much more interested in understanding cash flows than the gyrations of stock prices. If we get cash flows right, the stock price will move in tandem over time. The research firm that we work with currently sees META's cash flows continuing to fall over the next 18 months before rebounding before the end of 2024 back to the levels posted in 2019. This forecast lowers the mid-point of a fair market range for META's stock to $124.

I have great confidence in the valuation methodology used by our research partner. However, I do not always agree with certain underlying assumptions. In the case of META, I believe that their underlying growth and cash flow forecast assumptions are too pessimistic. Last year, when our research partner's target price for META was $350, I was more cautious and could not justify a stock price much higher than $275. For this reason, META is an average weighted stock in our portfolios, and our average cost across all clients is under $175 per share. I now believe that a realistic 24–36-month mid-point for the fair value of the stock is around $180 per share or 100% above the current level. I do not see the company's annual cash flows troughing nearly as low as our research partner is forecasting.

META will more than survive this year's Bear Market, and so will investors who avoid panicking because they are reacting to stock price gyrations without any thought about a company's financial metrics that ultimately support stock price over time.

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Disclosure:

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