SEVEN SUMMITS CAPITAL

The Worst Bond Bear Market in History....One Moonshot Crash Landing, Many Significant Opportunities Abound in Both Stocks & Bonds

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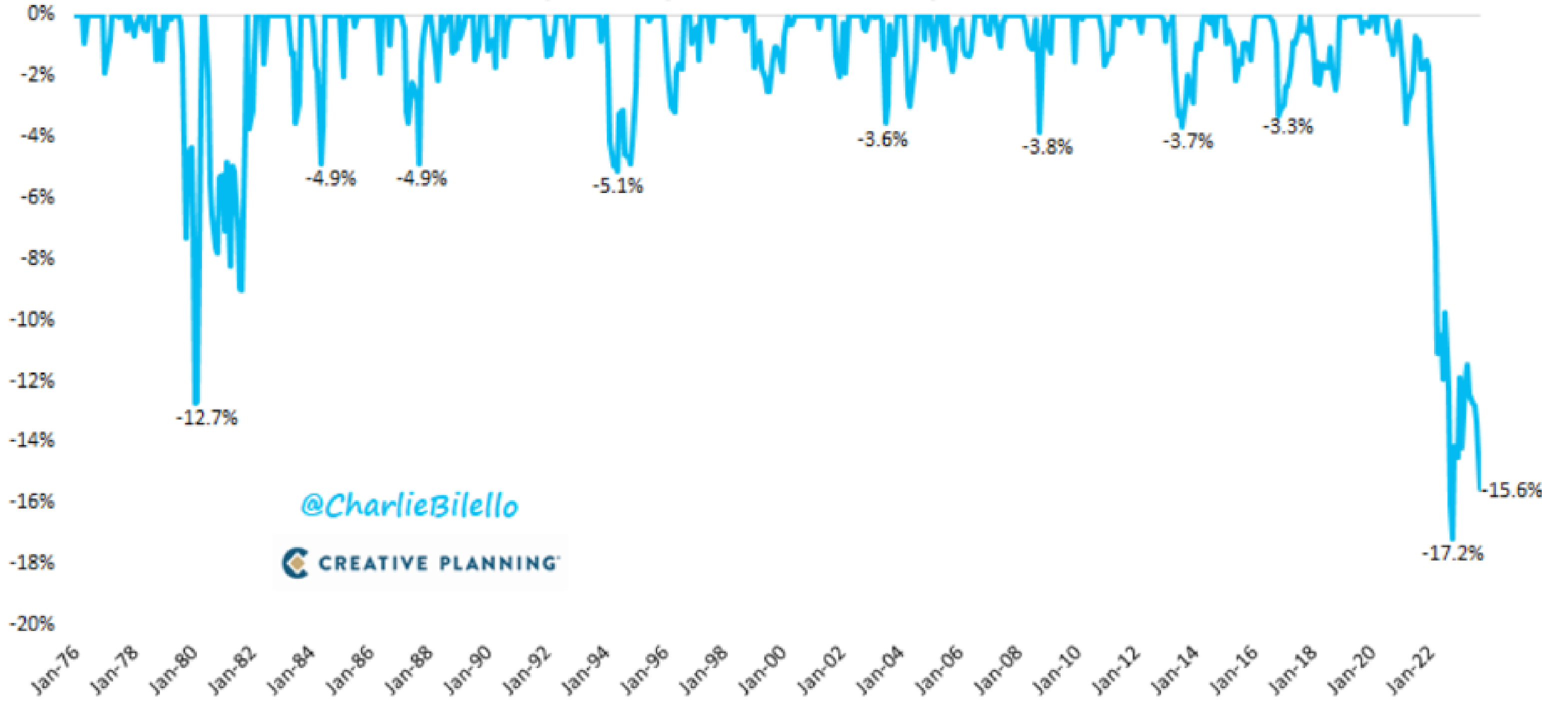
The “keep it simple” view of investing is that equities will provide “real” investment returns over and above inflation over the long term. Fixed income (bonds) is supposed to provide protection and a range of total returns that approximate inflation plus the term premium. The term premium is a “real” return compensating an investor holding longer-term bonds for taking on duration.

Our commentaries are predominately focused on equities because most clients have growth-oriented portfolios. Conventional wisdom is that stocks are more volatile than bonds, and bonds are safer than stocks. Using YCharts, Charlie Bilello created a very striking illustration using the annual price returns of the Bloomberg US Aggregate Bond Index, which spans nearly 50 years. Unless you are old enough to have been investing in the markets in 1980, you have not witnessed a year when the value of your bonds declined more than 10% in any one year….until 2022 and so far in 2023. See the illustration below showing the magnitude of drawdowns of the broadest index of U.S. bonds since 1976:



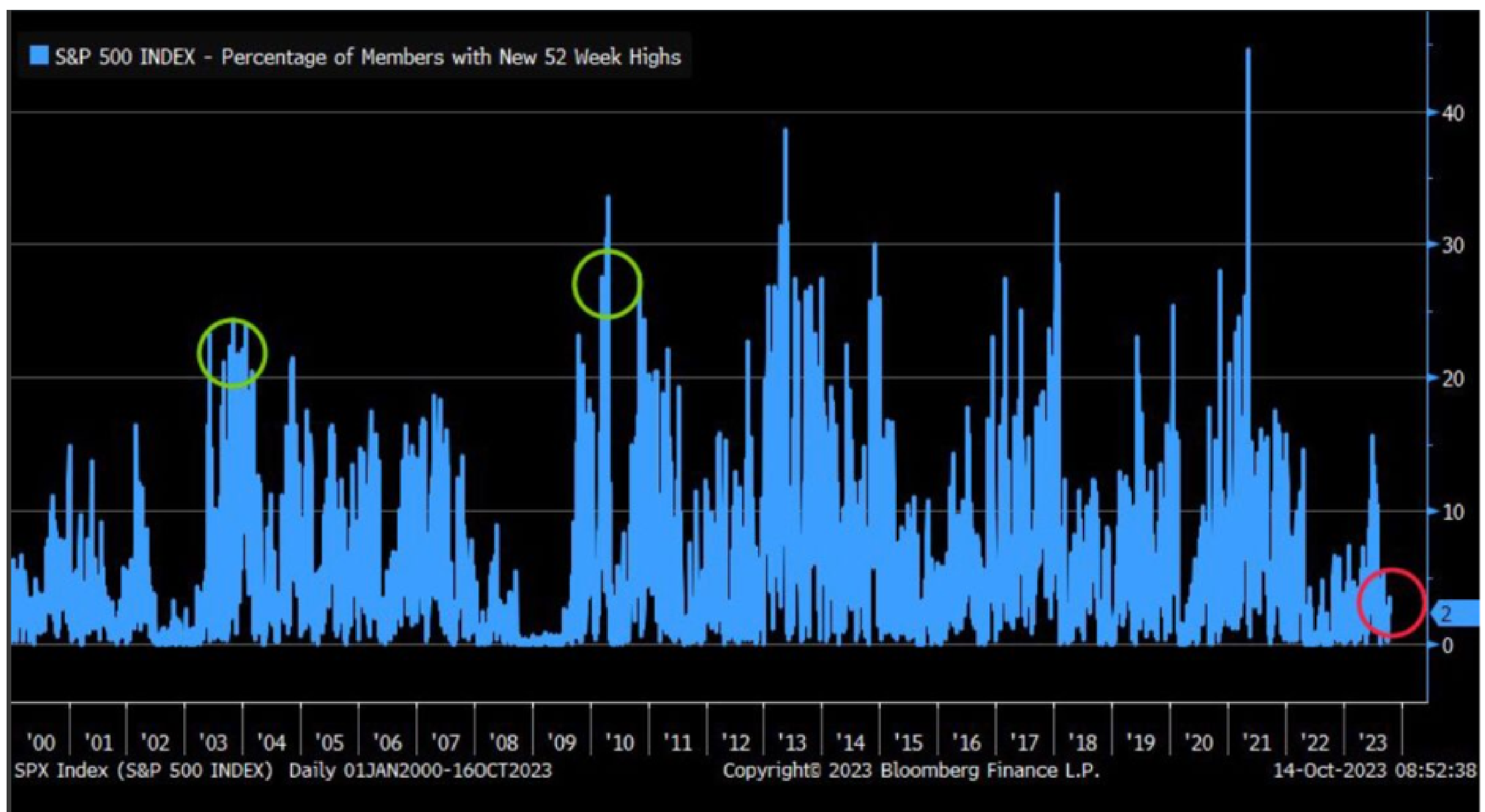
The unprecedented losses in bonds over the last 21 months since the beginning of 2022 have wiped out over seven years of price appreciation of the Total Bond Market ETF (BND), which Charlie Bilello illustrated below:

The unprecedented losses for bond investors have been overshadowed by the price action of equities (stocks) in most investors' minds. Investors have been conditioned to believe stocks are scary and risky, and bonds represent safety. We wrote in the August 2021 Investment Commentary about the risk of fixed income (bonds):

From a risk management standpoint, Seven Summits Capital sees very little reason to take on such meager return expectations that accompany a broad quality bond allocation. These unattractive return expectations are exacerbated by substantial interest rate risk that an investor assumes when attempting to be "conservative." When any investment starts with meager return expectations and comes with significant binary risk related to a single factor such as interest rate direction, the risk-return analysis dictates that it is too risky to consider.

We now feel very differently about fixed income at the current level of interest rates. With most equities that we own still sitting far below our intrinsic value calculations, we see any meaningful allocation shifts from equities to fixed income as too precarious to consider. However, for any new capital deposited by our clients into their balanced investment accounts, we will likely commit a meaningful percentage of that new capital to fixed income with very attractive total return expectations over the next several years.

This month anniversaries the beginning of a new Bull Market in the broad equity indices. However, this Bull Market certainly feels like something other than early Bull Markets of the past. Two predominant reasons are that the Federal Reserve continues its restrictive monetary policy, and we have not experienced a recession. The economy's resilience in the face of significant increases in interest rates has confounded many economists and market watchers. The Federal Reserve's seemingly unrelenting fixation on projecting to the markets that they will do "whatever it takes" to bring inflation down to near its target and the economy's surprising resilience serve to keep the markets in a perpetual state of caution, fearing the next "shoe to drop." We can see how this "Bull Market" differs from the last two early Bull Markets in the chart below, produced by Liz Ann Sonders of Charles Schwab (she states: "Just passed 1-year mark for S&P 500's Oct 2022 low, yet only 2% of members are making new one-year high … vastly different compared to bear markets that ended in 2002 and 2009, when >20% of members were making new highs):



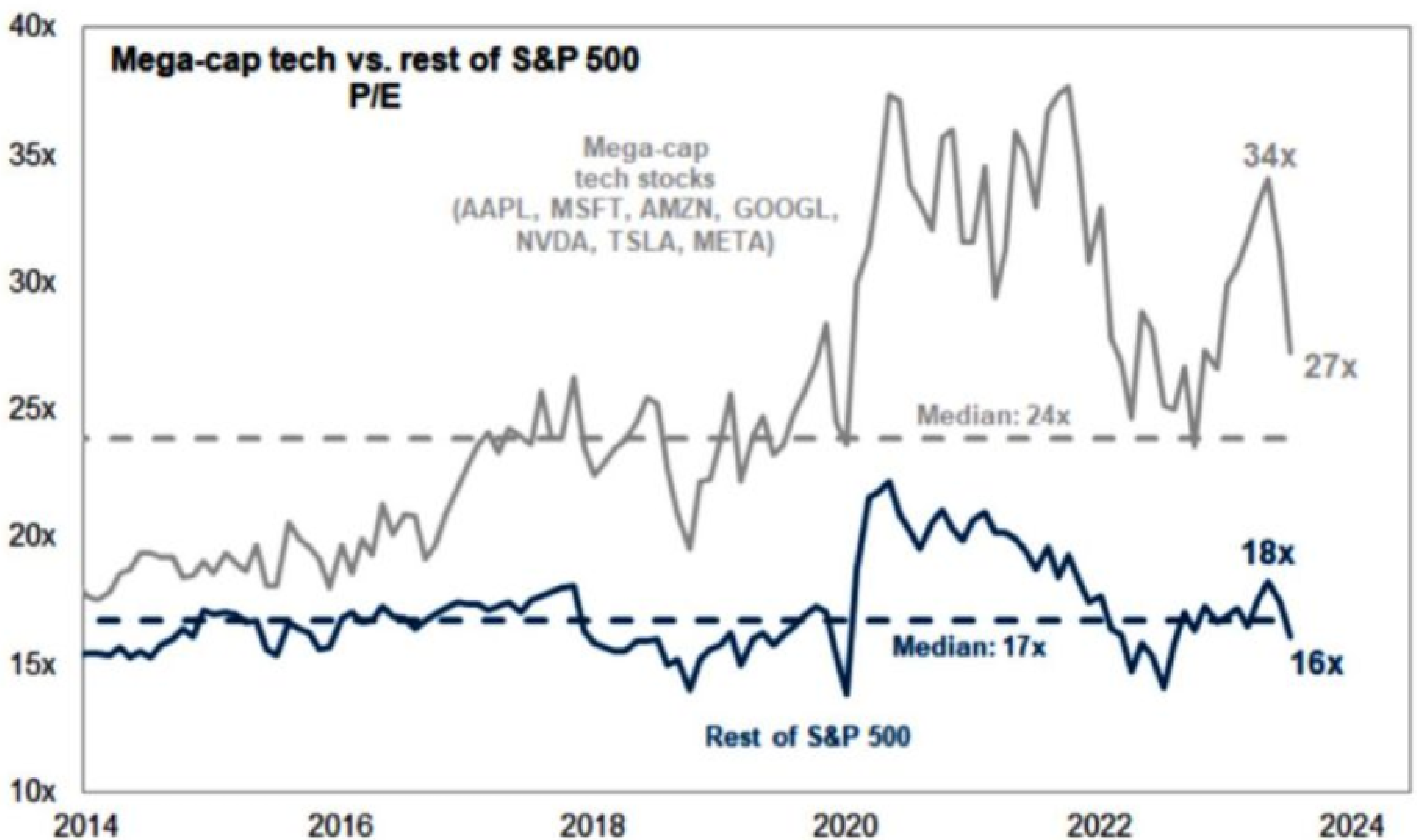
Investing is simple, but it is hard. Simple such that we, as long-term investors, attempt to buy securities that we deem as materially under-valued and hope to hold them until the gap between price and value narrows. Hard because all investing is built upon forecasts measured in years and decades, while markets react in real-time, usually taking on a "glass half empty" or "glass half full" view in the short term.

Since the last commentary, we have fielded questions from clients on two long-time holdings, Athersys (ATHX) and Tandem Diabetes (TNDM). With Athersys, after many years of advancing its

proprietary adult stem cell therapies through the regulatory, clinical trial process for several substantial therapeutic indications, we substantially reduced our holdings after the company released, a voluntary, long-awaited interim analysis of the company's clinical trial for Stroke therapy. After extensive prior clinical trial data analysis, the interim analysis was an eagerly awaited pivotal event the company strongly believed would clearly show that the current Phase III, 300 patient, trial would show clear statistical efficacy. This is not what occurred. The interim analysis was inconclusive based upon the 300-patient population. The conclusion was that the patient trial population would need to be significantly larger to produce a statistically significant outcome. It is hard to express how disappointing this result was for the company, investors, and the many neurological scientists and physicians who were hopeful and optimistic that this interim analysis would show a clear path to FDA approval. Based upon this result, we decided to significantly reduce our exposure to this company's stock and reallocate that portfolio position to another promising healthcare-related growth investment. The idea of a "moonshot" allocation is to take several relatively small positions in companies with significant, mostly, unrealized opportunities in which we closely monitor and provide ample time to allow those opportunities to be successfully capitalized upon. In practice, one successful "moonshot" can easily make up for two or three under-performers or "duds." We held out high hopes for Athersys and unfortunately, it appears that management decisions regarding trial design and balance sheet management failed its promising scientific advances.

Regarding Tandem Diabetes, a very long-term hold of ours has come under significant selling pressure of late. Our original purchases of Tandem Diabetes stock occurred over six years ago at per-share prices of less than four dollars per share. Over the last two months, the company's stock price has dropped from the mid-30s to the high teens. It is clear to us that these price declines are directly related to the selling pressure that has occurred among virtually all companies whose future growth has been deemed to be at risk with the advent of two FDA-approved obesity drugs. Since Tandem Diabetes is broadly selling insulin pumps and related consumables to the diabetic population, its stock has been in the crosshairs of the long obesity drug company stocks/short diabetes exposed companies. This selling pressure has even expanded to medical device companies that treat heart disease and joint replacement, which may have diminished growth should the number of people with obesity be meaningfully diminished. This type of trading may have some merit, but it lacks appropriate nuance. In the case of Tandem Diabetes, this company's primary end market is those who have Type 1 Diabetes, not Type 2 Diabetes. Type 1 Diabetes only constitutes roughly 5% of all people diagnosed with Diabetes. Only Type 2 Diabetes has a contra-indication of obesity. However, it is too early for the trading strategies to factor in such distinguishing factors. Understanding what we own and making nuanced investment decisions is what we do. Thus, we see this primarily unwarranted sell-off in Tandem Diabetes as an opportunity, not a warning signal.

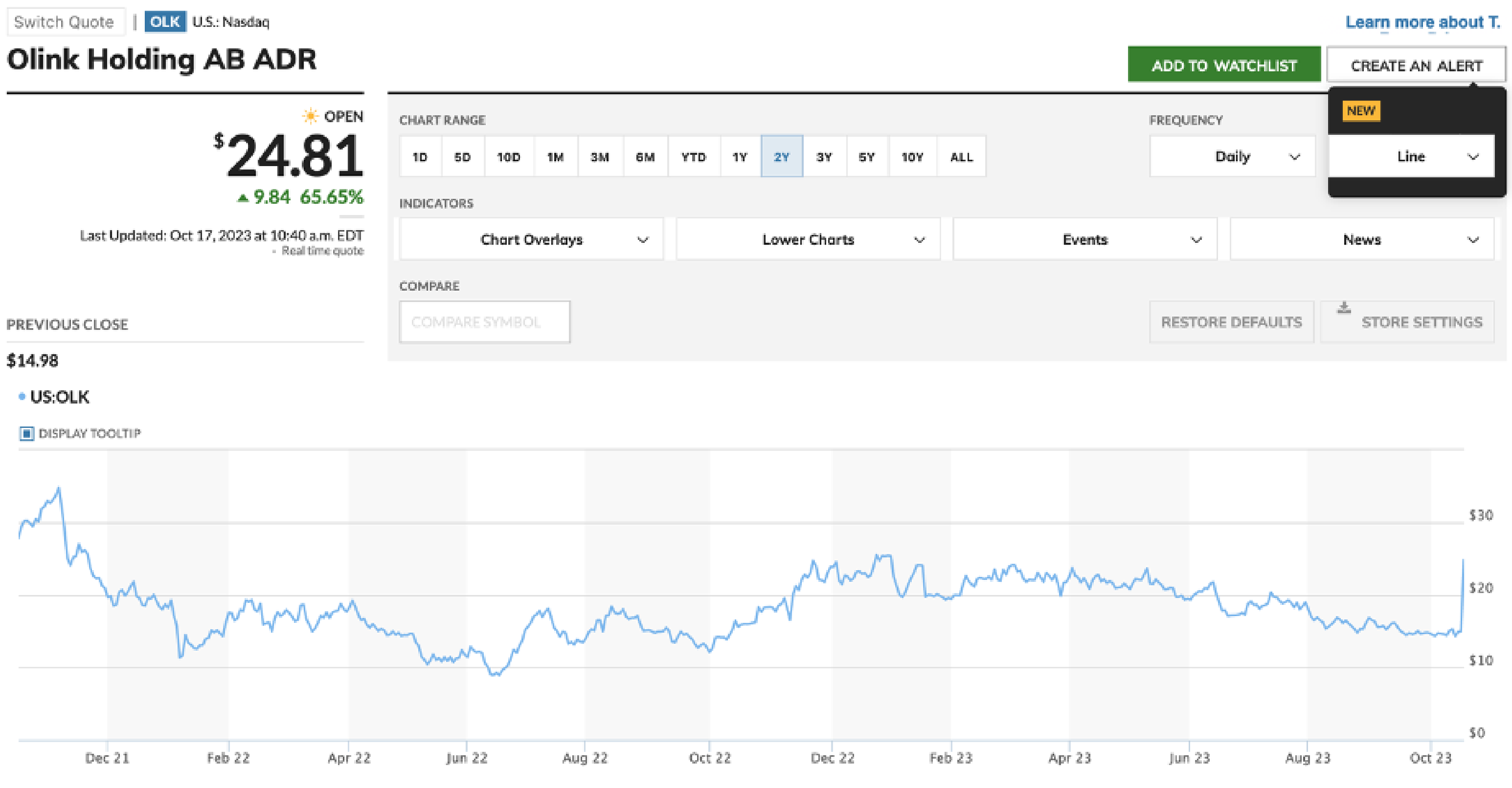
Significant comfort comes from understanding what the value drivers are among your investments. To understand the value drivers, one does not need to be a market expert; one needs to understand what makes a business successful, competitive and innovation advantages and risks are present, and how to estimate intrinsic value based upon reasonable forecasts. Markets give us prices; business fundamentals give us value. One prevalent but simplistic measure of value is the price-to-earnings ratio (P/E). We evaluate valuation metrics on a company-by-company basis, but most people are familiar with broad index P/E ratios and what they may tell us about the overall market valuation. We do not find such "average" valuation measures particularly useful, but the average investor needs to understand how such widely reported metrics can be misleading. It is conventional wisdom of late to point to the S&P 500 P/E ratio, which has been well above the historical average, and conclude that the market is over-valued. In past commentaries, we have discussed the significant distortions of the largest six or seven mega-cap technology company stocks on S&P 500 returns and valuation metrics. Goldman Sachs produced the chart below, which again highlights how misleading an overall S&P 500 P/E ratio can be:



Clients often ask us why we don't own or have more significant allocations to AAPL, MSFT, GOOGL, NVDA, TSLA, and META (Facebook). The chart above clearly illustrates why our discipline does not allow us to follow the herd and simply overweight these popular stocks. An investor typically does not

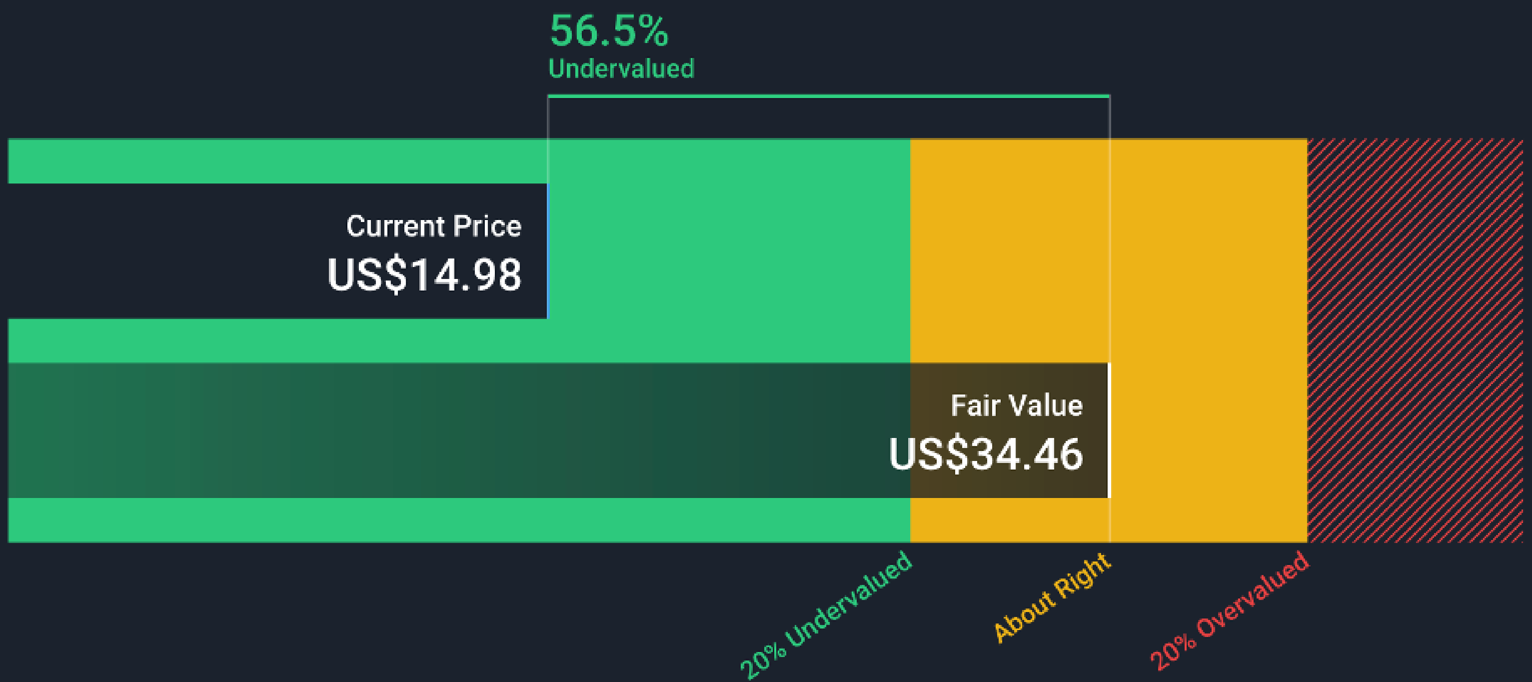
find value in following the herd, although such a tendency among many investors, novice and professional alike, has been quite profitable this year. We are not averse to buying shares in the "Magnificent Seven," however we pick our spots. For example, we broadly added or established new positions in META a year ago when the stock severely sold off to under $90 per share. Today, META's stock is trading above $310 per share.

Markets are different from what always meets the eye on the surface. This willingness to look beyond the averages and discover where value resides is what separates an active, fundamentally driven investor from an asset allocator who provides the illusion of active management but, in reality, is just shifting allocations from one measure of average to another based upon whatever trend analysis or momentum scoring they use. The latter strategy is perceived as a more active approach, but it is an index-chasing exercise. The former requires more in-depth analysis and an understanding of business fundamentals regarding equities. But most importantly, it requires a conviction that a particular discipline, with patience, will result in more winners than losers. A recent Thermo Fisher (TMO) acquisition of a smaller company, Olink Holdings AB (OLK) illustrates just how large the market price to intrinsic value variance can get when certain parts of the market fall out of favor. See the Marketwatch chart of OLK below over the last two years and the one day, 68% jump in stock price resulting from the announced acquisition of the company by Thermo Fisher:



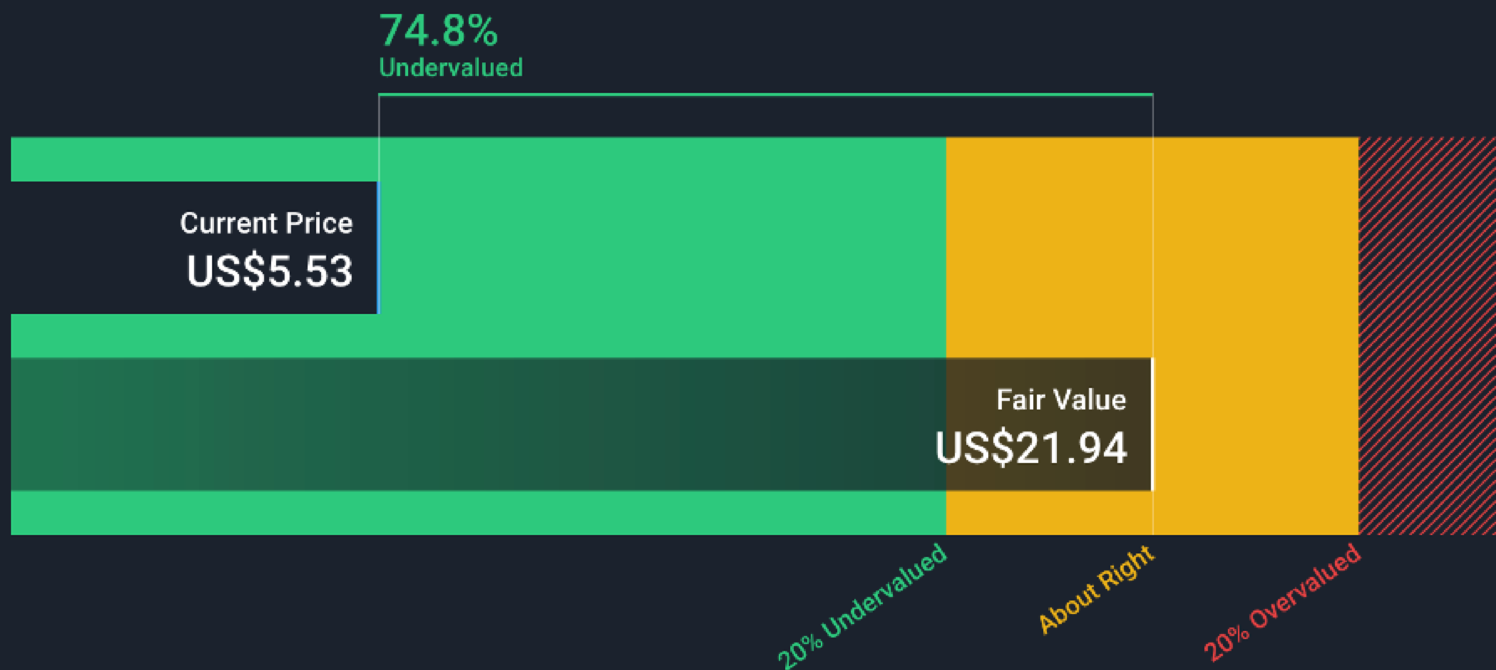
Over the last 25 years, I have witnessed countless cases of M&A releasing the value in a stock that the market does not recognize. If a market is efficient, how can a billion-dollar-plus company's value appreciate 65% in one day? The answer to that question is that the market swings from over-valuing expected future cash flows to under-valuing the same or even higher expected cash flows. This is

because markets are essentially "moody," and the sentiment swings can be violent over relatively short periods. Looking at the chart above, the market had priced Olink Holding's expected future cash flows at nearly $35 per share in late 2021 and under $10 per share in the Summer of 2022. The intrinsic value of a large company does not change over short periods nearly as much as its stock price can change. It turns out that Thermo Fisher's (TMO) acquisition price looks like a relative bargain, even though they are paying nearly 70% more for the company than the value the market assigns. This makes sense because Thermo Fisher needs to pay a price that allows for a certain internal target for Return on Invested Capital (ROIC). See Simply Wallstreet's discounted cash flow fair value estimate for OLK the day before Thermo Fisher's buyout offer:



Earlier, I spoke about a widely held company in our client portfolios, Tandem Diabetes (TNDM). We do strongly believe that Tandem's current price reflects a very significant misjudgment on the market's part regarding the impact on Tandem's future growth from newly approved weight loss drugs. We see this error by the market being materially corrected in a relatively short time. We have another widely held company, GoodRx (GDRX), whose stock was significantly punished in 2022 for a short-term fundamental issue that was non-recurring. This overdone, in our opinion, sell-off in GDRX has not yet materially recovered. We strongly believe that it will and thus we remain patient investors. We are patient investors because we keep our eye on the intrinsic value of the company, which is best illustrated by a Discounted Cash Flow valuation exercise. Again, for this, I will use Simply Wallstreet's

calculation, whose assumptions approximate the assumptions that we use internally. See the result of this calculation below:



We do not try to play the markets, and as equity investors, we seek out large variances between market price and intrinsic value. We can calculate intrinsic value, but being able to forecast when a price/valuation variance will narrow is unknowable. In Olink's case, that variance was largely narrowed overnight by an acquisition offer. In Tandem's case, we believe that the variance attributed to the market's confusion over the difference between Type One Diabetes and Type Two Diabetes will reverse fairly quickly. In GDRX's case, it is anyone's guess. Our expectation for GDRX is that the market will need to be convinced that its temporary "hiccup" in growth due to the one-time factor in 2022 is indeed fully behind it. The only way for the company to provide the market with the proof it is looking for will be to put up the numbers quarter-by-quarter. We are comfortable waiting because we see a very comfortable 74.8% "margin of safety" provided by the gap between the current price and "fair value."

We could go on and on illustrating price versus intrinsic value on a company-by-company basis, but we will spare you that. We hope that clients reading this commentary take some comfort in what we are presenting and that non-client investors gain valuable perspective that helps them become better investors.

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Disclosure:

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- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.

- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.

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